Analysis of the 1991-92 Tax Expenditure Budget

Overview and Detailed Compendium of Individual Tax Expenditure Programs

Legislative Analyst's Office
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Introduction

Introduction

This report has been prepared pursuant to Resolution Chapter 70, Statutes of 1985 (ACR 17, Bates), which requires the Legislative Analyst to prepare a biennial review of the state's tax expenditure programs. These programs, as defined by ACR 17, include the various tax exclusions, exemptions, preferential tax rates, credits, and deferrals which reduce the amount of revenues collected from the state's "basic" tax structure. These provisions of law are called *tax expenditure programs (TEPs)* because the benefits they convey to individuals and businesses make them similar in their effects to direct governmental expenditure programs. However, there is a major difference between these two types of programs — namely, the "cost" of a tax expenditure program is measured by reduced tax collections, rather than by the level of expenditures authorized through the normal legislative appropriations process.

This report is the third in the series of reports we have issued pursuant to ACR 17. The initial report was issued in January 1987, and included two separate volumes. The first volume provided an overview of the 1987-88 tax expenditure budget, and detailed reviews of selected individual tax expenditure programs. The second volume provided a compendium of the state's individual tax expenditure programs. The second report in the series was issued in December 1988, and consisted of the 1988-89 tax expenditure budget overview and detailed reviews of additional selected individual tax expenditure programs. This third report provides an overview of the 1991-92 tax expenditure budget and a new compendium of state tax expenditure programs. The new compendium contains updated estimates of the costs of tax expenditure programs, and reflects the many tax law changes which have occurred since the first compendium was published in 1987.

Purpose of the Report

The objective of this report is to provide information to the Legislature which will be of use in reviewing the state's tax expenditure budget. Periodically reviewing tax expenditures has always made sense, given the billions of dollars in foregone revenues that it costs to provide these programs. This year, however, such review especially merits the Legislature's attention given the enormous budgetary imbalance facing the state. As we discuss in our publication *The 1991-92 Budget: Perspectives and Issues*, one of the strategies available to the Legislature in addressing the state's budgetary imbalance is to modify or eliminate various existing tax expenditure programs. This report provides information which will facilitate the Legislature's efforts to make use of this strategy.

Contents of the Report

This report is divided into two sections. *Part One* provides an overview of the state's tax expenditure budget for 1991-92. It summarizes the estimated individual and collective costs of the state's TEPs, the changes in these costs since 1989-90, and how these costs compare to the state's direct expenditure budget. It also discusses the considerations involved in determining whether a tax expenditure program should be modified or repealed.

Part Two is our detailed compendium of California's individual tax expenditure programs, categorized by type of tax. Altogether, 268 tax expenditure programs are identified in this compendium, including 197 state-level programs and 71 local property tax programs. For each program, the following information is provided:

- The *legal authorization* for each tax expenditure program. In most cases, this is a reference to the California Revenue and Taxation Code, although in some cases the authorization is found in the California Constitution or other state statutes. In those income tax programs which partially or fully conform to federal law, the appropriate federal code reference is also provided.
- A *description of the basic provisions* of each tax expenditure program, including the conditions under which it applies.
- The *apparent rationale* for each program. In most cases, this rationale can be categorized as providing a *tax incentive* to encourage some type of economic behavior, or as granting *tax relief* to certain groups of individuals or businesses. We have also identified certain cases where the primary rationale is to facilitate the administration of the tax itself.

  The rationales cited for these programs represent our attempt to identify what the apparent logic is that justifies each program's establishment or continuation. They should not be viewed as providing any evidence as to a program's cost-effectiveness or its value to the public, however, as in many cases these issues have not been evaluated.
- The *estimated cost* of each program, as measured by foregone tax revenues, for the period 1989-90 through 1991-92 (if available). In most cases, the estimates shown have been provided by the state's major tax collection agencies (the California Franchise Tax Board and the California Board of Equalization) or the Department of Finance. In other cases, however, the estimates have been developed directly by our own staff.

  There are a significant number of programs for which no estimate is available, due to data limitations. In addition, many of the available estimates are subject to significant margins or error.
- A program's *statutory sunset date*, if there is one.
- Any *special comments* about a program's underlying rationale, characteristics or effectiveness we have identified that may assist the Legislature and other readers in understanding the program's application and impact.

In addition, the Appendix to the report lists various tax expenditures which we have previously reviewed and our recommendations regarding them.

Acknowledgements

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Part One

Part One

Overview of the 1991-92 Tax Expenditure Budget

Introduction

This part of the report provides an overview of the state's tax expenditure budget for 1991-92. It briefly discusses what the term "tax expenditure" means and the issues involved in measuring the dollar value of the state's tax expenditure budget. It next presents estimates of the state's revenue losses due to tax expenditures in 1991-92, and compares these costs to the costs of direct expenditures for the same period. Finally, it discusses how the Legislature can review these programs as a part of its efforts to address the state's budgetary imbalance, and suggests criteria to use in that review process.

What is a Tax Expenditure?

In this report, tax expenditures are defined as in ACR 17 to include "the various tax exclusions, exceptions, preferential tax rates, credits and deferrals which reduce the amount of revenue collected from the state's basic tax structure." These provisions are called *tax expenditure programs (TEPs)* because the benefits they provide to individuals and businesses make them very much like regular direct governmental expenditures, except that they are paid for by reduced tax collections rather than through the normal legislative appropriation process.

Obviously, in order to apply ACR 17's definition of tax expenditures, it is necessary to first define the term "basic tax structure." In general, this report adopts a fairly broad view of the basic tax structure, by including as tax expenditures all those programs that provide benefits on a relatively wide-spread basis to taxpayers *generally,* as well as those that provide benefits only on a selective basis to *certain* taxpayers. This broad view is used not because a more restrictive definition of tax expenditures is necessarily incorrect, but rather in recognition of the fact that individual legislators themselves have differing views about exactly which tax provisions should be defined as tax expenditures. Thus, by providing data on the complete menu of tax provisions which are potentially classifiable as tax expenditures, the report attempts to ensure that the Legislature will have at its disposal all of the information that might be needed in its review of the tax expenditure budget. A brief description of the basic tax structure for each tax appears at the beginning of the report section dealing with each tax, accompanied by an index of the TEPs pertaining to it. An index of TEPs by selected major subject areas appears at the end of the report.

Measuring the Costs of Tax Expenditures

In order to develop a "tax expenditure budget," the costs of the individual tax expenditure programs must first be determined. The costs of TEPs normally are not directly observable, however, because they are funded not by direct appropriations, but rather by uncollected revenues. Therefore, these costs must be *estimated.* Three main problems are commonly encountered when attempting to develop tax expenditure cost estimates:

- First, *data limitations often make it difficult to accurately identify the revenue losses from individual tax expenditure programs.* For example, if certain types of income or transactions do not need to be reported for tax purposes, there may be no reliable record of their magnitude and thus no way of estimating how much revenue their taxation would produce. Efforts to overcome this problem through the use of taxpayer surveys, special studies, and data published by governments or industry trade associations, normally are only partially successful.
- Second, *even when a reasonably accurate direct revenue-loss estimate is available for an individual tax expenditure, it often will overstate what the net revenue gain would be from eliminating it.* This is because various "secondary effects" result from eliminating tax expenditures, because of income effects or behavioral changes they induce in taxpayers. For example, the repeal of the sales tax exemption on food items would have the effect of reducing the disposable income of taxpayers, to the extent that taxpayers purchase approximately the same amount of food with or without the sales tax in place. This reduction in disposable income could, in turn, result in a reduction in consumer spending on other items subject to the sales tax, thereby partially offsetting the direct revenue gain from eliminating the TEP.
- Third, *one cannot simply add together the revenue losses from individual tax expenditure programs to obtain an accurate measure of the cost of the total tax expenditure budget.* Rather, the total revenue gain that the elimination of all tax expenditures would produce can be either greater or less than the sum of the revenue gains from individual tax expenditures. This is because of interactions among these different TEPs. For example, eliminating the "basis adjustment" for inherited property would, by putting some taxpayers into higher marginal income tax brackets, increase the revenue gain that a subsequent elimination of certain itemized deductions would produce.

Given the above, even the best possible estimates of tax expenditure costs inevitably will have shortcomings. With this qualification in mind, we now turn to a discussion of the 1991-92 tax expenditure budget.

Analysis of the 1991-92 Tax Expenditure Budget

This section discusses the size and composition of the 1991-92 tax expenditure budget, and various issues which face the Legislature when reviewing this budget.

Overall Size and Composition of the Tax Expenditure Budget

Figure 1 summarizes the size and composition of the 1991-92 tax expenditure budget. This budget includes 197 individual state tax expenditure programs, each of which is identified and separately discussed in Part Two of this report. In addition to these state-level TEPs, 71 state-established local government property tax TEPs are identified and discussed. (As explained below, we have included these local property tax TEPs because of the state costs which result from them.)

Size of the Tax Expenditure Budget. In order to measure the dollar size of the tax expenditure budget, we have relied primarily upon data provided to us by the California Franchise Tax Board (which administers the personal income tax and bank and corporation tax), the California Board of Equalization (which administers all other state taxes), and the California Department of Finance (which conducts its own review of tax expenditure programs). In the case of some TEPs for which these agencies could not provide us with cost estimates, we have made our own estimates. In spite of this, however, there remain a signifi-

Figure 1

Identifiable Revenue Losses From Tax Expenditure Programs in 1991-92, by Major Program Category[a]

(dollars in millions)

	Estimated Revenue Loss		
Program Category	Amount	Loss as a Percent of Estimated Tax Collections[b]	Loss as a Percent of Total Identifiable State-Level Tax Expenditures
Personal income tax programs	$13,360	67%	67%
Sales and use tax programs	4,199	25	21
Bank and corporation tax programs	1,757	32	9
Programs for other state taxes	611	6	3
Subtotals, all state tax programs	$19,927	38%	100%
Local property tax programs	2,859	16	—
Local share of sales and use tax programs	1,733	26	—
Totals, all programs	$24,519	32%	—

[a] Detail may not add to totals due to rounding.
[b] Based upon revenue estimates published in January 1991 in the *1991-92 Governor's Budget*.

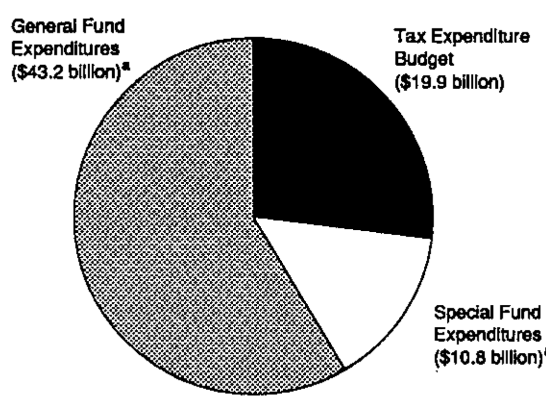
cant number of TEPs for which no revenue-loss estimate is available from any source, due to current data limitations. As noted earlier, it also must be stressed that even in the case of TEPs for which we show cost estimates, significant error margins accompany many of them due to the measurement difficulties discussed above.

With these limitations in mind, Figure 1 indicates that the 1991-92 estimated revenue loss from tax expenditures totals at least $24.5 billion. Of this amount, *state-level* programs where identifiable cost estimates are available account for approximately *$19.9 billion.* In addition, the local property tax TEPs result in local revenue losses totaling $2.9 billion, of which about one-third represents state costs (see discussion below), while the local share of revenue losses from sales and use tax TEPs totals about $1.7 billion. The actual total cost of the tax expenditure budget is unknown due to the many tax expenditure programs for which cost estimates currently do not exist. Nevertheless, because cost estimates do exist for most of the major TEPs, the $19.9 billion figure gives a reasonable overall indication of the general magnitude of the 1991-92 state-level tax expenditure budget.

By comparison, the state's direct expenditure budget for 1991-92, as proposed in January 1991 in the *1991-92 Governor's Budget*, totals $54 billion (excluding bond fund expenditures), including $43 billion in General Fund expenditures. Thus, the $19.9 billion state-level tax expenditure budget is approximately 37 percent of the state's direct expenditure budget. This relationship is illustrated in Figure 2.

Figure 2

1991-92 State Tax Expenditure Budget Compared to Direct Expenditures



[a] As proposed in the *1991-92 Governor's Budget*.

Composition of the Tax Expenditure Budget. The composition of the 1991-92 state-level tax expenditure budget is illustrated in Figures 1 and 3. As these figures indicate:

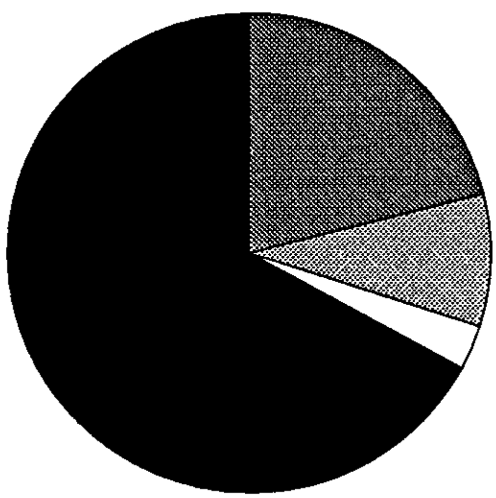
- Personal income tax TEPs amount to $13.4 billion, or approximately 67 percent of total identifiable state tax expenditures.
- State sales and use tax TEPs amount to $4.2 billion, or approximately 21 percent of total identifiable state tax expenditures.
- Bank and corporation tax TEPs amount to $1.8 billion, or 9 percent of total identifiable state tax expenditures.
- TEPs related to other state-level taxes amount to slightly over $600 million, or 3 percent of total identifiable state tax expenditures.

Thus, personal income tax TEPs and sales and use tax TEPs account for the largest dollar shares of 1991-92 state tax expenditures. Figure 1 also shows that state TEPs amount to about 38 percent of projected 1991-92 state tax revenues, with personal income TEPs equaling 67 percent of projected personal income tax revenues, sales and use tax TEPs equaling 25 percent of projected sales and use tax revenues, and bank and corporation TEPs equaling 32 percent of projected revenues from this source. Given the above, state-level TEPs will reduce by about 27 percent the amount of revenues which otherwise would be produced by the basic tax structure in 1991-92.

In terms of the actual number of individual TEPs, we have identified 268 programs, including 84 for the personal income and bank and corporation taxes, 84 for the sales and use taxes, 29 for other state taxes, and 71 for the local property taxes.

Figure 3

Composition of the 1991-92 Identifiable State Tax Expenditure Budget



Personal Income Tax Programs	$13.4 billion
Sales and Use Tax Programs	4.2 billion
Bank and Corporation Tax Programs	1.8 billion
Programs for Other State Taxes	0.6 billion
Total, State Tax Expenditure Budget	$19.9 billion

Major Individual Tax Expenditure Programs

Figures 4 through 8 summarize, by tax, the most significant individual TEPs for which identifiable cost estimates are available.

Personal Income Tax TEPs. The largest personal income tax TEPs (Figure 4) are deductions for mortgage interest expenses ($2.5 billion), income exclusions for employer and employee contributions to pension plans ($2.2 billion) and for employer contributions to health plans ($1.6 billion), the standard deduction ($705 million), the income exclusion of capital gains on the sale of residences ($611 million), deductions for charitable contributions ($570 million), deductions for certain property and vehicle-related taxes paid ($538 million), and the income exclusion for social security benefits ($540 million). Altogether, the above programs amount to $9.2 billion and account for 69 percent of all personal income tax TEPs. In totaling the costs of personal income tax TEPs ($13.4 billion), we have excluded the personal exemption on the grounds that a strong case exists for defining it as part of the "basic" tax structure. In addition, we have included only that portion of the standard deduction that is in excess of the deductible expenses which nonitemizing taxpayers could have claimed in the absence of the standard deduction. We have done so because it is only this amount that the state would collect in additional tax revenues if the standard deduction were to be eliminated.

Bank and Corporation Tax TEPs. The largest identifiable bank and corporation tax TEPs (Figure 5) are the special treatment of income from Subchapter S corporations ($540 million), the carry-forward of net operating losses ($474 million), and the "water's edge" treatment of income of international corporations ($370 million). These three programs account for $1.4 billion, or 77 percent of total identifiable costs for bank and corporation TEPs. However, other programs for which revenue losses have not been identified, such as accelerated depreciation, may be larger in magnitude than some of those identified in Figure 5.

Sales and Use Tax TEPs. The largest sales and use tax TEPs (Figure 6) are the exemptions for food products ($1.7 billion), and for gas, electricity, water, steam, and heat ($1.6 billion). These two programs account for 78 percent of the total identifiable costs of sales and use tax TEPs. The remaining 22 percent of identifiable costs are attributable to about a dozen smaller programs. However, there are over 70 additional sales and use tax TEPs for which revenue-loss estimates currently are not available.

TEPs for Other State Taxes. Of the remaining state taxes, the largest TEPs (Figure 7) include the insurance tax exemption for nonprofit hospital service corporations ($450 million), the aircraft jet fuel license tax exemption ($70 million), the cigarette tax exemption for distributions to the armed forces and Veterans' Administration ($31 million), and the reduced insurance tax rate for pension and profit-sharing plans ($27 million).

Property Tax TEPs. The most significant property tax TEPs (Figure 8) include the business inventory exemption ($1 billion), the exemption for furnishings and other personal effects ($935 million), the homeowners' exemption ($361 million), the exemption for property associated with charitable nonprofit activities ($248 million), and the exemption for open-space lands ($156 million). These and other estimates of property tax TEPs presented in this report reflect the total local revenue loss attributable to these programs.

Although property taxes are a local revenue source, and therefore legislatively enacted exemptions and preferential treatments under this tax do not technically constitute state TEPs, they do impose certain state costs. For example, property tax TEPs reduce local property tax allocations to schools, and the state is required under current law to replace the revenue lost to schools with increased school apportionments. The state also provides subventions to various other local government entities to compensate them for revenue losses from certain state-imposed TEPs, such as the property tax exemptions for homeowners and senior citizens. It is for these reasons

Figure 4

Identifiable State Revenue Losses from Personal Income Tax Expenditure Programs in 1991-92

(dollars in millions)[a]

Type of Program	1991-92 Estimated State Revenue Loss
A. Exclusions and Exemptions from Reported Income	
Pension contributions and earnings	$2,230
Employer contributions to health plans	1,560
Capital gains on sales of residences (combined programs)	611
Social security benefits	540
Life insurance investment income	315
Interest on government debt obligations	332
Capital gains for inherited property	240
Miscellaneous fringe benefits	180
Compensation for injuries or sickness	155
"Cafeteria plan" benefits	125
Employer contributions to life insurance	82
Unemployment insurance benefits	67
Mutual fund pass-through interest	57
Other programs with identifiable revenue effects	119
Subtotal	**$6,556**
B. Adjustments to Reported Income	
Contributions to self-employed retirement plans	$137
Contributions to IRA accounts	95
Subtotal	**$232**
C. Tax Deductions	
Mortgate interest	$2,475
Standard deductions	705
Charitable contributions	275
Certain property and vehicle taxes paid	538
Employee business and miscellaneous expenses	275
Medical and dental expenses	107
Carry-over of net operating losses	67
Other programs with identifiable revenue effects	99
Subtotal	**$4,836**
D. Tax Credits	
Renters' credit	$501
Dependent exemption credit	350
Child and dependent care expenses	178
Capital gains from sale or exchange of residental rental or farm property	89
Senior exemption credit	85
Low-income housing credit	44
Small employer health coverage	40
Other programs with identifiable revenue effects	69
Subtotal	**$1,356**
E. Other Programs	
Special filing status for heads-of-households and surviving spouses	$380
Total, Personal Income Tax Programs	**$13,360**

[a] Detail may not add to totals due to rounding. Personal exemption credits other than special benefits provided to heads-of-households and surviving spouses have been excluded, on the grounds that they constitute part of the "basic tax structure." The standard deduction revenue loss is based on the amount by which standard deductions claimed exceed the itemized deductions which nonitemizers could claim in the standard deduction's absence.

Figure 5

Identifiable State Revenue Losses from Bank and Corporation Tax Expenditure Programs in 1991-92

(dollars in millions)

Type of Program	1991-92 Estimated State Revenue Loss
A. Exclusions and Exemptions from Reported Income	
Water's-edge election	$340
Tax-exempt corporations	72
Life insurance investment income	18
Subtotal	**$430**
B. Tax Deductions	
Subchapter S corporations[a]	$540
Net operating loss carry-forwards	474
Expensing of exploration, development, research and experimental costs	70
Charitable contributions	48
Percentage allowance for depletion of minerals and other natural resources	26
Other programs with identifiable revenue effects	17
Subtotal	**$1,175**
C. Tax Credits	
Small employer health coverage	$60
Increased research and development expenses	45
Solar energy and energy conservation equipment	15
Low-income housing credit	10
Employer child care credit	8
Other programs with identifiable revenue effects	14
Subtotal	**$152**
Total, Bank and Corporation Tax Programs	**$1,757**

[a] *Revenue loss shown is net of the personal income tax revenue gain generated by the required pass-through of Subchapter S earnings to individual shareholders.*

that we have included property tax TEPs in this report. We do not separately identify the state costs from these TEPs in our report, however, because those payments show up in the state's direct expenditure budget (for example, as part of the costs for state aid to K-12 school districts). These state costs, however, amount to about one-third of the local revenue loss from property tax TEPs.

Issues Facing the Legislature With Respect to the Tax Expenditure Budget

In its annual budget deliberations, the Legislature reviews the direct expenditure budget through a process which requires existing programs and proposed adjustments to those programs to be justified in order to receive funding. In general, the tax expenditure budget escapes this kind of regular review because (1) tax expenditure program costs do not require annual appropriations and (2) tax expenditure programs are less likely to face legislative adjustments once enacted. Because of this lack of regular review, TEP programs may be allowed to continue which (1) are not cost-effective relative to their direct expenditure alternatives, (2) may be or have been demonstrated to be ineffective in meeting legislative goals, or (3) may be in direct conflict with current legislative goals.

In the context of the state's current fiscal difficulties, the review of tax expenditure programs can play an especially meaningful role. In

Figure 6

Identifiable State Revenue Losses from Sales and Use Tax Expenditure Programs in 1991-92

(dollars in millions)

Type of Program	1991-92 Estimated State Revenue Loss*
Food products	$1,680
Gas, electricity, water, steam, and heat	1,550
Prescription medicines	270
Agricultural feed, seeds, and fertilizers	139
Newspapers and periodicals	123
Candy and confectionery items	95
Custom computer programs	64
Sales of mobilehomes (various programs)	45
Bottled water	31
Leases of motion pictures	27
Other programs with identifiable revenue effects	175
Total, Sales and Use Tax Programs	**$4,199**

* *Estimated local revenue losses to cities, counties, transit districts, and other local government agencies equal approximately 41 percent of the state revenue losses shown, or approximately $1,733 million in total.*

Figure 7

Identifiable State Revenue Losses from Tax Expenditure Programs for Other Major State Taxes in 1991-92

(dollars in millions)

Type of Program	1991-92 Estimated State Revenue Loss
Insurance tax exemption for nonprofit hospital service corporations	$450
Aircraft jet fuel license tax exemption	70
Cigarette tax exemption for distributions to the armed forces and Veterans' Administration	31
Partial insurance tax exemption for employee pension and profit sharing plans	27
Other programs with identifiable revenue effects	33
Total, Programs for Other State Taxes	**$611**

Figure 8

Identifiable Local Revenue Losses from Property Tax Expenditure Programs in 1991-92

(dollars in millions)

Type of Program	1991-92 Estimated Local Revenue Loss[a]
Business inventories	$1,000
Household furnishings	935
Homeowners' exemption	361
"Welfare" exemption (various programs)	248
Real property under an open-space contract	156
Real property used exclusively for religious worship purposes	64
Real property owned by private colleges and seminaries	57
Other programs with identifiable revenue effects	38
Total, property tax programs	**$2,859**

[a] Estimates represent total local revenue loss from TEPs and do not reflect partially offsetting state expenditures for K-14 school apportionments.

our publication *The 1991-92 Budget: Perspectives and Issues,* the review of tax expenditure programs is identified as one of a number of strategies that the Legislature could use in addressing the budget gap. In undertaking this type of review, the objectives of each TEP must be reviewed and agreed upon, and second, a judgment must be made regarding whether each TEP is cost-effective, both in its own right and relative to other programs that the Legislature has an interest in funding.

Determining TEP objectives and their priority. It is important for the Legislature to review and agree upon each TEP's objective(s) because a program's effectiveness and economic efficiency cannot be properly evaluated without its purpose being known. As noted above, the underlying rationales for most existing TEPs fall into three general categories: (1) to provide tax relief to specific individuals and/or businesses, (2) to provide economic incentives to encourage certain types of private sector economic activity, or (3) to simplify or reduce the costs of state tax administration. In reviewing the tax expenditure budget, the Legislature needs to determine if the apparent TEP rationales for individual programs which we have identified in Part Two of this report are consistent with its current policy objectives and spending priorities.

Determining the Cost-Effectiveness of TEPs. Assessing the overall cost-effectiveness of individual TEPs involves determining whether their objectives actually are being realized, whether a TEP's benefits exceed its revenue cost, and whether there is a less costly way of providing these same benefits (that is, whether the TEP is cost-efficient). In this regard, ***we recommend*** that the Legislature:

- Eliminate programs whose goals may be consistent with those of the Legislature, but which have been shown to be ineffective in influencing taxpayer behavior to meet those goals.
- Eliminate all tax expenditure programs which are not cost efficient, and where appropriate replace them with either tax expenditure or direct expenditure programs which can be designed to be cost efficient.
- Modify programs that provide untargeted tax relief so that they target tax relief only to those taxpayers who most need it.

- Eliminate those tax expenditure programs which may be cost-efficient but which are not as high a legislative priority as other (either direct expenditure or tax expenditure) programs.

Figure 9 summarizes the basic action steps outlined above which we recommend the Legislature follow in conducting its review of the tax expenditure budget, and in considering how to apply the strategy of modifying or deleting certain tax expenditure programs to help address the state's current budgetary imbalance. The Appendix to this report lists various tax expenditure programs which we have reviewed previously and our recommendations regarding them. ♦

Figure 9

Action Steps for Legislative Review of Tax Expenditures

☑ **Review and agree upon the basic rationales and objectives of individual tax expenditure programs, including whether their purpose is to:**

- Provide tax relief to specific taxpayers.
- Provide economic incentives to encourage certain types of taxpayer behavior.
- Simplify or facilitate tax administration.

☑ **Review the available evidence on the overall effectiveness and economic efficiency of individual TEPs.**

☑ **Take the following actions with regard to individual TEPs:**

- Eliminate TEPs whose rationales and objectives are no longer valid or of low priority.
- Eliminate or modify TEPs which are not accomplishing their objectiives.
- Eliminate TEPs which are not cost-efficient, even if they are effective, and if appropriate replace them with either tax expenditure or direct expenditure programs which *are* cost-efficient.
- Modify inadequately targeted tax relief and incentive-oriented TEPs so that they are better targeted to those who need or will respond to them, and so that "windfall" benefits to unintended taxpayers are eliminated.

Part Two

Personal Income Tax

Bank and Corporation Tax

Index

Income Taxes — An Overview

This section deals with tax expenditure programs associated with taxes related to income earned by individuals, businesses, and other taxable entities. These taxes include the personal income tax and the bank and corporation tax.

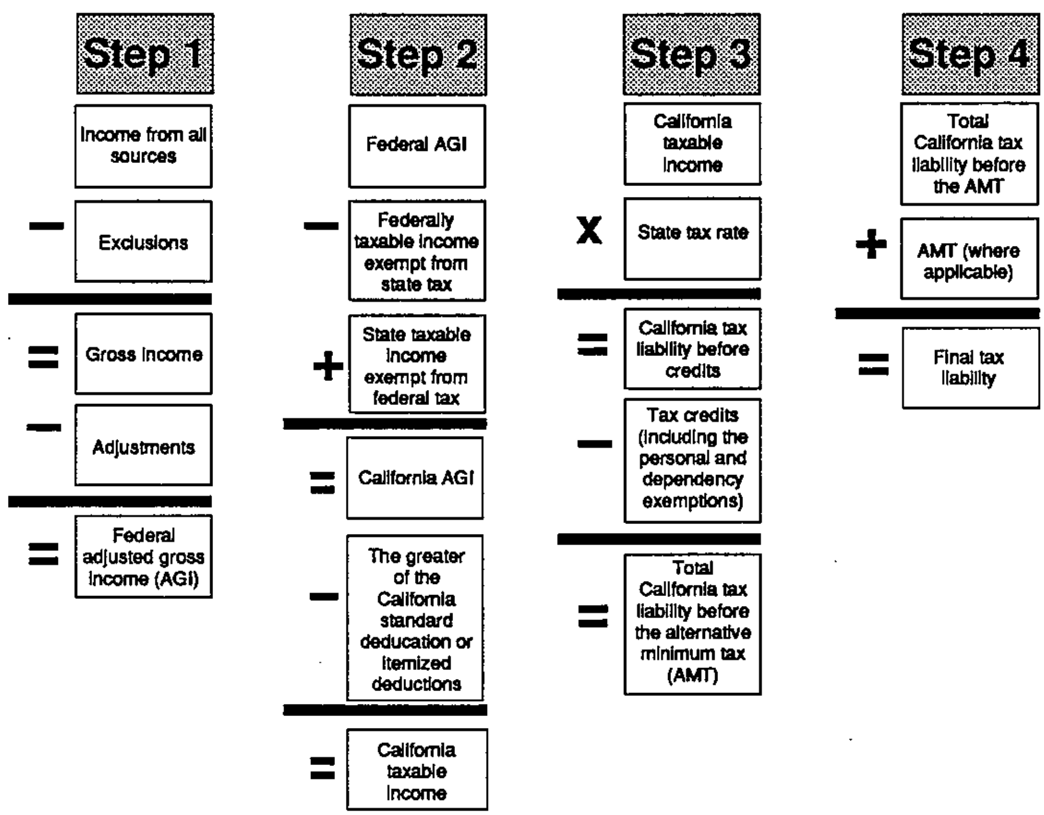
The Personal Income Tax

The personal income tax (PIT) is imposed on income received by all California residents and nonresidents to the extent they receive income from sources within the state. It includes taxes on wages and salaries, distributed profits from partnerships and sole proprietorships, capital gains, stock dividends, and interest income. The personal income tax is paid by individuals, estates, and trusts. State income taxes are deductible when computing federal taxable income. Thus, each dollar of state income taxes paid results in a partially offsetting reduction in federal income tax liabilities, depending on a taxpayer's federal marginal income tax rate.

Determining Income Tax Liabilities. Figure 1 illustrates how income tax liabilities are computed, including the role of the various categories of tax expenditures discussed in this report in determining these liabilities. First, those tax expenditure programs that represent income exclusions, adjustments, and deductions are used to reduce total income and arrive at California taxable income. The appropriate tax rate is then applied to California taxable income to arrive at personal income tax liability before the applica-

Figure 1

Determination of Personal Income Tax Liabilities



tion of tax credits. These tax credits — another category of tax expenditures — are then used to reduce that tax liability on a dollar-for-dollar basis. In certain cases, when a "high income" taxpayer has a low tax liability due to significant use of certain types of tax expenditures known as tax preference items, an alternative minimum tax (AMT) must be paid in addition to the regular income tax. In essence, the AMT serves to recapture some of the taxes lost due to tax breaks available primarily to high income taxpayers. These amounts recaptured by the AMT are not incorporated in the revenue loss estimates presented in this report.

Filing Status and Tax Rates. Taxpayers must file their income tax return under one of the following five filing categories: single person, married person filing a separate return, married person filing a joint return, single head of household, or surviving spouse. These categories, known as filing status, determine the tax rate schedule and the amount of certain deductions and exemptions to which the taxpayer is entitled. Taxpayers pay marginal tax rates ranging from 1 percent to 9.3 percent on their taxable income. For example, a married couple would use the tax schedule shown in Figure 2 in computing its 1990 tax liability.If the couple had taxable income of $40,000, it would pay a tax (prior to credits) of $1,286.

Under PIT, the boundaries of the income tax brackets and certain tax exemptions and deductions are adjusted upward annually (indexed) for inflation.

Bank and Corporation Taxes

The bank and corporation (B&C) tax actually refers to three separate taxes: the bank and corporation franchise tax, the corporation income tax, and the bank tax. All three taxes are assessed on the "net income" or "profits" earned by a taxpayer during the tax year. They are assessed on profits from all sources including business profits, dividends, interest, rent, royalties, and capital gains (gains from the sale of assets). Taxable profits are defined as gross income less deductions for allowable business expenses.

Determining the California Tax Base of Businesses With Out-of-State Operations. Interstate and international corporations that earn profits from non-California sources use the so-called unitary apportionment formula to determine the amount of their profits which are subject to California tax. The unitary apportionment formula uses three factors to determine California's share of a corporation's total profits. In essence, a company multiplies its total profits by the average of: its ratio of California property to its total property, its ratio of California sales to its

Figure 2

Personal Income Tax Schedule for a Married Couple

If taxable income is:			Then state tax liability before credits equals:				
$0	to	$8,426	$0	+	1.0%	of income over	$0
8,426	to	19,970	84.26	+	2.0%	of income over	8,426
19,970	to	31,514	315.14	+	4.0%	of income over	19,970
31,514	to	43,750	776.90	+	6.0%	of income over	31,514
43,750	to	55,292	1,511.06	+	8.0%	of income over	43,750
55,292	and over		2,434.42	+	9.3%	of income over	55,292

total sales, and its ratio of California payroll to its total payroll.

International corporations may use the unitary apportionment formula in either of two different ways: (1) they may apply the formula based upon their *worldwide* profits earned and *worldwide* apportionment factors or (2) they may apply the formula based on profits earned and factors determined within the *United States only*, by making a "water's edge" election.

Determining Tax Liabilities. Once a corporation's taxable California profits are determined, they are then subject to either the California franchise tax or the California income tax. In addition, the profits of banks are subject to the separate bank tax.

The Bank and Corporation Franchise Tax. The bank and corporation franchise tax is assessed for the privilege of doing business in California. It is required of all corporations (except insurance companies which instead pay a separate tax on premium sales), whether organized in California or out of state, which are actively engaged in any transaction for the purpose of financial gain in California. Although the franchise tax is called a privilege tax, rather than an income tax, it is assessed at a 9.3 percent rate on a corporation's net income. Those corporations whose franchise tax liability when calculated in this way is less than $800 must still pay a "minimum franchise tax" of $800. Most of the businesses paying taxes in California pay the franchise tax.

The Corporation Income Tax. The corporation income tax is assessed on those out-of-state corporations which earn income from California sources, but are not considered to be doing business in the state. Typically, these businesses do not have factories or offices in the state, but instead operate through agents or traveling sales persons. The corporation income tax is nearly identical to the franchise tax, as the tax liability is derived by applying the same 9.3 percent rate to the corporation's net income. Corporations with a tax liability less than $800, however, do not have to pay the minimum franchise tax, as they are not "doing business" in the state.

The Bank Tax. The bank tax is a surcharge in addition to the franchise tax levied on banks and financial institutions doing business in California. This tax is levied in lieu of local property taxes and business taxes from which banks are exempt. The bank tax rate is calculated annually, and is designed to yield the equivalent of the average corporate tax liability for local property and business taxes. This tax rate was equal to 2.35 percent in 1990-91. ◆

Capital Gains Exclusion for Inherited Property

***Program Type:** PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$200
1990-91	200
1991-92	200

Authorization

California Revenue and Taxation Code Sections 18031 and 18036, which partially conform to federal Internal Revenue Code Section 1014.

Description

This program exempts from capital gains taxation the appreciation in the value of property which has occurred prior to the transfer of the property from a decedent to an heir. Thus, the heir's "basis" in the property, from which capital gains will be measured, is adjusted upward to equal the fair market value at the time of the decedent's death. Accordingly, taxes on the capital gains that materialize prior to the property transfer are permanently forgiven.

Rationale

This program provides tax relief to heirs who inherit property that has appreciated in value while held by the deceased. The most commonly cited rationale for this is that the estates of deceased persons are themselves subject to taxation; thus, subjecting capital gains to taxation would amount to a form of "double taxation" on the estate.

It also is frequently argued that, without this program, heirs might need to sell their inherited property to pay the tax on previously accumulated capital gains.

Comments

The rationale for this program has several weaknesses. First, California currently imposes two types of death taxes on property: (1) the estate tax and (2) the generation-skipping transfer tax. However, neither of these taxes imposes any real burden on California taxpayers, because both represent so-called "pick-up" taxes that simply collect a tax that would otherwise go to the federal government. That is, they merely enable California to take maximum advantage of the federal credits that are allowed for state taxes paid, at no cost to California taxpayers.

Second, the concern that heirs might need to sell their inherited property in order to pay capital gains taxes can be dealt with directly by a tax-deferral program. A tax-forgiveness program is not necessary to address this concern. ❖

Capital Gains Exclusion on the Sale of a Residence for Taxpayers over Age 55

***Program Type:** PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$130
1990-91	140
1991-92	150

Authorization

California Revenue and Taxation Code Section 17131, which conforms to federal Internal Revenue Code Section 121.

Description

This program allows a $125,000 once-in-a-lifetime exclusion of capital gains on the sale of a principal residence for taxpayers over the age of 55. In order to qualify for the exclusion, the taxpayer must have used the property as his/her principal residence for at least three years.

Rationale

This program provides tax relief to older persons who decide to sell their residences. The program has the effect of shielding certain older taxpayers from heavy tax burdens when they decide to either become renters or to purchase small owner-occupied units, such as condominiums. Because of persistent increases over time in housing and rental costs, some of these taxpayers might find it difficult to provide adequately for their housing needs if the exclusion were not available.

Comments

This program initially was introduced at the federal level in 1964, and was confined to taxpayers 65 or older and to homes sold for $20,000 or less. Since that time, its provisions have been significantly broadened.

Without this one-time exclusion program, some older taxpayers would be discouraged from ever selling their homes because of the large capital gains taxes that might result. This is because they would not be able to fully shelter their capital gains under the deferral program (see following program) if they chose either to rent or to purchase a new housing unit that was less expensive than the old one. Thus, this program encourages more efficient housing decisions by the elderly since it removes a financial disincentive for them to sell their home and move into a smaller unit. However, the exclusion also converts the continuing interest-free loan on tax liabilities under the deferral program (discussed next) into a permanent forgiveness of tax liabilities. Thus, this program compounds the favorable tax treatment given housing relative to other investments. ◆

Deferral of Capital Gains on the Sale of Principal Residences

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$410
1990-91	430
1991-92	460

Authorization

California Revenue and Taxation Code Section 18031, which partially conforms to federal Internal Revenue Code Section 1034.

Description

This program allows taxpayers to defer recognizing capital gains on the sale of their principal residence when a replacement residence of equal or greater value is purchased within two years. However, taxpayers must reduce their "basis" in the new residence by the amount of the unrecognized capital gain.

Rationale

This program provides tax relief to homeowners who sell their residences and purchase another. Its underlying intent is to avoid putting an additional burden on persons who must necessarily sell homes because of such factors as an increase in family size or an employment change. Without this program, families facing such "involuntary conversions" might face undue hardship in acquiring satisfactory or comparable housing.

The program also provides an incentive for individuals in the economy to invest more of their money in housing, since it gives home ownership a competitive advantage over other types of investments. This is because a portion of the capital gains from most other types of assets is taxed when the assets are sold. ◆

Deferral of Capital Gains from Housing Sales to Low-Income Residents

Program Type: *PIT and B&C*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	NA	NA
1990-91	$1	$1
1991-92	1	1

Authorization

California Revenue and Taxation Code Sections 18041.5 and 24955.

Description

This program allows taxpayers to exclude from taxable income their capital gains from the sale of government-assisted low-income housing units to low-income tenants. In order to qualify for the exclusion, a majority of the housing units sold must remain in use by low-income tenants for either 30 years from the date of sale or for the remaining term of existing federal government financial assistance, whichever is longer. In addition, the taxpayer must reinvest all of the proceeds from the sale in residential property other than a personal residence. The taxpayer's "basis" in the new residential property is reduced by the amount of the gain from the sale, resulting in a tax deferral rather than permanent tax forgiveness.

Rationale

This program provides an incentive for owners of low-income housing that has been subsidized by the federal government, to sell the property to low-income tenants for continued use as low-income housing, rather than sell it for other purposes or convert it to other purposes upon termination of the federal subsidy. It does this by providing for a tax-deferral on the gain from that sale. This deferral of the tax liability amounts to an interest-free loan from the government, which increases the economic gain from the property sale.

Comments

In the 1960s, the federal government provided low-interest loans and rent subsidies through various programs administered by the federal Housing and Urban Development Department (HUD) and Farmers' Home Administration (FaHA). In return, private developers and owners agreed to build or operate rental projects which were protected by low-income use restrictions. In order to stimulate private sector participation, the owners were given the option to terminate their contracts prior to the loan maturity dates. As owners exercise their options to sell and/or federal subsidy periods expire, the units may be sold or converted to market-rate units, thereby displacing low-income tenants and reducing the state's supply of affordable low-income housing.

This is a newly enacted program created by Ch 1436/90 (SB 1286, Seymour). ❖

Exclusion for Employer-Sponsored Educational Assistance Programs

Program Type: *PIT only*
Sunset Date: *December 31, 1991*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	NA
1990-91	$15
1991-92	18

Authorization

California Revenue and Taxation Code Section 17151, which partially conforms to federal Internal Revenue Code Section 127.

Description

This program allows taxpayers to exclude from their gross income contributions made to qualified educational assistance programs by their employers on their behalf. The amount which may be excluded under this program is limited to $5,250 annually. In order to qualify for this exclusion, the educational program must be provided for the exclusive benefit of employees and their dependents, and comply with various federal rules to ensure nondiscrimination in favor of highly compensated employees.

Rationale

This program provides an incentive for employers to provide and employees to accept contributions to educational assistance programs in lieu of taxable monetary compensation. This is because a given level of contributions is worth more to employees on an after-tax basis than an equivalent amount of taxable income.

Comments

This program conforms to an identical federal program, except that the federal program provides an exclusion from 1988 through 1991. In contrast, California law provides for the exclusion in 1988, 1990 and 1991. ◆

Exclusion for Employer-Paid Group Legal Assistance

Program Type: *PIT only*
Sunset Date: *December 31, 1991*

Estimated Revenue Loss
(dollars in millions)

PIT Fiscal Year	*Amount*
1989-90	NA
1990-91	$5
1991-92	5

Authorization

California Revenue and Taxation Code Section 17157, which partially conforms to Internal Revenue Code Section 120.

Description

This program allows taxpayers to exclude from gross income contributions made to qualified group legal assistance programs by their employers on their behalf, up to a maximum amount of $70 per year. In addition, in order to qualify for this exclusion, the assistance program must be provided for the exclusive benefit of employees and their dependents, and comply with various federal rules to ensure nondiscrimination in favor of highly compensated employees.

Rationale

This program provides an incentive for employers to provide and employees to accept contributions to group legal assistance programs in lieu of monetary compensation. This is because a given contribution to such a program is worth more to employees on an after-tax basis than an equivalent amount of taxable income.

Comments

This program conforms to an identical federal program, except that the federal program provides an exclusion from 1988 through 1991. In contrast, California law provides for the exclusion in 1988, 1990, and 1991. ✦

Tax Exemption for Unemployment Insurance Benefits

Program Type: PIT only

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$59
1990-91	63
1991-92	67

Authorization

California Revenue and Taxation Code Section 17083.

Description

This program exempts unemployment compensation from the recipient's gross income.

Rationale

Several reasons are often mentioned for the tax relief provided by this program. One is that legislatively provided social welfare benefits should not be taxed, since they have been structured to provide specific amounts of after-tax purchasing power to recipients. A second is that paying taxes on such benefits could be an especially onerous burden on jobless individuals, who often have trouble paying for basic necessities such as housing, food and clothing. A third is that, because California does not permit employers to deduct their unemployment insurance taxes as a business expense, the taxation of unemployment benefits would amount to a form of "double taxation."

Comments

State law does not conform to federal provisions, as contained in the 1986 Federal Tax Reform Act, which require certain taxpayers to include their unemployment compensation as gross income. The intent of the federal requirement is to treat government-paid unemployment benefits more like privately provided unemployment compensation benefits. The latter are fully taxable to recipients to the extent that they exceed prior contributions.

The subsidy provided by the program is worth disproportionately more to higher-income households, due to their higher marginal income tax rates. Economists argue that a side-effect of this program is that it provides a disincentive for certain unemployed persons to seek jobs, since it reduces the after-tax cost of being unemployed. This is particularly relevant in such cases as unemployed spouses of moderate- to high-income taxpayers, whose economic need for jobs often is much less pressing than for lower-income individuals. ♦

Tax Exemption for Employer Contributions to Health Plans

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$1,200
1990-91	1,365
1991-92	1,560

Authorization

California Revenue and Taxation Code Section 17131, which conforms to federal Internal Revenue Code Section 106.

Description

This program exempts employer contributions to accident and health plans from the gross income of employees.

Rationale

This program provides tax relief to all individuals whose employers contribute to the costs of accident and health plans that provide compensation for sickness and injury. The most commonly advanced rationale for this is that paying taxes on these noncash benefits would impose a hardship on many taxpayers.

In addition, the program provides both employers and employees with an incentive to make health insurance a standard part of the employees' compensation package. Many people argue that this is a desirable social goal, because it provides security to workers and reduces the need for the government itself to provide health care programs.

Comments

It has been reported that three-fourths of all persons with private health coverage in the United States participate in employer-subsidized plans such as those that qualify under this program.

The consensus of economists is that state and federal programs like this one have contributed significantly to shifting the mix of employee compensation away from wages and salary income in favor of nonmonetary fringe benefits. In fact, some economists believe that the subsidy provided by these programs has reduced the after-tax cost of health care to such a degree that there is excessive use of health care services by those with employer-subsidized health plans (such as unnecessary doctor visits and excessive use of prescription medications and laboratory tests). To the extent that this is true, these programs can result in a misallocation of economic resources and the escalation of health care costs. (For a discussion of these issues see, for example, Henry J. Aaron and Harvey Galper, *Assessing Tax Reform,* The Brookings Institution, 1985, especially pages 4-5).

In addition, these programs provide proportionately greater benefits to higher-income taxpayers. This is because higher-income taxpayers have higher marginal income tax rates. Further, they participate in employer-subsidized health care plans to a greater extent than do lower-income taxpayers. ❖

Tax Exemption for Employer Contributions to Pension Plans

Program Type: *PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$2,060
1990-91	2,140
1991-92	2,230

Authorization

California Revenue and Taxation Code Section 17501, which conforms to federal Internal Revenue Code Sections 401 through 404.

Description

This program exempts employer contributions to qualified retirement plans and simplified employee pension plans (SEPs) from the gross income of employees, subject to certain conditions. (Employees do, however, eventually have to pay tax on that portion of the retirement benefits they receive which were funded through employer contributions.) In general, the allowable annual contribution that can be excluded from gross income is limited to the lesser of 25 percent of the taxpayer's compensation, or $30,000.

Rationale

This program provides tax relief to persons who receive income in the form of employer contributions to their pension plans. This tax relief is in the form of a tax deferral, since these persons eventually are subject to paying taxes on the retirement benefits they receive. The underlying rationale for the program is that persons should not have to pay taxes on income until this income actually is received.

Comments

In the long run, the tax deferral provided by this program has a net cost to the state. This is because most persons are in lower marginal income tax brackets after retirement, compared to their working years, when their employers were contributing to their retirement plans. In addition, the present value of the deferred taxes is less than the value of the taxes that the state would have received if they had been paid at the time of the employer contributions.

The amounts shown above include the revenue losses associated with the exclusion for employee contributions to qualified retirement and salary reduction plans (see following program). ◆

Exclusion for Employee Contributions to Qualified Retirement and Salary Reduction Plans

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 17501, which conforms to Internal Revenue Code Section 401 through 404, and 408.

Description

This program allows an exclusion from gross income for a taxpayer's contributions to a qualified employer-sponsored retirement plan, a simplified employee pension plan (SEP), or a cash or defined arrangement (CODA) such as a 401(k), 403(b), or 457. Taxpayer contributions to a CODA are limited annually to a $7,979 as of 1990, but can be increased under special circumstances.

Rationale

This program provides individuals with an incentive to participate in employer-sponsored retirement plans and salary reduction plans by permitting them to defer taxes on their contributions until they are "withdrawn" as benefits after retirement. Specifically, this deferral reduces the cost of funding a specified level of retirement benefits, because the present value of taxes paid upon the withdrawal of benefits would be less than the present value of taxes paid when the contributions are made. In addition, the program provides a further tax reduction to such individuals to the extent that their marginal tax rates are lower when they retire and receive retirement distributions compared to when they made the contributions.

Comments

California has been in conformity with federal law since 1987.

Revenue loss estimates for this tax expenditure program are included in the revenue loss estimates for the exemption for employer contributions to pension plans (see previous program). ❖

Tax Exemption for Social Security Benefits

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$500
1990-91	515
1991-92	540

Authorization

California Revenue and Taxation Code Section 17087.

Description

This program exempts social security benefits and federal railroad retirement benefits from the recipient's gross income.

Rationale

This program provides tax relief to social security and railroad retirement recipients, the apparent rationale being to protect the retirement income of elderly individuals.

Comments

Federal law provides for the partial taxation of social security and railroad retirement benefits. The amount of these benefits that must be reported as income equals the lesser of one-half of the benefits received, or one-half of the excess of the taxpayer's "combined income" (as defined) over a specified base amount. This partial taxation was adopted at the federal level to put social security benefits more on a par with other types of pension benefits, which are taxable only to the extent that the annuity or pension received exceeds a taxpayer's own, direct contributions.

Because the exclusion of social security benefits from income is worth more to taxpayers as their marginal tax rates rise, social security recipients with substantial amounts of taxable income from other sources reap the greatest benefits from this state program. ❖

Tax Exemption for Employer Contributions to Life Insurance

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$74
1990-91	78
1991-92	82

Authorization

California Revenue and Taxation Code Section 17081, which conforms to federal Internal Revenue Code Section 79.

Description

This program exempts from employees' gross income that portion of employer contributions to group-term-life insurance policies associated with the first $50,000 in individual coverage. Also exempt are contributions to life insurance policies which specify that the beneficiary is the employer or a charitable organization, and insurance contributions under a qualified pension or profit-sharing plan.

Rationale

This program, by subsidizing the cost of life insurance, provides tax relief to policyholders and an incentive for employees and employers to incorporate life insurance coverage into their compensation packages. According to federal reports, the original rationale for the federal program (to which California conforms) was two-fold. First, it was believed that there were difficulties in properly apportioning life insurance premium costs among individual employees, since premium costs depend on such factors as age, health, and related mortality factors (this is no longer perceived as a serious problem). Second, it was believed that life insurance benefits would help keep family units intact upon death of the primary breadwinner.

Comments

Higher-income taxpayers benefit disproportionately under this program, both because of their higher marginal tax rates, and because employer-paid insurance is most commonly provided for management-level employees.

Life insurance *proceeds* themselves are not taxed (see following program). Thus, the provision of life insurance as a fringe benefit is completely tax exempt for many individuals. However, life insurance purchased by self-employed individuals, or by individuals whose employers do not make premium contributions, receive no tax break comparable to this program. ❖

Tax Exemption for Investments in Life Insurance and Annuity Contracts

Program Type: PIT and B&C

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$260	$18
1990-91	280	18
1991-92	315	18

Authorization

California Revenue and Taxation Code Sections 17131, 17131.5, and 24305, which conform to federal Internal Revenue Code Section 101, and California Revenue and Taxation Code Sections 17801, 17805, and 24302, which partially conform to federal Internal Revenue Code Section 72.

Description

This program allows an exclusion from gross income for the proceeds received by a beneficiary from the life insurance policy of a deceased person. Any interest component of such proceeds is taxable and must be included in gross income. Howver, surviving spouses of a decedent-insured who died before October 23, 1986 may exclude $1,000 of such interest annually. If the proceeds are received under circumstances other than death, then only the original investment in the contract (for example, aggregate premium and any other consideration paid) is excludable from gross income.

Rationale

This program provides tax relief to persons who have been designated as beneficiaries of deceased persons' life insurance policies. To the extent that these beneficiaries were financially dependent on the deceased, the program helps to stabilize their economic situations.

Comments

Higher-income individuals are likely to benefit disproportionately from this program, since insurance coverage tends to be positively correlated with income, and high-income taxpayers are in the highest marginal income tax brackets. With few exceptions, California has been in conformity with federal law since 1987.

Beginning in 1991, CH 1387/90 (AB 2663, Peace) makes amounts received under a "living benefits" contract excludable from gross income. These types of contract arrangements can be made in situations in which the insured, under a life insurance policy, has a catastrophic or life-threatening illness or condition. Consequently, the policy owner gives up or transfers the right to receive death benefits under the policy in exchange for compensation amounting to less than the death benefits. ◆

Tax Exemption for Interest on Government Debt Obligations

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$210
1990-91	240
1991-92	275

Authorization

California State Constitution, Article XIII, Section 26, and California Revenue and Taxation Code Sections 17133, 17143, and 17145, which partially conforms to Internal Revenue Code Section 852.

Description

This program exempts from gross income the interest income earned on certain debt obligations issued by the U.S. government, the District of Columbia, and California state and local government entities. In addition, the interest received from a mutual fund also is tax exempt if government obligations (California state and local governments and the federal government) comprise 50 percent or more of the fund's portfolio or of a series of assets within the portfolio.

Rationale

This program subsidizes the costs of governmental borrowing, by providing tax relief to investors who purchase qualifying debt obligations issued by California governments or by the federal government. This tax relief encourages investors to accept lower interest returns on these obligations which, in turn, reduces the debt-servicing costs of these debt-issuing governmental entities. In addition, the program provides an incentive for certain investors to purchase more government-issued debt than they otherwise would. As a result of these factors, governments are better able to finance needed public outlays.

Comments

While the interest on qualifying obligations is tax exempt, any *capital gains* on the sale of such tax-exempt obligations must be reported as income.

Despite the widespread use and long history of tax-exempt financing, considerable controversy surrounds the continued broad-based use of programs like this. One reason for this involves the popularity of subsidized debt to finance projects which are not strictly "governmental" in nature, such as industrial projects and home purchases. Another reason is that many economists view tax-exempt borrowing as an inefficient means of subsidizing governmental projects, because a portion of the foregone tax revenues end up in the hands of high-income investors. For a discussion of these and other related issues regarding this program, see *The Use of Tax-Exempt Bonds in California: Policy Issues and Recommendations*, Legislative Analyst's Office, State of California, December 1982, 355 pages.

The revenue loss figures shown above only include losses from outstanding state and local obligations, and mutual fund pass-through interest dividends. No loss figure is included for federal debt obligations since federal law itself prohibits states from taxing the interest on U.S. government debt obligations. ❖

Tax Exemption for Compensation for Injuries or Sickness

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$145
1990-91	150
1991-92	155

Authorization

California Revenue and Taxation Code Section 17131, which conforms to federal Internal Revenue Code Section 104.

Description

This program allows taxpayers to exclude from their gross income the compensation they receive from workers' compensation, accident insurance, and health insurance, due to sickness or injuries. The exemption also covers the amount of any *compensatory damages* awarded for injury or sickness, regardless of whether the award is made under an in-court or out-of-court settlement or whether the taxpayer receives a lump-sum award or installment payments. (However, *punitive* damages *are* taxable.) In addition, certain amounts paid by an employer to reimburse an employee for expenses incurred for the care of the employee, the employee's spouse, or the employee's dependents are tax exempt.

Rationale

This program provides tax relief to qualified taxpayers on the grounds that sickness or injury often imposes economic hardship and can limit the ability of individuals to pay for such basic necessities as housing, food and clothing. Under these conditions, taxes on compensation for injuries or sickness are viewed as a particularly onerous burden.

Comments

This program covers the disability benefits received under the California Unemployment Insurance Law, but does not apply to amounts received as reimbursement for medical expenses claimed as tax deductions in prior years. ❖

Tax Exemption for Compensation for Slander or Libel

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 17131, which conforms to federal Internal Revenue Code Section 104.

Description

This program allows taxpayers to exclude from their gross income the compensation they receive for slander or libel of personal reputation. The exemption applies to the amount of any *compensatory damages* awarded, regardless of whether the award is made under an in-court or out-of-court settlement or whether the taxpayer receives a lump-sum award or installment payments. *Punitive damages*, however, must be included as taxable income.

Rationale

This program provides tax relief to qualified taxpayers on the grounds that economic hardship could result from slander or libel of a personal reputation. For example, a person whose reputation is damaged because of slander may have difficulty obtaining a job or qualifying for a loan.

Comments

The federal tax exemption for compensation for slander or libel (to which California conforms) is not specifically mentioned in the Internal Revenue Code. However, the IRS allows a tax exemption for such compensation, based on court decisions which point to its similarity to compensation for other types of personal injuries which *are* specified in the code as tax exempt. ❖

Tax Exemption for Employee Death Benefits

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$2
1990-91	2
1991-92	2

Authorization

California Revenue and Taxation Code Section 17131, which conforms to federal Internal Revenue Code Section 101 (b).

Description

This program allows up to $5,000 in death benefits paid by an employer to be excluded from the gross income of a deceased person's beneficiaries or estate.

Rationale

This program provides tax relief to a decedent's beneficiaries under the rationale that death benefits often are used by such individuals to adjust to the economic hardships caused by the death of decedents, and to cover death-related expenses (such as burial costs).

Comments

The $5,000 limitation on excludable benefits applies regardless of the number of employers involved.

California conformed in 1985 to a 1984 federal law change which extended this program to certain benefits paid on behalf of self-employed individuals. ❖

Tax Exemption for Meals and Lodging Furnished by an Employer

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$33
1990-91	33
1991-92	33

Authorization

California Revenue and Taxation Code Section 17131, which conforms to federal Internal Revenue Code Section 119.

Description

This program allows taxpayers to exclude from gross income the value of meals and lodging furnished by an employer (other than the military). To qualify for the exemption, the meals or lodging must be provided at the employer's place of business and for the convenience of the employer. In addition, for the value of lodging to be exempt, the taxpayer must be required to accept the employer-provided lodging as a condition of employment. This means that the taxpayer must accept the lodging in order to carry out the duties of his or her job. However, if the employer provides a cash allowance or reimbursement for meals or lodging, the taxpayer must include this amount in reported gross income.

Rationale

This program provides tax relief to taxpayers who are required to live in or eat at facilities which are owned by their employers. The primary rationale for the program is to simplify tax administration. For example, the value to an employee of employer-provided meals or lodging is often difficult to establish. In addition, the lodging provided by an employer may simply duplicate rather than substitute for private quarters, in which case its value to the employee would be negligible.

Comments

In some cases, such as a live-in housekeeper or resident apartment manager, employer-furnished meals and lodging may represent a large portion of the employee's total compensation. To the extent that the employee's regular wages are lower as a result of this program, the government ends up subsidizing occupations that are characterized by such forms of compensation. The program also provides an incentive for employers and employees to rely on such nonwage compensation, since the after-tax value of a dollar of such nonwage income is greater than that of a dollar of regular wage income. ❖

Tax Exemption for Miscellaneous Fringe Benefits

Program Type: *PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$157
1990-91	168
1991-92	180

Authorization

California Revenue and Taxation Code Section 17131, which partially conforms to federal Internal Revenue Code Section 132.

Description

These programs provide a tax exemption for specified types of employer-paid fringe benefits. These include: (1) special services provided to employees at no direct cost to them (such as free stand-by flights provided by airlines to their employees); (2) employee discounts for products and services sold by the employer; (3) use of company equipment (such as a company car); and (4) *de minimis* fringe benefits (such as personal use of an employer's copying machine or use of on-premises eating or gymnasium facilities).

Rationale

The rationale for this program depends on the type of fringe benefit. For instance, the exemption for employer-provided gymnasium facilities is intended to provide employers with an incentive to improve the well-being and productivity of their employees. The rationale for the exemption of other benefits appears to be based on administrative considerations, such as the difficulty of determining the value of the specific benefit to the employee. ❖

Tax Exemption for Scholarships, Fellowships, and Grants

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$18
1990-91	21
1991-92	25

Authorization

California Revenue and Taxation Code Sections 17131 and 17154, which conform to federal Internal Revenue Code Section 117.

Description

This program allows taxpayers to exclude from gross income any qualifying scholarships, fellowships and tuition grants they receive.

Rationale

The rationale for the tax relief that this program provides to scholarship, fellowship and grant recipients appears to relate to the problem of uniformity in the treatment of different taxpayers. According to federal publications, the federal program (to which California's program conforms) initially required that all scholarship, fellowship and grant income be *included* as gross income, unless the taxpayer could show that it was a *gift* (this is because gifts are nontaxable). However, when the Internal Revenue Code of 1954 was enacted, the present program was adopted on the grounds that it would treat all taxpayers consistently and uniformly, and eliminate the need to determine whether a "gift" was involved. Thus, the program is rationalized on the grounds that it provides equity among taxpayers and is administratively convenient.

Comments

The program applies to amounts received for such incidental expenses as travel, research, clerical assistance, and equipment, but does not apply to amounts received for teaching, research work, or similar services. In many cases the value of scholarships, fellowships, and grants is small enough that the recipients, who frequently are students with only limited outside income, would have little or no tax liabilities in the program's absence. In addition, the exclusion does not apply to the portion of the scholarships, fellowships, and grants which is used to pay for room, board, and other specified expenses. ✦

Tax Exemption for State Lottery Winnings

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
	PIT
Fiscal Year	*Amount*
1989-90	$31
1990-91	33
1991-92	37

Authorization

California Government Code Section 8880.68.

Description

This program exempts from gross income any winnings from the California State Lottery.

Rationale

This program presumably was intended to provide a tax incentive for individuals to participate in the state lottery. It does this by increasing the value of winnings from lottery wagering.

Comments

This program was established in November 1984 by Proposition 37, which enacted the California State Lottery Act of 1984.

State lottery winnings are subject to federal income taxation, to the extent that they exceed lottery wagering losses. Gambling winnings other than lottery winnings are subject to both state and federal income taxation, to the extent that they exceed gambling losses. ❖

Tax Exemption for Income from Investments in Economically Depressed Areas

Program Type: *PIT and B&C*

Estimated Revenue Loss (dollars in millions)		
	PIT	*B&C*
Fiscal Year	*Amount*	*Amount*
1988-89	NA	NA
1989-90	NA	NA
1990-91	NA	NA

Authorization

California Revenue and Taxation Code Sections 17231 and 24384.

Description

This program exempts from gross income the interest received from investments made in state-designated economically depressed areas, including "enterprise zones" and employment-incentive "program areas." For example, a taxpayer provides a loan to a business that is planning to expand its operations in an enterprise zone area. The interest income the taxpayer receives from the loan repayments is tax-exempt.

Rationale

This program provides an incentive for investments to be made in economically depressed areas of the state by increasing the after-tax return that taxpayers can earn on loans to businesses which are located in such areas. This increased rate of return may be necessary to induce investment in perceived "high risk" areas. ❖

Tax Exemption for Foster Care Payments

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$2
1990-91	2
1991-92	2

Authorization

California Revenue and Taxation Code Section 17131, which partially conforms to federal Internal Revenue Code Section 131.

Description

This program allows taxpayers to exclude from their gross income the payments they receive from state, local and nonprofit agencies as reimbursement for their costs of taking care of a foster child in their home.

Rationale

This program provides an incentive for individuals to take on the responsibilities of caring for foster children. The program also provides indirect financial assistance to the activities of nonprofit agencies, because they are able to provide a given desired level of after-tax foster care reimbursements at less cost (since the reimbursements are not taxable).

Comments

Payments made by a state or tax-exempt child-placement agency as "difficulty of care payments," or to reimburse a foster parent for the expenses of caring for a qualified foster child in the foster parent's own home, are excludable from gross income. Foster parents qualify if the foster child lives in the foster family home, and is placed in the home by a state agency or tax-exempt child-placement agency. ❖

Tax Exemption for Employee Ridesharing Benefits

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 17149, which partially conforms to federal Internal Revenue Code Section 124.

Description

This program allows taxpayers to exclude from their gross income the compensation or any other benefits they receive from an employer, for their costs of participating in a qualified ridesharing program. The exemption covers compensation or other benefits received for commuting in a third-party vanpool, private commuter bus, or subscription taxipool, and for monthly transit passes that are used by an employee or the employee's dependents.

Rationale

This program provides tax relief to employees who participate in ridesharing programs, and an incentive for employers to make ridesharing benefits a part of their employees' overall compensation. The program's underlying rationale is based on the view that state tax incentives are needed to encourage employees and employers to use ridesharing programs as a means of alleviating traffic congestion, reducing air pollution, and conserving gasoline.

Comments

The exemption provided by this program originally was established by Ch 25/82 (AB 548, Ryan), and was allowed for income years 1981 through 1985. Chapter 1444, Statutes of 1986 (SB 1794, Beverly), which extended the exemption through 1990, was repealed in 1987. The current program was enacted by Ch 1437/88 (SB 1904, Morgan). ◆

Tax Exemption for Employee Child and Dependent Care Benefits

Program Type: *PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$12
1990-91	15
1991-92	20

Authorization

California Revenue and Taxation Code Section 17131, which partially conforms to federal Internal Revenue Code Section 129.

Description

This program allows taxpayers to exclude from their gross income the compensation or any other benefits they receive from an employer for qualified child and dependent care services. In addition to exempting these employer-provided benefits, an employee may exempt the amount of child and dependent care benefits received through a salary reduction agreement entered into with his/her employer. In this case, the employee elects to receive a salary reduction in the amount of additional employer-paid child or dependent care benefits.

Rationale

This program provides tax relief for employees who receive child and dependent care benefits through either of the methods above, and an incentive for employers to make such benefits a part of their employees' overall compensation package. The program's underlying rationale is that it benefits society as a whole in several ways. One of these benefits is increased labor output and productivity, which occurs because the availability of child care enables more individuals to work and reduces employee absenteeism and turnover. This, in turn, can result in a second benefit -- reduced government payments to unemployed persons. A third benefit of the program is a reduction in the need for government-provided child care programs.

Comments

This program covers payments or services provided by the employer for child or dependent care services which enable the taxpayer to work. The allowable income exclusion is limited to the lesser of the taxpayer's own earned income, or his or her spouse's earned income. To qualify for the program, the assistance must be provided under a plan which does not discriminate in favor of officers, owners, or higher-paid employees, and meets various other requirements.

Federal tax law, as amended by the 1986 Tax Reform Act, limits the exclusion for employee child care benefits (both those paid by the employer and those provided through employee salary reductions) to $5,000 per year ($2,500 in the case of married individuals who file separately), beginning in 1987. Individuals are allowed to use this income exemption in conjunction with the tax credit for child and dependent care expenses. ❖

Tax-Exempt Status for Qualifying Corporations

Program Type: *B&C only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*B&C Amount*
1988-89	$25
1989-90	53
1990-91	73

Authorization

California Revenue and Taxation Code Sections 23701 through 23710.

Description

This program allows an exemption, from the bank and corporation franchise and income taxes, for the income of qualifying tax-exempt nonprofit and charitable organizations. (Franchise taxes are levied against all banks and corporations doing business in the state. The income tax is imposed on banks and corporations which do not do business in the state but which have income from California sources, such as holding companies and firms engaged only in interstate commerce). This exemption extends to the minimum franchise tax ($800 in 1990) which is imposed on corporations which otherwise would have a tax liability less than that amount. Qualifying organizations still are subject to taxes on their "unrelated business income," however, which includes income associated with activities that are not directly related to their tax-exempt status. For example, a church would have to pay taxes on the income earned from the lease of its personal property to a business, even though its income from religious-related activities would be tax exempt.

Rationale

This program provides tax relief to organizations which are engaged in various charitable, or otherwise not-for-profit activities. The tax-exempt status generally applies to nonprofit religious, charitable, educational, and scientific organizations. Certain homeownership organizations, civic and business organizations, and financial cooperatives also qualify for tax-exempt status. The commonly cited rationale for exempting such organizations from taxation is that they provide social benefits that are worthy of indirect public financial support.

Comment

The rapid increase in revenue losses from this exemption is due to increases in the minimum franchise tax, which rose from $300 in 1988-89 and $600 in 1989-90 to $800 in 1990-91. ◆

Tax Exemption for Recycled or Redeemed Beverage Container Redemption Payments

Program Type: *PIT and B&C*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	NA	NA
1990-91	NA	NA
1991-92	NA	NA

Authorization

California Revenue and Taxation Code Sections 17153.5 and 24315.

Description

This program allows taxpayers to exclude from gross income the amounts they receive for returning recyclable beverage containers to state-designated recycling centers.

Rationale

This program provides an incentive for taxpayers to return beverage containers to recycling centers. The program's underlying rationale is that resource conservation and litter reduction are worthy of public financial support.

Comments

This program was enacted by Ch 1290/86 (AB 2020, Margolin), which established a statewide recycling program for certain types of beverage containers. The program's exemption covers the amounts that a taxpayer receives as a redemption value or redemption bonus. "Refund value" refers to the minimum refundable value established by the California Department of Conservation (DOC) for each type of beverage container. The current refund value is 2 1/2 cents per container. A "redemption bonus" is an additional amount paid by the DOC to recycling centers for payment to those who return containers, in order to encourage the redemption of specific types of containers. ◆

Exclusion for Benefits Provided Under Cafeteria Plans

Program Type: *PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	75
1990-91	100
1991-92	125

Authorization

California Revenue and Taxation Code Sections 17131 and 17158, which conform to federal Internal Revenue Code Section 125.

Description

This program allows employees to exclude from their gross income benefits received from cafeteria plans, which are employer-sponsored benefit packages that offer employees a choice between taking monetary compensation and qualified benefits. The employee is allowed to choose among the "qualified benefits" of the plan, which can include benefits such as accident and health coverage, group-term life insurance coverage, or child and dependent care benefits. Qualified benefits cannot include scholarships and fellowship grants, employer-provided qualified transportation, employer-sponsored educational assistance programs, fringe benefits, or deferred compensation. If the employee chooses instead to take monetary compensation instead of the qualified benefits, it must be included in gross income.

Rationale

This program creates an incentive for employers to provide, and employees to accept, contributions made to benefit plans in lieu of monetary compensation. This is because a given contribution to such a program is worth more to employees on an after-tax basis than an equivalent amount of taxable income. In addition, the program provides both employers and employees with an incentive to make these types of benefits a standard part of the employees' compensation package. The rationale for the program is that it furthers a desirable social goal, because it improves workers' income security and reduces the need for government, itself, to provide these benefit programs.

Comments

California has been in conformity with federal law regarding cafeteria plan benefits since 1987. ❖

Tax Exclusion for Water's Edge Election

Program Type: *B&C only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*B&C Amount*
1989-90	$275
1990-91	305
1991-92	340

Authorization

California Revenue and Taxation Code Section 25115.

Description

This program gives a unitary multinational corporation the option of computing its California taxable income on a "water's edge" basis, which means the company's tax liability is determined on the basis of its United States income only, instead of on the basis of its worldwide income. Corporations that make a water's edge election for tax purposes must pay an "election fee," which is deposited into the state's Unitary Fund to be used for economic and business development purposes. A qualifying water's edge corporation is also allowed to deduct a percentage of its foreign dividends.

Rationale

This program provides tax relief to multinational corporations by allowing them to compute their taxes using an alternative method. One rationale for the program is that it is burdensome for some multinationals to keep track of all their worldwide income sources for the sole purpose of computing California tax liability. The water's edge election provides these corporations with an alternative that makes it easier for them to comply with California's tax laws, because it relies on the same information now required for federal tax purposes.

It also is argued that the worldwide method results in an unfairly high allocation of income for California tax purposes, and that the water's edge method reduces this distortion.

Comments

This program was enacted by Chapter 660, Statutes of 1986 (SB 85, Alquist), and is applicable for tax years beginning in 1988. The revenue loss amounts shown for this program are net of the state's Unitary Fund election fee revenues. ◆

Adjustment for Contributions to Individual Retirement Arrangement Accounts

Program Type: *PIT only*

Estimated Revenue Loss
(in millions)

Fiscal Year	*PIT Amount*
1989-90	81
1990-91	89
1991-92	95

Authorization

California Revenue and Taxation Code Sections 17201, 17501, 17085, and 17507, which conform to federal Internal Revenue Code Sections 219 and 408.

Description

This program allows a deduction for contributions to an individual retirement arrangement (IRA) account belonging to a taxpayer and his/her spouse. The annual maximum deduction permitted is $2,000. For taxpayers who also make contributions to an IRA account of a nonworking spouse, the maximum total deduction is $2,250, so long as the contribution to either IRA account does not exceed $2,000. Taxpayers who belong to employer-established pension programs can claim the deduction, provided their AGI is below $25,000 for single filers, and $40,000 for married joint filers; and the deduction is phased out for taxpayers whose AGI exceeds $35,000 and $50,000, respectively.

Rationale

This program provides an incentive for taxpayers to save for their retirement. It does this by permitting taxpayers to defer taxes on their IRA account contributions until they are withdrawn (after age 59-1/2), thereby increasing their investment earnings on such monies.

In addition, the program provides tax relief to IRA account owners, to the extent that their marginal tax rates are lower when they retire compared to when they are working.

Comments

California has been in conformity with federal law regarding deductions for IRA account contributions since 1987. ❖

Adjustment for Contributions to Self-Employed Retirement Plans

Program Type: *PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$115
1990-91	126
1991-92	137

Authorization

California Revenue and Taxation Code Sections 17501, 17504, 17506, and 17507, which conform to federal Internal Revenue Code Sections 219, 401 through 404, 408, and 415.

Description

This program allows a deduction from gross income for a taxpayer's contribution to a self-employed retirement plan (these plans are usually referred to as "Keogh" or "H.R. 10" plans). The deduction is limited to either (1) the entire amount of contributions, in the case of plans which provide a certain specified level of benefits (these are called "defined benefit" plans); or (2) up to 15 percent of self-employed income, for plans for which the contributions are based on the taxpayer's profits (profit-sharing plans); or (3) up to 25 percent of contributions to "defined contribution" plans, such as money purchase pension plans or simplified employee pension plans (SEPs).

Rationale

This program provides self-employed individuals an incentive to save for retirement by granting them the same basic type of tax deferral that is available to individuals who are covered by employer-established retirement programs.

Comments

California has been in conformity with federal law in this area since 1987. In general, no distinction is made between (1) pension, profit-sharing, and other retirement plans (including SEPs) established by corporations and (2) those established by self-employed individuals and partnerships. In addition, contributions and deductions for a self-employed participant in a qualified plan are limited in the same way as those of an employee participant. ❖

Standard Deduction (Zero Bracket Amount)

Program Type: PIT only

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$605
1990-91	665
1991-92	705

Authorization

California Revenue and Taxation Code Sections 17041 and 17073.

Description

This program allows taxpayers who do not itemize their deductions to claim a "standard deduction." The deduction amount for the 1990 income year was $2,169 for single-return taxpayers and $4,339 for joint-return taxpayers. The standard deduction is indexed annually for inflation, as measured by the change in the California Consumer Price Index over the preceding June-to-June period.

Rationale

This program is intended to simplify state tax administration and the tax-computation process for taxpayers who have a certain minimal level of itemized tax deductions.

Comments

Considerable disagreement exists regarding how the tax expenditure associated with the standard deduction should be defined and measured. The revenue loss figure shown above represents the amount the state would gain if the standard deduction were eliminated altogether, and those taxpayers who would otherwise claim it were instead required to itemize their deductions. However, at least two other ways of defining and computing the tax expenditure amount have been suggested:

- One view is that the standard deduction is part of the "basic tax structure" because it is available to all taxpayers. In this case, the standard deduction does *not* give rise to any tax expenditure, and only those itemized deductions in excess of the standard deduction are tax expenditures.
- A second view is that the standard deduction *is* a tax expenditure that is claimed, either directly or indirectly, by *all* taxpayers. This view is based on the notion that it is not possible to distinguish between itemized deductions, which are tax expenditures, and the standard deduction, which is really a "proxy" for some minimal level of itemized deductions. Under this view, the cost of this program should reflect not only the standard deductions explicitly claimed by *nonitemizers*, but also the standard deductions which *itemizers* implicitly receive from the "zero bracket amount," which is built into the state's tax rate schedules. In other words, this view holds that, to identify the full cost of this tax expenditure program, one must add together (1) the standard deductions claimed by nonitemizers and (2) that portion of the itemized deductions claimed by itemizers which is equivalent to the standard deduction.
- A third view is that the standard deduction has implicitly embedded into it an allowance for various types of individual itemized deductions, and only the amount by which the standard deduction *exceeds* each nonitemizer's own itemized deductions is a tax expenditure. ❖

Itemized Deduction for Casualty Losses

Program Type:* *PIT only

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$10
1990-91	12
1991-92	13

Authorization

California Revenue and Taxation Code Section 17131, which conforms to federal Internal Revenue Code Sections 165, 17207, and 24347.5.

Description

This program allows as a deduction from gross income any qualifying *casualty losses* that exceed 10 percent of federal adjusted gross income (AGI), to the extent that these losses are not compensated for by insurance or otherwise. In addition, the program allows that subgroup of casualty losses associated with certain officially designated *disasters* (as proclaimed by the President or the Governor) to be (1) carried back as a deduction against income for the prior year and/or (2) carried forward as a deduction against future income for up to five years. Fifty percent of the amount of any such loss remaining after five years may be carried forward for the next 10 taxable years.

The term "casualty loss" includes losses arising from fire, storm, shipwreck, floods, and other such casualties, or from theft. Each separate casualty or theft loss is deductible only to the extent that it exceeds $100, and the total of all individual losses is deductible only to the extent that it exceeds 10 percent of federal AGI.

Rationale

This program provides tax relief to individuals who suffer large casualty losses, have a tax liability, and are able to itemize deductions. The most commonly cited rationale for the program is that it helps to relieve the hardships that these losses can impose on such individuals.

Comments

This program has a number of important side effects and tax-equity considerations. First, because the program shifts part of the cost of a taxpayer's property losses to the general taxpayer, it serves as a form of indirect property insurance. As such, it gives taxpayers an incentive to purchase less private insurance than they otherwise might. Second, depending on the size of a casualty loss and a taxpayer's income level, different taxpayers sustaining identical casualty losses can be provided different amounts of tax relief, due to such factors as the 10-percent threshold, the $100 minimum-loss requirement, and differences in marginal tax rates. For example, a high-income taxpayer may not be able to claim any deduction for a $5,000 casualty loss due to the 10-percent threshold, whereas a low-income taxpayer would qualify for a large deduction. Conversely, the dollar amount of tax relief provided for a given dollar amount of casualty loss in excess of the 10-percent threshold will be greater for a higher-income taxpayer than for a lower-income taxpayer, due to the difference in their marginal tax rates.

The amounts shown above are for revenue losses associated only with the deduction for casualty losses. The revenue loss estimates for disaster-related losses are not available. The Franchise Tax Board expects disaster-related revenue losses to be minor since they are associated with those uninsured losses taken in excess of the 50 percent casualty loss deduction already in current law. ❖

Itemized Deduction for Medical and Dental Expenses

***Program Type:** PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$90
1990-91	99
1991-92	107

Authorization

California Revenue and Taxation Code Section 17131, which conforms to federal Internal Revenue Code Section 213.

Description

This program allows taxpayers to claim a deduction for specified medical and dental expenses, to the extent that these expenses exceed 7.5 percent of federal adjusted gross income (AGI) and are not compensated for by insurance or otherwise.

Qualifying medical expenses include payments for diagnosis, cure, mitigation, treatment, or prevention of disease, including certain related travel costs and lodging expenses. They also include the costs of prescription drugs, plus nonprescription insulin.

Rationale

This program provides tax relief to individuals who incur nonreimbursed medical expenses. The rationale for the program is that such expenses can impose extraordinary and involuntary financial burdens. In addition, the program provides some incentive for taxpayers to seek proper medical attention and preventive medical care, thereby improving the overall level of public health.

Comments

Although the basic rationale for this program relates to the involuntary nature of medical expenses, the deduction itself can be claimed for a variety of expenses that do not necessarily fall into this category. Such expenses include those for certain cosmetic surgery, rest cures, and other basically "optional" expenses, many of which are not covered under medical insurance programs because insurers consider them to be discretionary.

This program gives rise to a number of economic side effects and tax equity considerations. For example, because the program essentially shifts certain health-related expenses to the general taxpayer, it provides a form of indirect health insurance to individuals. Thus, it can give individuals an incentive to purchase less private health insurance than they otherwise might.

The tax subsidy given for a dollar of medical expenses also can differ, depending on such factors as a taxpayer's income level and amount of total medical expenses. For instance, the tax subsidy for low dollar amounts of medical expenses can be greatest for certain low-income taxpayers, since the 7.5-percent threshold can disqualify higher-income taxpayers from claiming them. On the other hand, the tax subsidy for high dollar amounts of medical expenses can be greatest for higher-income taxpayers, due to their higher marginal tax rates. ♦

Itemized Deduction for Certain Taxes Paid

Program Type: *PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$425
1990-91	480
1991-92	538

Authorization

California Revenue and Taxation Code Sections 17201, 17220 and 17222 which partially conform to federal Internal Revenue Code Section 164.

Description

This program allows taxpayers to claim an itemized deduction for the amount of certain property taxes and vehicle taxes paid to the state and local governments. Specifically, the program allows a deduction for (1) state, local, and foreign real property taxes; (2) state and local personal property taxes (including only the portion of the state vehicle license fee that does not represent annual charges for vehicle registration and weight); (3) one-half of self-employment taxes; and (4) other state, local, and foreign taxes relating to a trade or business, or to a property held for production of income. The program does not allow a deduction for sales taxes or income taxes (state, federal, or foreign) paid.

Rationale

This program provides tax relief under the rationale that already-paid taxes reduce the amount of a taxpayer's net income, thereby reducing the taxpayer's ability to pay state income taxes. The program also has been justified on the grounds that income should not be subject to double taxation by California state and local governments.

Comments

This program is available only to taxpayers who itemize their deductions. These taxpayers tend to fall disproportionately into moderate- and higher-income brackets. Because of this tendency, along with the state's graduated marginal tax bracket structure and the positive relationship between increases in the level of taxes paid and income, the tax relief provided by this program generally increases with income levels.

The Federal Budget Reconciliation Act of 1990 limited the aggregate amount of deductions such as this one which can be claimed by a taxpayer with AGI over $100,000. California tax law, however, does not contain these limitations. ❖

Itemized Deduction for Personal Interest Expenses

Program Type: *PIT only*
Sunset Date: *January 1, 1991*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$65
1990-91	32
1991-92	—

Authorization

California Revenue and Taxation Code Section 17224, which partially conforms to federal Internal Revenue Code Section 163.

Description

This program allows taxpayers to partially deduct the amount of qualifying personal interest expenses paid or accrued within a taxable year. The term "personal interest" includes all interest expenses except for (1) interest paid or accrued on indebtedness related to business activities, (2) interest associated with indebtedness incurred for the purpose of financing investment property, (3) interest associated with income or loss from passive activities, (4) home mortgage interest, and (5) interest on the unpaid portion of certain estate taxes. Thus, the deduction covers such items as interest paid on loans for nonbusiness-related purposes, consumer installment debt, and credit cards.

Rationale

The apparent, original rationale for this program is that such deductibility facilitates the acquisition of consumer goods by individuals who have insufficient income to purchase them outright, and thereby provides incentives for increased consumption and production.

Comments

Prior to 1987, personal interest was fully deductible as an itemized deduction. However, federal law, as amended by the Tax Reform Act of 1986, provided that this deduction be gradually phased out over five years beginning in 1987. The gradual elimination of this program arose out of a concern that providing incentives for taxpayers to borrow to finance their consumer expenses (by reducing the after-tax cost of doing so) encouraged "over-consumption" at the expense of savings and investment. In order to allow taxpayers time to adjust to the new rules, both federal and state lawmakers adopted a policy to phase out the deduction as follows: 65 percent of personal interest was deductible in 1987, 40 percent was deductible in 1988, 20 percent was deductible in 1989, and 10 percent was deductible in 1990. In tax year 1991, this deduction will be eliminated completely. ✦

Itemized Deduction for Mortgage Interest Expenses

Program Type: *PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$2,080
1990-91	2,277
1991-92	2,475

Authorization

California Revenue and Taxation Code Section 17201, which conforms to federal Internal Revenue Code Section 163.

Description

This program generally allows taxpayers to deduct the amount of qualified mortgage interest expenses paid or accrued within a taxable year. Qualified mortgage interest includes interest on indebtedness secured by a taxpayer's residence, that is, incurred in acquiring, constructing, substantially improving, or refinancing the residence. In addition, interest on indebtedness to purchase second homes and vacation homes, and interest on home equity borrowing also qualify for the deduction. The aggregate amount of indebtedness incurred to purchase, construct, or improve a home may not exceed $1 million (or $500,000 for a married individual filing a separate return). The total amount of interest on a home equity loan generally may not exceed interest on indebtedness of more than $100,000 (or $50,000 for a married taxpayer filing a separate return).

Rationale

This program provides an incentive for home ownership. This is because most home purchases require mortgage financing, and the deduction reduces the net after-tax costs of such borrowing. It often is claimed that homeownership is worth encouraging on the grounds that it generates substantial public benefits, including neighborhood stability, promotion of civic responsibility, and encouragement of proper maintenance of residential structures by their occupants.

Comments

One of the side-effects of this program is that it encourages consumers to finance their homes and other purchases through borrowing, even if their income level is high enough to avoid the need to do so. In this sense, the program provides some incentive for "over-borrowing." The program also encourages taxpayers to increase the amount they spend on housing because it reduces the after-tax costs of such expenditures. In addition, the program disproportionately benefits higher-income individuals who are most likely to purchase their own homes. Further, higher-income individuals realize greater tax savings for a given amount of interest deduction due to their higher marginal tax rates.

The Federal Budget Reconciliation Act of 1990 placed additional limitations on the aggregate amount of deductions such as this one which can be claimed by a taxpayer with AGI over $100,000. California does not conform to these limitations, however.

The economic and fiscal effects of this program were reviewed in the Legislative Analyst's *Report on the 1988-89 Tax Expenditure Budget: Overview and Selected Reviews* (see *The Personal Income Tax Itemized Deduction for Mortgage Interest Expenses*). The major findings were that although the program is at least partially successful in enabling certain taxpayers to buy homes, it is relatively inefficient. The interest rate subsidies made available under the program provide "windfall" benefits to many taxpayers who would have purchased homes in the absence of the program, and encourage certain individuals to *over-consume* housing by buying bigger and more expensive homes than they otherwise would. Given these findings, we recommended that the Legislature consider the following options: (1) limit the amount of mortgage interest which may be deducted, (2) eliminate the deduction for second homes and nonhousing expenses, (3) convert the current deduction to a tax credit, and 4) use the savings from "tightening up" eligibility under this program to provide additional subsidies targeted at low-income households and first-time homebuyers. ◆

Itemized Deductions for Charitable Contributions

***Program Type:** PIT and B&C*

Estimated Revenue Loss (dollars in millions)

Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$477	$45
1990-91	523	47
1991-92	570	48

Authorization

California Revenue and Taxation Code Sections 17241, and 2357 through 24359.

Description

This program allows taxpayers to deduct cash and specified noncash contributions to charities, religious organizations, governmental bodies, and other qualifying nonprofit organizations. The itemized deduction for personal income taxpayers is generally limited to 50 percent of adjusted gross income (AGI). The deduction available under Bank and Corporation Tax law may not exceed 5 percent of California taxable income. Contributions that exceed these percentage limitations may be carried forward for up to five years.

Rationale

This program provides an incentive for taxpayers to donate cash, property, or services to designated charitable organizations. It does this by reducing the net cost to the giver of making a contribution. The underlying rationale for the program is that qualifying organizations provide socially beneficial services which are viewed as being worthy of indirect state financial support.

Comments

One effect of this program is that, for personal income taxpayers, the state government provides donors with a subsidy that, per dollar of donation, increases in value as the donor's marginal tax bracket rises. Economists widely agree that permitting a deduction for charitable contributions tends to stimulate the volume of charitable donations, although there are differences of opinion regarding the exact nature of this response. The state's treatment of charitable contributions was changed to conform to federal law in 1987. ◆

Itemized Deduction for Moving Expenses

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$33
1990-91	36
1991-92	38

Authorization

California Revenue and Taxation Code Section 17201, which conforms to Internal Revenue Code Sections 1073 through 1078.

Description

This program allows taxpayers to claim an itemized deduction for their expenses associated with beginning a job in a new location. These deductible expenses may include 100 percent of direct expenses (the costs associated with travel and moving household and personal belongings to the new residence), and up to $3,000 of indirect expenses (the cost of house-hunting trips, temporary living expenses, and certain residential buying and selling expenses). Any reimbursement from employers for any of these costs, however, must be included in gross income.

Rationale

This program provides tax relief to individuals whose employment requires that they relocate. The basic rationale is that such moving expenses actually are a type of employee business expense that is necessary in order to earn income.

Comments

To be eligible for a moving expense deduction, the move must meet two basic tests: a distance test and a time test. The distance test requires that a taxpayer's new job location be at least 35 miles farther from the taxpayer's old residence than the old residence was from the former place of employment. The time test requires that the employee be employed on a full-time basis at the new location for at least 39 weeks during the 12-month period following the move. Self-employed individuals must work in the new location for at least 78 weeks during the next two years following the move. ◆

Deduction for Contributions of Computers and Scientific Equipment to Educational Institutions

Program Type: *B&C only*
Sunset Date: *December 31, 1993*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*B&C Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 24357.8 and 24357.9.

Description

This program allows corporations to claim a larger-than-normal deduction for contributions of computers, software, and scientific equipment to institutions of higher education. The deduction is equal to the lesser of (1) the taxpayer's "basis" in the equipment, plus one-half of the difference between this basis and the equipment's market value or (2) twice the taxpayer's basis in the equipment.

Example

A computer manufacturer donates two computers and a printer to a community college. The total production cost of the donated items was $500,000, and its market value is $800,000. Under this program, the company can claim a deduction of $650,000 ($500,000 for the depreciable basis plus one-half of $300,000). Without this program, the deduction would be limited to $500,000.

Rationale

This program provides companies with an incentive to donate computers, computer software, and other scientific equipment to colleges and universities.

Comments

This program was added in 1982 by Ch 1558/82 (AB 2595, Deddeh). It was amended in 1983 by Ch 1161/83 (AB 2049, Vasconcellos), which made contributions for "instructional purposes" eligible for the deduction. Among other things, the 1983 amendments made it possible for companies to claim the special deduction for contributions to community colleges. Chapter 1423, Statutes of 1985 (AB 430, O'Connell), extended the original sunset date for the deduction from June 1985 to year-end 1987, and Ch 1308/85 (AB 1306, Killea), made software and ancillary (necessary for the installation, activation, diagnosis, maintenance, repair, or servicing of scientific and research) equipment eligible for the program. ✦

Deduction for Contributions Made through Tax Return "Checkoffs"

Program Type: *PIT only*
Sunset Date: *January 1, 1992*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Sections 18500 through 18543.

Description

This program allows taxpayers to make certain tax deductible contributions simply by designating a specific contribution amount on their tax return. The recipient programs which qualify to be designated under this program include the California Fund for Senior Citizens, the U.S. Olympic Committee, the Children's Trust Fund, the Election Campaign Fund, the Vietnam Veterans' Memorial Account, the Alzheimers' Disease and Related Disorders Fund, and the Rare and Endangered Species Preservation Fund.

Rationale

This program provides an incentive for taxpayers to make donations to specified programs. The underlying rationale for this is that these programs are socially beneficial, and viewed as deserving of governmental encouragement and financial support.

Comments

The Vietnam Veterans' Memorial checkoff program is scheduled to sunset January 1, 1991. The other programs all sunset on January 1, 1992. ◆

Itemized Deduction for Employee Business and Miscellaneous Expenses

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$245
1990-91	260
1991-92	270

Authorization

California Revenue and Taxation Code Sections 17072.5 (a), 17076, and 17201, which partially conform to federal Internal Revenue Code Sections 162 and 212, and Sections 17269, 17270, and 17271, which contain California provisions that are different from federal law.

Description

This program allows a taxpayer to deduct from gross income a portion of certain unreimbursed:

- Business expenses including travel, meals, and lodging.
- Miscellaneous expenses related to (1) producing or collecting taxable income; (2) management, conservation, or maintenance of income-producing property; and (3) tax return preparation fees.

Generally, a taxpayer may claim a deduction for 80 percent of such expenses to the extent that this 80-percent amount exceeds 2 percent of the taxpayer's *federal* adjusted gross income (AGI).

Rationale

This program provides tax relief to employees on the grounds that qualifying expenditures are a direct cost of earning income and, therefore, should be deductible.

Comments

This program provides an incentive for employers to require, and employees to be willing to incur, certain job-related expenses. For example, the program increases the likelihood that an employee will be willing to pay his/her own way to a business conference, particularly if the conference is of personal interest because of its location or the professional opportunities it offers.

Federal tax law places additional limitations on the aggregate amount of deductions, such as this one, which can be claimed by a taxpayer with AGI over $100,000. California does not conform to these additional limitations. ◆

Deduction for Depreciation in Excess of Straight-Line Depreciation

Program Type: *PIT and B&C*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	NA	NA
1990-91	NA	NA
1991-92	NA	NA

Authorization

California Revenue and Taxation Code Section 17201, which conforms to federal Internal Revenue Codes 167 and 168, and California Revenue and Taxation Code Sections 24349 and 24354.1.

Description

Depreciation deductions enable taxpayers to recover their investments in income-producing assets, such as equipment and buildings, over specified periods of time. This program allows taxpayers to claim depreciation deductions in excess of "straight-line" depreciation on physical assets that are used in the production of income.

Under the time-honored "straight-line" depreciation method, a property's value is depreciated evenly over its useful economic life span. This program permits several alternative, more generous, accelerated depreciation methods to be used. The methods permitted vary, depending on the type of property and when it is placed in service. These alternative methods include (1) the 200-percent, 150-percent, and 125-percent "declining balance" methods; (2) the "sum-of-years-digits" method; and (3) other methods, such as the "sinking-fund" method. Such accelerated depreciation methods enable taxpayers to recover the costs of replacing their income-producing capital assets sooner than otherwise, through the deferral of tax liabilities, and thereby realize an increased rate of return on their investments.

Example

A taxpayer purchases a machine for use in his or her business for $20,000. The machine has a useful life of 20 years, after which its salvage value will be $2,000. Under the straight-line method, the taxpayer may claim a depreciation deduction of $900 per year. In contrast, under the 200-percent declining balance method, for example, the taxpayer could claim an annual depreciation allowance that is twice the percentage amount permitted under the straight-line method. Thus, the first year's depreciation allowance for this property would be $1,800.

Rationale

This program, by enabling taxpayers to defer some of their tax liabilities, provides an incentive for taxpayers to invest in income-producing assets. This is because the deferral of tax liabilities amounts to an interest-free loan from the government, which increases the rate of return on capital investments. In addition, such tax deferments reduce investment payback periods, thus improving the financial liquidity of investors. The program also is sometimes rationalized on the grounds that it compensates property owners for the failure of the tax code to adjust the depreciable basis of property upward over time for the effects of inflation.

Comments

In theory, depreciation allowances are intended to permit taxpayers to deduct the true economic costs of using an asset in the production of their income. Another way of looking at this is that depreciation allowances compensate taxpayers for the loss in productive capability of their income-producing property as it ages, so that, at the end of the property's life, the accumulated depreciation benefits permit it to be replaced. The revenue loss from this program is generally considered to be the cost of depreciation methods above and beyond the straight-line method. From a pure economic perspective, however, the technically correct measure of depreciation-related tax expenditure costs is the amount by which actual depreciation claims (however computed) exceed pure economic depreciation (that is, the decline in physical productivity of an asset) over time. This technically correct tax expenditure amount tends to be less than that reported above, because the tax code does not adjust the depreciable basis of property for inflation. ◆

Accelerated Depreciation Deduction for Child Care Facilities

***Program Type:* B&C only**

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*B&C Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 24371.5.

Description

This program allows corporations to depreciate the costs of their qualified child care facilities over a shortened 60-month period, using the straight-line depreciation method and no salvage value. In the absence of this program, the depreciation period for such facilities would generally amount to 10 years for personal property or 45 years for real property. This treatment is available only for child care facilities provided by an employer for use by employees.

Rationale

This program is intended to give employers a financial incentive to build or provide child care facilities for their employees. It does this by accelerating depreciation deductions so as to defer tax liabilities. This amounts to an interest-free loan from the government, which reduces the employer's costs of providing child care facilities.

Comments

This program was available under Personal Income Tax Law through 1987. Federal tax law has a similar program; however, it applies to expenditures incurred on facilities prior to 1982. ✦

Accelerated Depreciation Deduction for Low-Income Housing

Program Type: *B&C only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*B&C Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 17201 and 24354.2.

Description

This program allows taxpayers to depreciate the cost of rehabilitating low-income housing over a 60-month period, instead of over the longer period that otherwise would apply (up to 40 years, depending on the type of property). In order to qualify for this program, rehabilitation-related expenditures must have been made after December 31, 1970 and prior to January 1, 1987. Thus, this program is not available for projects started after January 1, 1987, although benefits will be realized by program beneficiaries through the 1992 income year. The expenditures eligible for this treatment are generally limited to $20,000. Programs certified by the federal and state government may depreciate $40,000 of eligible expenditures under this program.

Rationale

This program is intended to give property owners an incentive to upgrade or rehabilitate rental housing facilities that are occupied by low-income tenants. It accomplishes this by using accelerated depreciation as a means of deferring taxes. This amounts to an interest-free loan from the government, which, in turn, increases the rate of return on the investment expenditures associated with such projects and shortens their payback period.

Comments

The 1986 Federal Tax Reform Act established a new tax credit program to promote the development of low-income housing (which California also has adopted). This tax credit program is available to compensate developers for the costs of construction and/or rehabilitation of low-income housing incurred after January 1, 1987. The amount of state tax credits available under this program is currently capped at $35 million annually, and must be allocated by the Tax Credit Allocation Committee to specific development projects. ♣

Accelerated Depreciation Deduction for Cogeneration and Alternative Energy Equipment

Program Type: *PIT and B&C*
Sunset Date: *January 1, 1986*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	NA	NA
1990-91	NA	NA
1991-92	NA	NA

Authorization

California Revenue and Taxation Code Sections 17250, 17251 and 24372.

Description

This program allows taxpayers to amortize the cost of qualifying cogeneration and alternative energy equipment over a 60-month period using the "straight-line" depreciation method, with an option to use a 12-month depreciation period if the equipment is located in California. In the absence of this program, such costs would be depreciable over periods as long as 12 years.

The term "alternative energy" is defined for the purposes of this program as equipment used to produce or convert energy from the following sources: cogeneration, solar energy, geothermal, biomass, and small hydroelectric facilities. To qualify under the program, the equipment cannot rely on either fossil fuel or nuclear fuel as its primary fuel source. The program applies only to equipment placed in service before January 1, 1986. Thus, this program is not available for equipment placed in service after January 1, 1986, although benefits will be realized by program participants through the 1988 income year.

Rationale

This program provides an incentive for taxpayers to invest in property that conserves energy or utilizes alternative or renewable energy sources. The rationale for this program is the belief that it is important to promote more efficient uses of energy and reduce the state's dependence on fossil fuels, including imported oil. The program attempts to do this by permitting rapid depreciation of equipment costs, so as to enable taxpayers to, in effect, defer their taxes. The tax deferral amounts to an interest-free loan from the government which, in turn, increases the real rate of return on the investment expenditures. By implicitly reducing the payback periods for such investments, the program also helps to offset some of the risk inherent in them.

Comments

The economic and fiscal effects of this program were reviewed in two reports prepared by the Legislative Analyst's Office (see *Cogeneration Equipment Investments: The Effects of Rapid Amortization*, June 1985, 40 pages; and *Alternative Energy Equipment Investments: The Effects of Rapid Amortization*, December 1985, 40 pages). These reports recommended that the program not be extended because it had not stimulated much new investment in alternative energy and cogeneration equipment in California. ❖

Accelerated Depreciation Deduction for Pollution Control Equipment

Program Type: *B&C only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*B&C Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 17250 and 24372.3. California law is generally equivalent to federal law.

Description

This program allows taxpayers to depreciate the cost of pollution control facilities over a 60-month period, as opposed to a period of over 10 years which would otherwise apply. Qualifying facilities must be located within California and be appropriately certified by the California Department of Health Services.

Rationale

This program provides tax relief for businesses that are required by federal, state, and local regulations to install pollution control equipment. This tax relief takes the form of allowing taxpayers to, in effect, defer some of their tax liabilities by giving them larger depreciation write-offs during the early years following an investment in qualifying pollution control equipment. The tax deferral amounts to an interest-free loan from the government, which, in turn, increases the financial ability of taxpayers to make such required investments. ❖

Accelerated Depreciation for Reforestation Expenditures

Program Type: B&C only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*B&C Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections17201 and 24372.5,which conform to federal Internal Revenue Code Section 194.

Description

This program allows taxpayers to amortize over a seven-year period up to $10,000 per year of certain qualifying reforestation expenditures. Qualifying expenditures include the direct costs of forestation and reforestation, including seeds, labor, and equipment costs. In the absence of this program, reforestation expenditures would be recoverable only at the time timber is harvested.

Rationale

This program apparently is intended to give taxpayers an incentive to reforest private lands where logging and timber-related activities have depleted available stocks of timber. Thus, the program provides an incentive for increasing the future supply of harvestable timber. It accomplishes this by permitting taxpayers to recover their capital costs more quickly, thereby deferring tax liabilities. The tax deferral amounts to an interest-free loan from the government, which, in turn, increases the rate of return on such investments. Rapid amortization for activities with lengthy payoff periods, such as reforestation, also dramatically improves the cash-flow position of investors, and, thus, their financial liquidity.

Comments

California conformed to federal provisions in 1983. Prior to 1983, California taxpayers were allowed to amortize reforestation expenditures over a five-year period. ◆

Accelerated Depreciation Deduction for Property Used in Economically Depressed Areas

Program Type: PIT and B&C

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	NA	NA
1990-91	NA	NA
1991-92	NA	NA

Authorization

California Revenue and Taxation Code Sections 17252.5, 17265, and 24356.2.

Description

This program allows taxpayers to claim accelerated depreciation write-offs for certain business property used in designated economically depressed areas of the state, including "enterprise zones" and employment-incentive "program areas." Qualifying property includes, among others, that used for the production of pollution control devices and the production of renewable energy resources. In general, the program permits a taxpayer to "expense" (that is, immediately deduct as a current business-related expense) a certain portion of the costs of these types of property.

Rationale

This program provides an incentive for taxpayers to make business investments in economically depressed areas of the state. It does this by enabling taxpayers to use expensing to defer tax liabilities. This deferral amounts to an interest-free loan from the government, which, in turn, increases the rate of return on taxpayers' investments and improves their cash-flow position. The underlying rationale for this program is that the stimulation of investment in economically depressed areas can lead to improved economic conditions which yield various social benefits, including reduced state costs for unemployment and welfare benefits.

Comments

Taxpayers are permitted to expense a certain portion of the cost of qualified property under this program. In the case of property located in a "program area," a taxpayer can deduct (as an expense) 40 percent of the cost of the property, subject to a dollar limit of $100,000 in years one and two of the area's designation, $75,000 in years three and four, and $50,000 thereafter. The remaining 60 percent of a property's depreciable basis is subject to write-off using standard depreciation options.

In the case of property located in "enterprise zones," qualifying property may be expensed up to a maximum dollar deduction of $5,000 in years one and two, $7,500 in years three and four, and $10,000 thereafter.

In the case of property used in the production of pollution control devices and reusable resources, qualifying property includes machinery and machine parts used for fabricating, processing, assembling, and manufacturing machinery and parts used for the production of renewable resources or of air or water pollution control devices.

It should be noted that the statutory authorization for this program is worded somewhat ambiguously. In particular, taxpayers may have some difficulty discerning whether the expensing provision relating to pollution control equipment applies to pollution control equipment itself *located* in a qualifying depressed area, property located in such areas that is used to *produce* pollution control equipment, or properties *not* located in such areas that are used to produce pollution control equipment *used* in such areas. Given this ambiguity, it is possible that expensing is being claimed by certain taxpayers who do not actually qualify for it. ❖

Expensing of Agricultural Costs

Program Type: *PIT and B&C*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$8	$4
1990-91	8	4
1991-92	8	2

Authorization

California Revenue and Taxation Code Sections 17201 and 24369, which conform to Section 172 of the federal Internal Revenue Code.

Description

This program allows taxpayers to "expense" (that is, deduct as a current business-related expense) soil, water conservation, and fertilizer expenditures, up to a maximum of 25 percent of their gross income from farming. Any qualified expenses in excess of the 25 percent limitation, however, may be carried forward and expensed in future years.

In the absence of this program, the qualifying expenditures would be considered capital expenditures to be written off during the period when the income resulting from the expenditures is realized (that is, when farm products are sold), using standard depreciation rules.

Rationale

This program provides a tax incentive to encourage certain types of farming-related conservation investments, particularly those with lengthy development and payback periods. The program accomplishes this by allowing very rapid cost write-offs that, in effect, permit the deferral of taxes on farming income. This amounts to an interest-free loan from the government, which, in turn, raises the rate of return on qualifying investments and shortens their payback periods. The program also has been rationalized as a way of simplifying record-keeping for small farming businesses.

Comments

Qualifying expenditures include those for the treatment or moving of earth (including leveling, grading, furrowing, and other improvements); the fertilization of land; the construction of water channels, drainage ditches, and similar water conservation projects; the eradication of brush; and planting of windbreaks.

The 1986 Federal Tax Reform Act restricted a taxpayer's ability to expense agricultural costs for federal tax purposes to those expenditures which are consistent with a soil conservation plan approved by the Soil Conservation Service of the Department of Agriculture, and California has adopted these limitations as well. ◆

Expensing of Employer Ridesharing Program Costs

Program Type: PIT and B&C

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	NA	NA
1990-91	NA	NA
1991-92	NA	NA

Authorization

California Revenue and Taxation Code Section 24343.5.

Description

This program allows taxpayers to "expense" (that is, immediately deduct as a current business-related expense) costs associated with providing ridesharing programs for employees. The deduction covers a taxpayer's expenses to provide for company commuter vans or bus service to employees; subsidizing employee commuting expenses in third-party vanpools, private commuter busses, or subscription taxipools; free parking facilities for carpools; and certain other ridesharing programs. In addition, taxpayers are allowed an accelerated (36-month) depreciation deduction for costs of facility improvements for employee ridesharing, bicycling, and walking programs.

Rationale

This program provides an incentive for employers to establish ridesharing programs for their employees. It does this by allowing employers to partially offset their costs for sponsoring such programs by deferring tax payments. The program is based on the belief that state tax incentives are needed to encourage employees and employers to use ridesharing programs so as to alleviate traffic congestion, reduce air pollution, and reduce gasoline consumption.

Comments

California law now allows taxpayers to claim a tax credit for a portion of those expenses incurred in providing ridesharing programs for employees. Any amount claimed as a tax credit cannot be claimed as an expense under this program.

It is possible that certain noncapital ridesharing expenses, such as subsidies for monthly transit passes, may be deductible by the employer as a business expense, even without this program. This is because an employer may consider such expenses to be "ordinary and necessary" in some situations and, therefore, deductible as a regular business expense. Thus, in some cases, employers benefit from the program only to the extent that it allows them to recover their costs for *capital-related* ridesharing expenditures (such as for vehicles and facilities) over a shorter-than-normal period.

The expensing of employer ridesharing costs was originally authorized by Ch 25/82 (AB 548, Ryan), and was allowed for income years 1981 through 1985. Ch 1444/86 (SB 1794, Beverly), which reinstated the program through 1991, was repealed in 1987 and replaced with the current-law provisions of Ch 1437/88 (SB 1904, Morgan). ◆

Expensing of Exploration, Development, Research, and Experimental Costs

Program Type: PIT and B&C

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$20	$45
1990-91	25	50
1991-92	20	70

Authorization

California Revenue and Taxation Code Sections 17260, 17601, 24423, and 24365. California law is generally equivalent to federal law.

Description

This program allows taxpayers to "expense" (that is, immediately deduct as a current business-related expense) the cost of research and experimental activities, and qualified mining-related exploration and development costs for mines and mineral deposits.

Research and Experimental Activities. The program applies to business expenditures to develop or create an asset that has a useful life of more than one year, such as expenditures to develop a new consumer product or improve a production process. In the absence of this program, these expenditures would be capitalized and subsequently recovered through depreciation deductions spread over the life of the asset.

Exploration and Development Activities. Qualified exploration and development activities include those in connection with a mine or other mineral deposit. In addition, taxpayers may elect to expense intangible drilling and development costs of oil, gas, and geothermal wells.

Rationale

This program provides an incentive for taxpayers to undertake research and experimental projects, and to locate and recover minerals from the earth by enabling them to more quickly deduct their associated costs. This quicker deduction, in effect, enables taxpayers to defer their taxes. The tax deferral amounts to an interest-free loan from the government, which, in turn, raises the real rate of return on qualifying expenditures and improves the taxpayer's cash-flow position. The underlying rationale for the program is that research and experimental projects and exploration and development activities, while often of great long-term importance to the state and its citizens, are inherently risky, and often do not generate any income for the taxpayer until a considerable period of time has passed. ◆

Expensing of Circulation Costs for Periodicals

Program Type: PIT and B&C

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	PIT Amount	B&C Amount
1989-90	Minor	Minor
1990-91	Minor	Minor
1991-92	Minor	Minor

Authorization

California Revenue and Taxation Code Sections 17201 and 24364, which conforms to federal Internal Revenue Code Section 173.

Description

This program allows taxpayers to "expense" (that is, deduct immediately as a current business-related expense) their costs for establishing, maintaining, or increasing the circulation of a periodical. Alternatively, the program allows such costs to be amortized over a three-year period. In the absence of this program, these costs would have to be capitalized, and then amortized over whatever period of time the taxpayer was able to determine the expenditure resulted in increased income.

Example

A taxpayer spends $100,000 for advertising and promotional activities during the current year in order to increase the circulation of a magazine the taxpayer publishes. The taxpayer can deduct the entire $100,000 as an expense on his or her current-year tax return or, if the taxpayer prefers, deduct it over a three-year period.

Rationale

There is no apparent rationale for this program strictly from the standpoint of providing tax incentives or tax relief. Rather, the rationale appears to be administrative in nature, and relates to the difficulty of identifying exactly when the benefits of circulation-related expenses are realized. In principle, these costs should be deductible when the benefits they generate are experienced in the form of increased income. In practice, however, it often is difficult to determine which individual periodical subscriptions result from advertising or promotional expenses, including how to treat multiple renewals of subscriptions over time. For this reason, it is simpler from a tax administration perspective not to require taxpayers to capitalize their costs, but rather to allow taxpayers to deduct them either immediately or over a fairly moderate, specified time period. ◆

Carry Forward of Net Operating Losses

Program Type: *PIT and B&C*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$54	$412
1990-91	49	427
1991-92	67	474

Authorization

California Revenue and Taxation Code Sections 17276, 17276.1, 17276.2, 24416, 24416.1, and 24416.2, which partially conform to federal Internal Revenue Code Section 172.

Description

This program allows taxpayers to carry forward, for up to 15 years, a portion of their net operating losses. Generally, most businesses may carry forward 50 percent of their "excess" net operating losses in any given year (that is, the unrecovered losses that exceed their taxable incomes in that year) to offset their income in the following 15 years, and thereby reduce their cumulative state tax liabilities. Businesses operating in certain geographic locations designated as "Enterprise Zones" or "Economic Incentive Program Areas" may carry forward 100 percent of their net operating losses, and use them to offset income earned in future years attributable to those designated areas. This treatment is also available for farming and new small businesses.

Example

A business incurs an excess net operating loss of $70,000 during one tax year. The business earns a net profit of $25,000 in the second year and $40,000 in the third year. Under this program, the taxpayer can apply $25,000 in losses to his second-year profits, thus completely eliminating his tax liability in that year. In addition, he can apply the $10,000 in net operating losses "left over" to his third-year profits, reducing his taxable income in that year to $30,000.

Rationale

This program is intended to provide tax relief for businesses that incur operating losses. In addition, it is an attempt to recognize that a taxable year is an arbitrary period of time with respect to measuring income and losses. For example, a firm might incur expenses in an early year (that result in net operating losses), in order to produce income (resulting in profits) in a later year. From an economic perspective, these losses and profits are related, and basing the firm's tax only on its reported net profits in individual years overstates the net economic income resulting from the investment in later years.

This program was established by Ch 1138/87 (AB 53, Klehs), which partially conformed state tax law to the Federal Tax Reform Act of 1986. ❖

Percentage Allowance for Depletion of Mineral and Other Natural Resources

Program Type: PIT and B&C

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$16	$19
1990-91	16	22
1991-92	16	26

Authorization

California Revenue and Taxation Code Sections 17683, 24832, and 24833.

Description

This program allows taxpayers to claim a fixed percentage deduction for resource depletion, which generally proves to be in excess of the deduction amount that otherwise would be allowed under the normal cost-depletion method. Under the program, a specified percentage of gross income (depending on the type of resource involved) may be deducted as a depletion allowance, except that this depletion amount cannot exceed 50 percent of a taxpayer's related net income before applying the depletion deduction.

For oil, gas, and geothermal wells, the allowable depletion percentage is 22 percent. However, the dollar deduction cannot exceed $1.5 million, and the computed 22 percent deduction amount must be reduced by 125 percent of the amount by which it exceeds $1.5 million. Thus, for example, no deduction is allowed if the 22 percent depletion amount is equal to $7.5 million. The allowable depletion percentage for minerals ranges from 5 percent to 22 percent, depending on the type of mineral.

Example

A taxpayer owns and operates an oil well that produces $100,000 in gross income. Under this program, the taxpayer is allowed to claim a deduction for 22 percent of this amount ($22,000), which is intended to offset the physical and economic resource costs associated with depleting the oil reserves in the well.

Rationale

This program provides an incentive for taxpayers to explore for and develop oil, gas, and other mineral resources. The underlying rationale for this is that such activities, which are important to the future of the state's economy, also can be extremely costly and inherently risky.

Comments

"Percentage depletion" differs from "cost depletion." Cost depletion allows for the recovery of the initial costs of discovering, purchasing, and developing mineral reserves over the period during which a reserve produces income. In addition, each year the taxpayer deducts the portion of his/her cost that is proportional to the fraction of the resource reserve that has been depleted in that year. Thus, under cost depletion, the amount of cost recovered through depletion allowances cannot exceed the original cost of acquiring and developing the reserve. In contrast, under the percentage depletion method, a taxpayer deducts a fixed percentage of gross income from the reserve as a depletion allowance, regardless of the amount actually invested.♦

Reserve Method Deduction for Bad Debts

Program Type: B&C only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*B&C Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 24348.

Description

This program allows financial institutions to elect to use the "reserve method" for deducting their losses from bad debts. Under this method, a deduction is allowed for a reasonable addition to what is known as a "bad debt reserve account." These are accounts set up by the taxpayer as an allowance against the possibility that some debts may later prove to be uncollectible. The amount allowed in the account is generally based on the taxpayer's past experience with bad debts.

During a given year, debts that become uncollectible are charged against a taxpayer's bad debt reserve, which reduces the balance in the reserve. The taxpayer makes additions to the reserve account to (1) offset the amount of bad debts which have been charged off and (2) allow for future bad debt charge-offs (attributable to increases in accounts receivables). The deduction is allowed for both of these kinds of additions to a bad debt reserve.

In the absence of the program, the taxpayer would be required to use the "specific charge-off method," under which the taxpayer would deduct bad debts only when they are determined to be uncollectible.

Rationale

This program provides tax relief to financial institutions who incur bad debts, to the extent that it allows them to claim a deduction for bad debt losses prior to the time the losses actually occur. The tax relief takes two forms. First, the early claiming of bad debt losses increases the "present value" of the deduction for bad debts to the taxpayer. Second, by "spreading" out deductions for bad debts, the program lessens the chance that a taxpayer will be unable to deduct the full amount of such debts.

Comments

According to federal reports, the federal deduction (to which California generally has conformed) for bad debt reserves was first allowed in 1947, when there was fear of a postwar economic downturn. It was intended to reflect the banking industry's experience with bad debts during the depression period.

The Federal Tax Reform Act of 1986 prohibits most corporations from using the reserve method for determining the deduction for bad debts, beginning in 1987. However, the reserve method still will be allowed for commercial banks whose assets do not exceed $500 million and for thrift institutions.

Chapter 600, Statutes of 1986 (SB 85), conformed California tax law to the 1986 federal provisions as they apply to nonfinancial institutions. Thus, for state tax purposes, financial institutions will continue to qualify for this program.❖

Subchapter S Corporations

Program Type: B&C only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*B&C Amount*
1989-90	$430
1990-91	480
1991-92	540

Authorization

California Revenue and Taxation Code Sections 23800 through 23811, which partially conform to federal Internal Revenue Sections 1361 through 1379.

Description

This program allows eligible small business corporations to elect "S" corporation status for purposes of determining their tax liability. "S" corporations pay taxes on corporate income at a reduced rate of 2.5 percent. In addition, however, individual shareholders of an "S" corporation pay personal income taxes on their pro rata share of corporate income.

By contrast, a regular (or "C") corporation pays taxes on corporate income at a rate of 9.3 percent. Corporate shareholders, in contrast, pay taxes on corporate earnings only to the extent that such earnings are paid out of dividends.

In order to be eligible to elect "S" corporation status, the corporation must have (1) a valid federal "S" election in effect, (2) fewer than 35 shareholders, and (3) only one class of stock. Those corporations which meet these criteria and make a federal "S" election are deemed to have made an "S" election for state purposes as well. A corporation may make a separate state election to be treated as a "C" corporation for state tax purposes, however, even if a federal "S" election has been made.

Rationale

This program is intended to provide tax relief to small corporations while still allowing them to take advantage of the limited liability aspect of corporate status. Generally, businesses that make an "S" election pay less taxes than they would as "C" corporations.

Comments

Under federal law, an election of "S" corporation status completely eliminates any tax liability of the corporation. All income and expenses are passed through to shareholders, and net income is taxed on a pro rata basis as if it were individual income. ✦

Personal Exemption Tax Credit

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$751
1990-91	772
1991-92	831

Authorization

California Revenue and Taxation Code Section 17054.

Description

This program allows all taxpayers to claim a personal tax credit. The amount of the credit depends on a taxpayer's filing status, and the credit amount is indexed annually based on the June-to-June change in the California Consumer Price Index. For 1990, the credit amounts are $58 for single-return taxpayers and $116 for joint-return taxpayers.

Nonresidents who are required to file California tax returns are allowed partial personal exemption credits, based on the ratio of their California adjusted gross income (AGI) to their total AGI.

Rationale

This program provides broad-based tax relief to California taxpayers.

Comments

Federal law allows exemptions in the form of *deductions* from AGI, instead of as tax credits. The 1990 federal exemption amount is $2,050 per taxpayer, taxpayer's spouse, and each dependent. ❖

Dependent Exemption Tax Credit

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$297
1990-91	326
1991-92	350

Authorization

California Revenue and Taxation Code Section 17054.

Description

This program allows taxpayers to claim a tax credit for each of their dependents. The allowable credit amount is indexed annually for inflation, based on the June-to-June increase in the California Consumer Price Index. For 1990, the credit amount was $58 per dependent.

Rationale

This program provides tax relief to taxpayers who are financially responsible for the support of dependents, such as children. The apparent rationale for this is that such financial responsibilities reduce the ability of individuals to pay taxes.

Comments

Federal law allows taxpayers to claim an exemption *deduction* from adjusted gross income for their dependents, instead of tax credits. In 1990, the federal exemption deduction for a dependent is $2,050. In general, California allows a dependent credit for everyone for whom a federal dependent exemption is allowed. ❖

Blind Exemption Tax Credit

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$1
1990-91	1
1991-92	1

Authorization

California Revenue and Taxation Code Section 17054.

Description

This program allows a taxpayer who is blind to claim an additional personal exemption tax credit. The amount of this credit (which is indexed annually for inflation) is $58 in 1990.

Rationale

This program provides tax relief to those who are blind.

Comments

Federal law provides an additional standard deduction from adjusted gross income (AGI) instead of a tax credit to blind taxpayers, under Internal Revenue Code Section 63 (f). In 1990, the amount of this deduction was $650 for married individuals (whether filing separately or jointly) and surviving spouses, and $800 for single individuals. ❖

Senior Exemption Tax Credit

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$72
1990-91	78
1991-92	85

Authorization

California Revenue and Taxation Code Section 17054.

Description

This program allows taxpayers over the age of 65 to claim an additional personal exemption tax credit. The amount of this credit (which is adjusted annually for inflation) is $58 in 1990. In the case of a husband and wife filing a joint return, if both are over the age of 65, the amount of the credit is equal to $116 in 1990.

Rationale

This program provides tax relief to those over the age of 65.

Comments

Federal law allows an additional standard deduction from adjusted gross income for taxpayers age 65 or over. The amount of this deduction is $650 for married individuals (whether filing separately or jointly) and surviving spouses, and $800 for single individuals. ❖

Tax Credit for Child and Dependent Care Expenses

Program Type: *PIT only*
Sunset Dates: *Employment-Related Dependent Care Expenses - December 1, 1993; Parental Dependent Care Expenses - December 1, 1994*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$146
1990-91	166
1991-92	178

Authorization

California Revenue and Taxation Code Section 17052.6, which partially conforms to federal Internal Revenue Code Section 21, and California Revenue and Taxation Code Section 17052.20.

Description

This program allows taxpayers to claim a tax credit for a portion of the costs they incur in providing care for their children. The credit may be claimed by persons who either (1) incur direct costs for child care because they are working or (2) incur opportunity costs of foregone earned income because they have decided to stay home to care for a child.

Parents Who Work. The allowable credit amount in this case equals a specified percentage, based on the taxpayer's adjusted gross income (AGI), of a corresponding federal credit for child and dependent care expenses. The current federal credit ranges from 20 percent to 30 percent of qualifying expenses, again depending on AGI, with the credit percentage declining as AGI rises. The effective state credit ranges from 6 percent to 9 percent of qualifying expenses for persons with AGI of $40,000 or less, again declining as AGI rises. The credit percentage then further decreases proportionally as the AGI rises above $40,000.

Any credit in excess of the taxpayer's tax liability may be carried forward into succeeding tax years until the credit is exhausted, or unless the qualified parent becomes employed and elects to use the employment-related credit option.

Parents Who Stay Home. A credit of $1,000 is available to a taxpayer who decides to forego earned income in order to stay at home and take care of a dependent child under the age of 13 months. In the event that this individual receives unearned income (such as interest or dividend income), the credit is reduced by $200 for every $1,000 over the AGI level of (1) $40,000, if the qualified parent is married and filing a joint return or is a surviving spouse, or (2) $28,500 if the parent is the sole head of household.

Rationale

This program is intended to provide tax relief to individuals who must obtain care services for children in order to be able to work or look for jobs, and for those parents who desire to stay home to care for their children. By linking the amount of the credit to a taxpayer's AGI, both state and federal law attempt to target the tax relief to taxpayers with low or moderate incomes. These persons often are least able to pay for child care services. Many of these persons must work, while others might not be able to enter or remain in the labor force without child care assistance.

Comments

Prior to 1985, California's credit was not tied to the federal credit. The current credit amounts were established by Ch 1347/90 (SB 2208, Morgan). This program goes into effect as of January 1, 1991. ◆

Tax Credit for the Low-Income Elderly

Program Type: PIT only
Sunset Date: January 1, 1992

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$3
1990-91	3
1991-92	4

Authorization

California Revenue and Taxation Code Section 17052.9, which partially conforms to federal Internal Revenue Code Section 22.

Description

This program allows a special tax credit to be claimed by taxpayers who are over 65 years of age or permanently and totally disabled. The allowable credit amount is 50 percent of the federal credit available to these taxpayers. Special provisions, however, apply to government retirees who receive public pension benefits.

The basic federal credit equals 15 percent of "base" income, which is defined as (1) $5,000 for a single-return taxpayer and $7,500 for a joint-return taxpayer where both spouses qualify, minus (2) the amount of nontaxable social security benefits received, and further reduced by (3) one-half of adjusted gross income (AGI) in excess of $7,500 for a single-return taxpayer and $10,000 for a joint-return taxpayer.

Rationale

This program provides tax relief to elderly taxpayers who have limited income. The rationale for this is that the ability of such individuals to pay taxes often is limited, given their income constraints and their need to provide for special retirement expenses, such as health care.

Comments

Because of the way that "base income" is defined, the credit generally phases out automatically at an income level of $17,500 for single-return taxpayers and $25,000 for joint-return taxpayers. Of course, because the credit is nonrefundable, it provides no benefits for individuals who have no tax liabilities. ◆

Tax Credit for Renters

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
	PIT
Fiscal Year	*Amount*
1989-90	$514
1990-91	477
1991-92	501

Authorization

California Revenue and Taxation Code Section 17053.5.

Description

This credit allows qualified renters to claim a refundable tax credit of $120 for joint-return, head-of-household, and surviving-spouse taxpayers, and $60 for single-return taxpayers.

The renter's credit is the only state tax credit that is refundable. The costs for the credit are funded through a transfer in the annual Budget Act from the General Fund to the Tax Relief and Refund Account. For budgetary purposes, the renter's credit claims are treated as a General Fund *expenditure*, rather than as a General Fund revenue loss, as explained below. In principle, however, the program is a tax expenditure, since its underlying rationale is tax-related.

Rationale

The renter's credit provides tax relief to renters, and is intended to offset the property taxes that renters indirectly pay through their rental payments. The credit is perceived as the renters' tax equivalent of the itemized deduction for property taxes that owners of homes are allowed to claim. Although landlords actually pay the property taxes on rental properties and get to deduct them as a business expense, it is generally acknowledged that such payments are incorporated into the rents paid by tenants. Thus, in the absence of this program, renters would be treated inequitably relative to homeowners.

Comments

The renter's credit was established by Ch 1406/72 (SB 90, Dills). The original renter's credit ranged from $25 to $45, depending on adjusted gross income. Chapter 99, Statutes of 1976 (AB 282, Brown), subsequently specified fixed dollar amounts for the credit, which were subsequently increased to $60 (single) and $137 (married and head-of-household taxpayers) by Ch 1207/79 (AB 1151, Roos). Chapter 1537, Statutes of 1982 (AB 2520, Sher), established a separate credit amount of $99 for joint-custody head-of-household taxpayers. This separate amount for joint-custody head-of-household taxpayers was eliminated by Ch 1138/87 (AB 53, Klehs). The current credit amounts represent a reduction from $137 to $120 for married couples filing joint returns, heads of households, and surviving spouses. The $60 credit for single taxpayers has remained the same.

The reason this program is funded through an annual General Fund appropriation relates solely to the now-defunct Federal Revenue Sharing (FRS) Program. Under that program, the amount of federal funds available to the state depended partially on its level of "tax effort" relative to other states, which was computed by taking into account the state's level of revenue collections. Thus, by funding the renter's credit through an appropriation instead of a revenue reduction, the state was able to show a greater "tax effort" and thereby increase its revenue-sharing allocation. Since the FRS Program no longer exists, this funding logic is no longer valid. ◆

Tax Credit for Low-Income Individuals

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$20
1990-91	21
1991-92	22

Authorization

California Revenue and Taxation Code Section 17069.

Description

This program allows taxpayers with low levels of adjusted gross income (AGI) to claim a nonrefundable tax credit for up to 100 percent of their state tax liability. The allowable credit percentage declines as a taxpayer's AGI rises, until an income threshold is reached where the credit completely phases out. In 1990, this phase-out AGI threshold is $10,960 for single, married-filing-separately, or head-of-household taxpayers, and $21,900 for married taxpayers filing jointly and surviving spouses. The income thresholds are indexed annually for inflation.

Example

A joint-return taxpayer has total AGI of $20,000 and claims the standard deduction. The applicable low-income credit for 1990 for a taxpayer with AGI between $19,810 and $21,900 is 20 percent. The net tax for this taxpayer is $112. Thus, this taxpayer's allowable low-income credit is $22 (20 percent of $112).

Rationale

This program provides tax relief to low-income individuals, under the rationale that these persons have the least "ability to pay" taxes due to their limited resources.

Comments

The low-income credit was first available in 1973. In 1976, it was changed from a percentage credit to a fixed dollar amount. The credit amount was indexed for inflation, beginning in 1978; however, the income thresholds were not indexed. As a result, by 1984 the credit had ceased to have any practical value, because it phased out at income levels below which no taxes were owed. In 1985, Chapter 1461, Statutes of 1985 changed the thresholds and indexed their brackets so that the credit would maintain its value over time.

The low-income credit is not allowed for estates or trusts, or for anyone who is required to pay the alternative minimum tax.

A comparable federal low-income credit is not available. However, there is a federal earned-income credit, which is available to low-income workers who meet specified requirements. This federal credit, as modified by the 1986 Tax Reform Act, equals 14 percent of earned income up to $6,500 of income, then phases out as income rises, until it disappears altogether for earned income or AGI of $19,340 or more, effective as of 1989. ◆

Tax Credit for Solar Energy Systems

***Program Type:** PIT and B&C*
***Sunset Date:** December 1, 1994*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$17	$6
1990-91	18	7
1991-92	18	7

Authorization

California Revenue and Taxation Code Sections 17052.5 and 23601.5.

Description

This program allows taxpayers to claim a tax credit for a portion of the costs of qualifying solar energy systems. The current provision allows for a credit of 10 percent of the cost of solar energy systems installed on commercial premises. In general, the credit applies to systems generating fewer than 30 megawatts of power. However, the credit also applies to larger systems in any year that federal law allows a credit for such systems. For 1991, federal law does allow such credits. The program will remain in effect until December 1, 1994.

Rationale

This program provides an incentive for taxpayers to install solar energy systems and thereby (1) reduce their consumption of fossil fuels and (2) provide markets for such systems. It has been argued that the credit is necessary to allow solar energy to effectively compete with other energy sources in the

Comments

The solar credit was originally enacted by CH 168/76 (SB 216, Alquist). Systems installed between 1976 and 1983 qualified for a 55-percent credit, with a dollar-for-dollar offset against any similar federal credits claimed. Chapter 323, Statutes of 1983 (AB 223, Vasconcellos), extended the sunset date from 1983 to 1987 and reduced the credit amount to 50 percent for residential systems and 25 percent for nonresidential systems. Chapter 1325, Statutes of 1985 (SB 243, Presley and Rosenthal), reduced the credit to 10 percent. Chapter 1139, Statutes of 1987 (SB 572, Garamendi), extended the credit through 1989 for systems installed on commercial property only, and Ch 1291/89 (SB 227 Garamendi), further extended the sunset date to December 1, 1994. ◆

Tax Credit for Low-Emission Fuel Conversion Costs

***Program Type:** PIT and B&C*
***Sunset Date:** February 1, 1995*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	Minor	Minor
1990-91	Minor	Minor
1991-92	Minor	Minor

Authorization

California Revenue and Taxation Code Sections 17052.11 and 23603.

Description

This program allows taxpayers to claim a 55-percent credit for the cost of converting new or used vehicles to "low-emission" vehicles. This credit is limited to a maximum of $1,000 per automobile or motorcycle and $3,500 for vehicles weighing more than 5,750 pounds. A low-emission vehicle is one which is certified to meet hydrocarbon emission standards at least twice as stringent as those applicable to gasoline-powered vehicles of the same model year and class.

Rationale

This program is intended to give taxpayers a financial incentive to use low-emission vehicles. The underlying objectives are to (1) reduce reliance on petroleum products, especially imported products, and (2) encourage development of technologies that use alternative fuel sources.

Comments

This credit was established in 1981 by Ch 1085/81, and is effective for income years 1981 through 1994. California law provides that, if a comparable federal credit is enacted, the state credit will be reduced by a corresponding amount. ❖

Tax Credit for Prison Inmate Labor Costs

***Program Type:** PIT and B&C*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	–	–
1990-91	–	–
1991-92	Minor	$1

Authorization

California Revenue and Taxation Code Sections 17053.6 and 23624.

Description

This program allows employers a tax credit equal to 10 percent of the wages they pay to each state prison inmate employed in a joint venture program for the purpose of producing goods or services. For purposes of this program, a joint venture employer is any public entity, nonprofit or for-profit entity, organization, or business which contracts with the Department of Corrections for the purpose of employing inmate labor. These work programs are to be patterned after business operations found outside of prison, and priority consideration is given to inmate employment which will retain or reclaim jobs in California, support emerging California industries, or create jobs to fill a void in the labor market. At least 80 percent of the labor involved in the project must be performed by prisoners.

Rationale

This program provides an incentive for California businesses to utilize state prison inmate labor. The rationale for the program is that it will provide meaningful work to prison inmates that will enhance their prospects for employment once released from prison, and also benefit the California economy. In addition, the wages earned by inmates can partially offset their expenses of incarceration, thereby rdeucing state costs.

Comments

The initial revenue losses associated with this program are speculative due to uncertainties regarding the number of qualifying joint venture programs and the annual compensation of those employed. Assuming that 10 percent of the qualifying target population is employed in the first year, the Franchise Tax Board estimates the potential revenue losses from this program to be in the range of $500,000 to $1.5 million, depending on whether the wages are paid at the minimum $4.25 level or the average national hourly wage of $10.37. If this program is expanded further, annual revenue losses could increase up to $11 million. This program was enacted by Proposition 139 in the statewide general election in November 1990. ◆

Tax Credits Related to Activities in Enterprise Zones and Other Economically Depressed Areas

***Program Type:** PIT and B&C*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$1	$3
1990-91	1	3
1991-92	1	4

Authorization

California Revenue and Taxation Code Sections 17052.13, 17053.8, 17053.9, 17053.11, 23612, 23622 and 23623.

Description

These programs allow taxpayers to claim tax credits for certain expenditures or income earned in economically depressed areas of the state, including those that have been designated as "Enterprise Zones" or Employment and Economic Incentive "Program Areas." Three specific tax credits are available:

- An income tax credit for employers, equal to a portion of the wages paid to qualifying "disadvantaged individuals." The credit amount depends on the length of time the disadvantaged individual had been unemployed immediately prior to being hired, and on whether the business is located in an enterprise zone or a program area. For *enterprise zone and program area businesses hiring individuals who have been unemployed for at least six months,* the credit is equal to 50 percent of the wages paid to qualifying employees during the first year, 40 percent for the second year, 30 percent for the third year, 20 percent fourth year, and 10 percent for the fifth year. For *businesses in program areas hiring individuals who have been unemployed for at least three months but less than six months*, the credit is 25 percent for the first year of employment, 40 percent for the second year, 30 percent for the third year, 20 percent for the fourth year, and 10 percent for the fifth year. The credits are not refundable, but unused portions may be carried forward and claimed in subsequent tax years.

- A 5-percent income tax credit for qualified employees to offset a portion of the taxes they would otherwise pay because of their employment in an enterprise zone business. The credit is reduced by 9 cents for each $1 in wages exceeding $10,500 in "qualified wages," as defined in the federal Internal Revenue Code, Section 3306 (b). The credit is nonrefundable, and unused portions may not be carried forward.
- An income tax credit for the amount of sales and use taxes paid on the purchase of machinery or parts used for specific purposes in enterprise zones or program areas. The maximum amount of credit which may be claimed is up to $1 million per year under the Personal Income Tax Law and up to $20 million per year under the Bank and Corporation Tax Law. The credit is nonrefundable, but unused portions may be carried forward into succeeding tax years.

Rationale

These programs are intended to provide incentives for stimulating employment and business activity in economically depressed areas of the state that have been designated as enterprise zones or program areas.

Comments

These programs were established in 1984 by the Enterprise Zone Act and Employment and Economic Incentive Act (Ch 45/84 – AB 40, Nolan, and Ch 44/84 -- AB 514, Maxine Waters, respectively), as amended in 1985 by Ch 1462/85 (AB 1843, Nolan and Maxine Waters). The third program component above originally was available only with respect to qualifying purchases in designated program areas, but was extended to enterprise zones in 1985. ◆

Tax Credit for Ridesharing Expenses

Program Type: *PIT and B&C*
Sunset Date: *January 1, 1996*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$4	$4
1990-91	4	4
1991-92	4	4

Authorization

California Revenue and Taxation Code Sections 17053, 17053.1 and 23605.

Description

This program allows a tax credit for certain ridesharing expenses incurred by employees and employers for commuting to and from work.

Employers. This program allows employers with 200 or more employees to claim a tax credit equal to 20 percent of the cost of purchasing, leasing, or contracting for the use of shuttle buses, vans, or other vehicles that are used in a company-sponsored voluntary ridesharing program conducted primarily in California. Employers with fewer than 200 employees may claim a 30-percent credit for these costs.

In addition the program allows a tax credit for the costs of providing subsidized public transit passes to employees. The amount of the credit for these passes is related to the employer's policy on employee parking. The amount of the credit is equal to:

- Forty percent of the cost if employers provide no free or subsidized parking.
- Twenty percent of the cost if the employer provides subsidized parking.
- Ten percent of the cost if the employer provides free parking.

The credits allowed for these costs are in lieu of any deduction to which the taxpayer would otherwise be entitled for the costs to which the credits apply. In addition, the cost "basis" (which is used for purposes of determining capital gains and losses when property eventually is sold) of any ridesharing vehicle is reduced by the amount of the credit allowed for the costs of that vehicle.

Employees. This program allows employees in vanpool ridesharing programs not sponsored by their employers to claim a credit equal to 40 percent of all vanpool subscription costs. In no case, however, may the credit exceed $480 per year. In order to qualify for the tax credit, the vanpool must carry on average at least seven adults to and from work on a daily basis.

These credits are nonrefundable. Any unused portion of the credit, however, may be carried over to successive tax years until fully used.

Rationale

This program is designed to provide a financial incentive for employers to subsidize the cost of employee use of carpools and public transportation, and for employees to use carpools and public transportation to commute to work. An increased use of carpools and public transportation would reduce traffic congestion and automobile emissions, which contribute to air pollution.

Comments

California also exempts from gross income any compensation received by an employee for the costs of participating in specified ridesharing arrangements. ❖

Tax Credit for Increased Research and Development Expenses

Program Type: PIT and B&C
Sunset Date: January 1, 1993

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$3	$41
1990-91	3	43
1991-92	3	45

Authorization

California Revenue and Taxation Code Sections 17052.12 and 23609, which partially conform to federal Internal Revenue Code Section 41.

Description

This program allows taxpayers to claim a tax credit for a portion of certain additions to their research and development expenses. The credit may be applied to "qualified" research conducted either "in-house" or by contract. Qualified research is defined as research that is (1) technological in nature; (2) intended to be useful in the development of a new or improved product, service, computer software, technique, formula, or invention of the taxpayer; (3) held for sale, lease, or license, or used by the taxpayer in a trade or business; and (4) performed in California. For most taxpayers, the credit is equal to 8 percent of the taxpayer's additional research expenses in a base period. This base period is defined as the three-year period immediately preceding the tax year. The base period for "basic" research is generally the three-year period, 1981 through 1983.

To the extent that the credit exceeds the taxpayer's net tax liability in the taxable year, the excess may be carried forward and used to reduce tax liabilities in subsequent years. The credit expires on January 1, 1993.

Rationale

This program provides an incentive for taxpayers to invest in research and development activities by reducing the after-tax cost of making such an investment.

Comments

Federal tax law provides a tax credit equal to 20 percent of research expenses. The federal base period for qualified research is different from the state's base period, however. The federal program is authorized through 1991. ◆

Tax Credit for Manufacturing Equipment Using Recycled Materials

***Program Type:** PIT and B&C*
***Sunset Date :** January 1, 1994*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$1	$1
1990-91	2	2
1991-92	2	3

Authorization

California Revenue and Taxation Code Sections 17052.14 and 23612.5.

Description

This program allows taxpayers to offset their tax liability by 40 percent of the cost of certain machinery or equipment used to manufacture finished products from recycled raw materials. In order to qualify for the tax credit, the machinery must be located in California and be used exclusively to manufacture finished products which are at least 50 percent composed of recycled materials generated from within California.

This tax credit is available for up to $625,000 of the cost of machinery purchased for any single manufacturing facility. A taxpayer qualifies for the credit to the extent that (1) the total adjusted "basis" of all qualified property owned on the last day of the tax year exceeds the largest total adjusted "basis" of all qualified property at any one time during the previous year and (2) the total capacity of qualified property on the last day of the tax year exceeds the largest total capacity of qualified property at any one time during the previous year.

In order to claim the credit, the taxpayer must receive certification from the Integrated Waste Management Board that the machinery meets the recycling program requirements. Once certified, the taxpayer may claim the tax credit as follows: (1) 20 percent of the cost of the qualified machinery in the year of purchase, (2) 15 percent of the cost of the qualified machinery in the following year, and (3) 5 percent of the cost of the qualified machinery in the second year succeeding the year of purchase. These tax credit amounts may be carried forward to offset future years' tax liabilities to the extent they exceed a taxpayer's liability in the years specified above.

Rationale

This program provides an incentive for manufacturers to invest in machinery utilizing recycled materials as inputs by reducing the after-tax costs of such investments. This serves to enhance the competitiveness of using recycled materials relative to virgin resources, which are themselves beneficiaries of certain other special tax provisions (e.g., depletion allowances in excess of "normal" depreciation for mineral and other natural resources, and expensing of exploration and development costs). It is argued that the substitution of recycled materials for virgin resources reduces the depletion of natural resources and lowers total waste disposal (including landfill) costs. In addition, the energy requirements of production processes using recycled materials are generally lower than those using virgin resources as inputs.

Comments

This tax credit was enacted by Ch 1091/89 (AB 1308, Killea), as part of a large "package" of legislation revamping the state's solid waste management program. ❖

Tax Credit for Employer Child Care Expenses

Program Type: *PIT and B&C*
Sunset Date: *January 1, 1992*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$1	$2
1990-91	1	5
1991-92	1	8

Authorization

California Revenue and Taxation Code Sections 17052.17, 17052.18, 23617 and 23617.5.

Description

Personal Income Tax Law and Bank and Corporation Tax Law provide several tax credits for employer-sponsored child care assistance programs. These tax credit programs allow employers to deduct the costs of certain contributions toward employee child care expenses incurred between January 1, 1988 and January 1, 1992. Specifically, employers may deduct:

- Thirty percent of the startup costs of establishing a child care program, the costs of constructing a child care facility, and/or the cost of child care referral services, up to $50,000 per tax year.
- Fifty percent of the cost of contributions to a qualified child care plan. A qualified care plan may include onsite or offsite child care centers, in-home care, and specialized centers which provide care for children with short-term illnesses. Qualifying contributions may not exceed $600 per employee per tax year.

In order to qualify for the tax credit these costs must be associated with programs primarily used by children of the taxpayer's employees who are under the age of 15. To the extent that the credit amounts exceed a taxpayer's net tax liability in the year the expenses are incurred, they may be carried forward and used to offset the taxpayer's liability in future years.

Rationale

This program is intended to give employers a financial incentive to provide for the child care needs of their employees. It does this by reducing the after-tax cost of making these provisions.

Comments

Employers must reduce their cost "basis" (which is used for purposes of determining capital gains and losses when property eventually is sold) in child care facilities on which a tax credit is claimed, by the amount of the credit claimed for those facilities. In addition, employers must reduce the amount of their business expense deductions and the portion of the facility's depreciable value on which they may claim accelerated depreciation, by the credit amount claimed. ◆

Tax Credit for Agricultural Product Donations

Program Type: *PIT and B&C*

Estimated Revenue Loss (dollars in millions)		
Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	Minor	Minor
1990-91	Minor	Minor
1991-92	Minor	Minor

Authorization

California Revenue and Taxation Code Sections 17053.12 and 23608.

Description

This program allows taxpayers who donate unspoiled agricultural products to nonprofit charitable organizations under the state's surplus food collection and distribution program to claim a tax credit for 10 percent of the cost to produce those products. Any tax deduction which would otherwise be allowed for these costs must be reduced by the amount of the tax credit claimed. In addition, the taxpayer must obtain a receipt from the nonprofit organization to whom the products are donated to provide to the Franchise Tax Board upon demand. To the extent that the credit exceeds the taxpayer's net tax liability in the taxable year, the excess may be carried forward to reduce tax liabilities in future years.

Rationale

This program is intended to encourage the donation of surplus agricultural products to nonprofit charitable organizations.

Comments

Federal tax law provides no comparable tax credit. ❖

Tax Credit for Military Pay

Program Type: *PIT only*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$3
1990-91	4
1991-92	5

Authorization

California Revenue and Taxation Code Section 17053.13.

Description

This program authorizes military personnel with adjusted gross incomes below $27,000 per year to claim a tax credit equal to 4 percent of their "eligible" income, up to a maximum credit of $40 per taxpayer per year. Eligible income consists of wages, salary and other compensation received for active duty, retirement, service in an auxiliary branch of the armed services, or service during a declaration of emergency by the Governor.

This credit is not refundable and must be used in the tax year it is earned. Thus, it cannot be carried forward and used to offset tax liabilities in future years.

Rationale

This program is intended to provide tax relief to individuals who are viewed as having helped their country through military service.

Comments

This credit replaced a previously provided exclusion from taxable income of $1,000 in compensation from military active duty, reserve duty, or retirement pay. Federal law does not allow either an exclusion or a credit for military pay; however, state and federal law are the same regarding a number of other exclusions provided for military compensation. For example, both state and federal law forgive the taxes (for the year of his or her death and any prior year during which he or she served in a combat zone) of military personnel who die as a result of serving in a combat zone. ◆

Tax Credit for Political Contributions

Program Type:* *PIT only

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$4
1990-91	4
1991-92	5

Authorization

California Revenue and Taxation Code Section 17053.14.

Description

This provision authorizes an individual to claim a tax credit equal to 25 percent of any political contributions he or she makes during the tax year. The amount of the credit may not exceed $50 for married couples filing joint returns and $25 for single filers. To the extent that the tax credit exceeds a taxpayer's liability in the year it is earned, it may be carried forward and used to offset taxes in future years. The credit must be used in the earliest tax year(s) possible, however.

Rationale

This program provides an incentive for more broad-based financing of political campaigns, especially in the form of relatively small individual contributions. The apparent rationale for this is the argument that broad-based financing of political campaigns promotes greater citizen participation in the election process and improves the ability of candidates not having independent financing to attract funds, thereby making elections more competitive.

Comments

This program replaced a former tax deduction for political contributions which was repealed by Ch 1138/87 (AB 53, Klehs and Hannigan).◆

Tax Credit for Small Employer Health Benefits

Program Type: *PIT and B&C*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	--	--
1990-91	--	--
1991-92	$40	$60

Authorization

California Revenue and Taxation Code Sections 17053.20 and 23615.

Description

This program provides a tax credit for "small" employers who provide health insurance to their employees. A small employer is one with no more than 25 employees. The amount of the credit is equal to the greater of (1) $25 per month per eligible employee or covered dependent or (2) 25 percent of the total amount paid per month per employee or covered dependent. Eligible employees are those who are residents of California, and work for the employer on average at least 35 hours per week. To qualify for the credit, the employer must pay at least 75 percent of the monthly premium for health coverage for employees and their dependents. In addition, the employer must make such health benefits coverage available to all eligible employees and their dependents at least once each year, and to all newly hired employees and their dependents within 60 days of the date of employment. This credit becomes effective on January 1, 1992.

To the extent that this credit exceeds an employer's net tax liability, it may be carried forward and used to offset taxes in succeeding income years, provided that it is applied to taxes in the earliest income year(s) possible.

Rationale

The purpose of this tax credit is to encourage owners of small businesses to provide health insurance to their employees. It reflects the view that owners of many small businesses cannot afford to provide such benefits as easily as owners of larger businesses.

Comments

This program will result in unknown but significant state costs. These costs have been estimated by the Franchise Tax Board to be $100 million in 1991-92 and $400 million in 1992-93. These cost estimates are subject to considerable error, as actual costs will be determined in large part by factors (such as participation rates) which are unknown at this time. ◆

Tax Credit for the Costs of Clinical Testing of Orphan Drugs

Program Type: *PIT and B&C*
Sunset Date: *January 1, 1993*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	Minor	$1
1990-91	Minor	1
1991-92	Minor	1

Authorization

California Revenue and Taxation Code Sections 17057 and 23609.5.

Description

This program provides a tax credit equal to 15 percent of the costs of performing clinical testing of "orphan drugs." Orphan drugs are drugs created to treat rare diseases and medical conditions where development is costly and the market potential for the drugs may be uncertain or limited. These tax credits are available for any human clinical testing of such drugs which is carried out under an exemption for a drug being tested for a rare disease or condition under the Federal Food, Drug, and Cosmetic Act.

Rationale

This tax credit is designed to reduce the after-tax cost of testing drugs for rare diseases or medical conditions. A drug manufacturing company often has a very uncertain expectation that the cost of developing such a drug and making it available to those suffering from such diseases or conditions would be recovered from sales of the drug. This reduces the incentive for "for-profit" drug manufacturing companies to try to develop these "orphan" drugs. This program is intended to mitigate this disincentive.

Comments

This tax credit was adopted in 1987 in partial conformity to a similar tax credit contained in federal income tax law. The federal tax credit is equal to 50 percent of the expenses of clinical testing of orphan drugs. The state definition of orphan drug is identical to the federal definition. The federal tax credit is currently scheduled to sunset December 31, 1991. ◆

Tax Credit for Low-Income Housing

Program Type: *PIT and B&C*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	$10	$3
1990-91	21	7
1991-92	44	10

Authorization

California Revenue and Taxation Code Sections 17058 and 23610.5.

Description

This program provides a tax credit for a portion of the costs of investing in low-income rental housing projects. The amount of the credit depends on the amount needed by the investor in order to make the project "economically feasible." This amount is determined by the California Tax Credit Allocation Committee, which reviews applications and allocates credits based on certain previously established legislative priorities. The maximum amount the committee may award to a project is designed so that the present value of four annual credit payments generally equals 30 percent of the investor's "qualified basis" in the low-income housing units. (Qualified basis is roughly equal to the acquisition, construction, and/or rehabilitation costs of the units.) In exchange for the tax credits, the investor must commit to either:

- Renting 20 percent of the units to individuals whose income is no more than 50 percent of area median income.
- Renting 40 percent of the units to individuals whose income is no more than 60 percent of area median income.

In addition, rents on these units may not exceed 30 percent of these specified income limits.

This program is different from other tax credit programs in that the committee allocates both state and federal tax credits to certain -- but not all -- projects submitted to them for review. The California Tax Credit Allocation Committee has a limited dollar amount of tax credits available. Specifically, the state credit ceiling is generally equal to $35 million per year.

Rationale

This tax credit program is intended to increase the number of affordable rental housing units available to low-income households in California, by reducing the after-tax costs to developers and investors who produce and invest in such units.

Comments

This program complements a federal tax credit program which also works to promote the development of low-income housing. The maximum federal tax credit that can be awarded is generally equal to 70 percent (on a present-value basis) of a taxpayer's qualified basis in the project, spread over a 10-year period. A project that receives the maximum in both state and federal credits receives 100 percent of the taxpayer's qualified basis over a 10-year period. Both the state and federal programs are administered by the California Tax Credit Allocation Committee. The state program is authorized as long as the federal program continues in existence.◆

Tax Credit for Capital Gains from Sale or Exchange of Residential Rental or Farm Property

Program Type: *PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	$78
1990-91	82
1991-92	89

Authorization

California Revenue and Taxation Code Section 17061.5.

Description

This program allows personal income taxpayers to claim a tax credit for a portion of the capital gain they realize on the sale or exchange of California residential rental and farming property held for more than one year. The amount of the credit is equal to 3 percent of the net capital gain in the case of property held for more than one year but not more than five years, and 4.5 percent in the case of property held for more than five years. If the credit allowed exceeds the taxpayer's tax liability in the year it is earned, it may be carried forward and used to offset taxes owed in succeeding years until it is exhausted.

Rationale

This tax credit was added to California law in 1987, when California eliminated the partial exclusion for capital gains income in conformity to the federal Tax Reform Act of 1986. Two rationales exist for the program. First, it was intended to provide tax relief to holders of farm and residential rental property in order to compensate them for the elimination of the preferential tax treatment of capital gains income. Second, the tax credit is intended to encourage investment in farm and residential rental property.

Comments

The effectiveness of the incentive provided under this program may differ for the two types of property that qualify. In the case of farmland, this program may actually promote the conversion of farmland to nonagricultural uses. This is because the credit may increase the farm owner's incentive to sell the property, and it is the case today that California farmland is often converted to residential or commercial uses when it changes ownership.

In the case of residential rental property, the argument that the credit increases investment in qualifying property appears stronger. This is because the credit effectively increases the rate of return for residential rental investment property relative to other investment opportunities. ◆

Tax Credit for GAIN Employees

Program Type: *PIT and B&C*
Sunset Date: *January 1, 1994*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*	*B&C Amount*
1989-90	Minor	$1
1990-91	Minor	1
1991-92	Minor	1

Authorization

California Revenue and Taxation Code Sections 17053.7 and 23621.

Description

This program provides a tax credit to employers of participants in the Greater Avenues for Independence Program (GAIN). The GAIN program requires all AFDC recipients and applicants, who do not have children under age six, to participate in employment-related training. The ultimate goal of the GAIN program is for participants to work in permanent, unsubsidized jobs. This tax credit is equal to 10 percent of the wages paid to each employee who is a participant in the GAIN program. The credit applies only to the amount of wages up to $3,000 per year per employee. In no case can the aggregate credit claimed over time exceed $600 per participating employee. In order to obtain the credit, the employer must request in writing and receive certification from the Employment Development Department that the employee is a participant in the GAIN program. This request for certification must be made on or before the individual begins work. An employer may not claim a tax credit for the wages of any employee who has previously worked for the employer.

Rationale

This tax credit provides an incentive for taxpayers to hire employees who come from disadvantaged backgrounds and otherwise would have difficulty getting jobs. The credit specifically is intended to (1) compensate for the negative impact of the minimum wage upon the employment of economically disadvantaged youth, (2) encourage employers to invest time and effort training those previously unemployable for work, and (3) reduce state aid payments to those who become employed.

Comments

This tax credit is in addition to any deduction to which the taxpayer may otherwise be entitled for the payment of wages. Federal law provides a similar tax credit for employers who hire disadvantaged individuals. The federal tax credit is equal to 40 percent of the first $6,000 of a qualified employee's first-year's wages. ◆

Tax Credit for Joint Custody Head of Household

Program Type: PIT only

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 17054.5.

Description

This program allows a tax credit for divorced or separated individuals who do not provide the principal residence for a dependent (and, therefore, do not qualify for the more advantageous "head-of-household" filing status), yet do bear significant costs in order to maintain a home for a dependent for part of the year. Specifically, the program allows a tax credit equal to 30 percent of a taxpayer's net tax up to a maximum amount ($231 in 1990), and is available to divorced or separated taxpayers who: (1) live apart from a spouse for at least six months prior to the end of the tax year and (2) provide for at least one-half of the cost of maintaining the principal residence of a dependent for at least 146 days and no more than 219 days of the tax year. Such a taxpayer who maintains the principal residence of a dependent for *more* than 219 days of the tax year qualifies for the more advantageous head-of-household filing status.

Rationale

This program is intended to provide tax relief to taxpayers who are single, or married and living apart, and who care for dependents such as children for a significant portion of the tax year. The program's rationale reflects the view that, in the case of taxpayers who have to maintain households in order to care for dependents, their economic burdens are greater than those of individuals with no such responsibilities.

Comments

Federal law defining "head of household" was incorporated into California law by reference for post-1986 years. In order for the head-of-household filing status to be claimed, the household must be the principal residence of the qualifying dependent for more than 219 days of the year.

Chapter 1537, Statutes of 1982 (AB 2520, Sher) created a special "joint custody head-of-household filing status with its own personal exemption credits and tax rates. This separate filing status was replaced with this tax credit by Ch 1138/87 (AB 53, Klehs). ◆

Tax Credit for Senior Head of Household

Program Type: *PIT only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*PIT Amount*
1989-90	–
1990-91	–
1991-92	NA

Authorization

California Revenue and Taxation Code Section 17054.7.

Description

This program allows elderly taxpayers who are surviving spouses to claim a personal income tax credit in an amount equal to 2 percent of their taxable income. This credit is only available to taxpayers with adjusted gross incomes less than $37,500, and the amount of the credit is limited to $750 in 1990.

Rationale

This program provides tax relief to elderly taxpayers who have low or moderate incomes. The rationale for this is that the ability of such individuals to pay taxes often is limited, given their income constraints and their need to provide for special retirement expenses, such as health care.

Comments

This program was established by Ch 1154/90 (SB 389, Seymour), and applies to tax years beginning on January 1, 1990 and thereafter. The maximum credit amount is indexed annually for inflation. The program provides no benefits for individuals who have no tax liabilities. ◆

Special Filing Status for Head of Household and Surviving Spouses

Program Type: PIT only

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*PIT Amount*
1989-90	$340
1990-91	360
1991-92	380

Authorization

California Revenue and Taxation Code Sections 17042, 17046, 17054, and 17054.6, which partially conform to federal Internal Revenue Code Sections 2, 151, and 152.

Description

This program allows taxpayers who care for dependents to qualify for lower tax rates than are available to single persons or to married persons filing separate returns. This program is intended to provide tax relief to heads of households who are single, or married but living apart, and surviving spouses. Surviving spouses qualify for a larger personal exemption in addition to the lower tax rates.

Rationale

The program's rationale reflects the view that taxpayers who have to maintain households in order to care for dependents have greater economic burdens than do individuals with no such responsibilities. In addition, the program reflects the view that tax relief may be necessary for surviving spouses to maintain their economic status.

Comments

Federal law definitions for the "head-of-household" and "surviving- spouse" filing statuses were incorporated into California law by reference in 1983 by Ch 488/83 (AB 36, Hannigan, Baker, Bergeson, Katz, and Naylor). In order to claim the head-of-household filing status, the taxpayer must provide the principal home of the qualifying dependent for over one-half of the year. In addition, the taxpayer must pay more than one-half of the cost of maintaining that household. A surviving spouse is a taxpayer whose spouse died within two years prior to the taxable year and who cares for a dependent child and has not remarried.

Chapter 846, Statutes of 1990 (AB 3086, Klehs), provides that taxpayers with a nondependent relative living in the home qualify for head-of-household filing status. For example, if a single custodial parent moved into the home of her widowed father, the father would qualify as a head of household. Although the child is the custodial parent's dependent, the grandfather qualifies to use the head-of-household filing status because he provides more than one-half of the cost of maintaining the home. This particular provision has a sunset date of January 1, 1992.

Sales and Use Tax

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Sales and Use Taxes — An Overview

Sales and use taxes are imposed on the purchase of tangible personal property by individuals or businesses. They are administered by the California Board of Equalization (BOE).

Sales Tax

This is the familiar tax that retailers add onto the price of most goods sold in California. The BOE collects the tax from the sellers of these goods.

Use Tax

The use tax complements the sales tax. It is imposed on the purchaser (at the same rate as the sales tax) for transactions in which the sales tax is not collected. The most common example is the purchase of goods from an out-of-state retailer for use in California. Historically, use tax collection efforts focused on purchases of goods by California businesses and on purchases of vehicles. In contrast, no attempt was made to collect use tax on most out-of-state purchases by individual customers. Recent changes to state law, however, now require many out-of-state mail-order houses to collect use tax on purchases by Californians. Also, the BOE now bills many returning travelers for use tax on foreign purchases identified on their customs declarations.

State and Local Tax Rates

The current state tax rate is 4.75 percent of the purchase price in a taxable transaction. (An additional 0.25 percent temporary tax to fund earthquake relief was in effect from December 1, 1989 through December 31, 1990, during which period the total state tax rate was 5 percent.) The estimated revenue losses that are shown in this report for sales and use tax expenditures represent the *state revenue loss only* from the basic 4.75 percent tax rate. In addition, however, these tax expenditures give rise to *local* revenue losses. This is because a uniform local sales and use tax of 1.25 percent is imposed by cities and counties, so that the combined state-local rate is at least 6 percent (6 cents per dollar of sales) everywhere in California. Also, local voters may approve additional countywide "transactions and use" taxes in quarter-cent increments up to a maximum of 1 cent per dollar of sales. Consequently, the total state-local tax rate varies among counties, ranging from 6 percent to 7 percent.

Application of the Tax

The tax is levied on the purchase price of tangible personal property. Real property is exempt (but not the materials used for construction). Services also are generally exempt. However, charges for labor to fabricate or craft goods directly for a consumer (such as the tailoring of a custom suit) are taxable.

Basic Categories of Exemptions

Two general categories of exemptions are part of the basic structure of the sales and use taxes.

Goods for Resale. Goods bought by a business for resale are exempt from tax. This exemption includes parts that a manufacturer purchases to incorporate into a product that, itself, will be sold. (However, purchase of the manufacturing equipment, itself, would not be exempt.)

Out-of-State Sales. Goods delivered to an out-of-state purchaser for use outside California are exempt from tax. ❖

Gas, Electricity, Water, Steam, and Heat

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$1,300
1990-91	1,420
1991-92	1,550

Authorization

California Revenue and Taxation Code Section 6353.

Description

This program exempts from taxation the transfer of gas, electricity, water (including steam), and geothermal brines or other heat sources delivered through mains, lines, or pipes. It also exempts water sold to an individual in bulk quantities (50 gallons or more) for household use, when the residence is not served by mains, lines, or pipes. In addition, the program exempts the transfer of steam, heat, or other energy produced by cogeneration.

Rationale

The basic exemption for gas, electricity, and water dates back to the inception of the sales tax in 1933, when companies providing these services were subject to a gross receipts tax that was in lieu of other taxes under the State Constitution. The original tax exemption merely recognized that the Constitution prohibited the imposition of other taxes, such as the sales tax, on these companies. Although these constitutional provisions were subsequently repealed, the exemption nevertheless remained in effect.

Currently, there are two rationales for this program. First, gas and electric bills are subject to municipal utility user taxes in many cities, often at rates higher than the sales tax rate. Thus, it is argued that the sales tax exemption avoids subjecting gas and electricity to double taxation.

Second, this program provides tax relief to consumers of gas, electricity, and water to the extent that sales and use taxes normally would be incorporated into the prices charged for these items. These utilities provide basic and necessary services and, as such, it is argued that they should not be made any more costly to consumers by imposing the sales tax on them.

Comments

Cities received almost $700 million from utility user taxes in 1987-88. Recent legislation (Ch 466/90 -- SB 2557, Maddy) extended to counties the authority to levy such utility user taxes. The exemption is not limited to residential gas and electricity service. Rather, it also includes commercial and industrial purchases of electricity and natural gas, to which the "necessity of life" rationale does not apply.

It is not clear that electricity, which is not a physical object or substance, would be subject to sales tax, even in the absence of this program.❖

Organic Products Grown Expressly for Fuel Purposes

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 6358.1 (a) (1).

Description

This program exempts from taxation the transfer of organic products grown expressly for fuel purposes, such as grain grown to produce fuel alcohol.

Rationale

This program provides an incentive for the production and use of organic products as fuel. It accomplishes this to the extent that it reduces the cost of buying or using organic fuels, thereby making them more attractive relative to conventional fuel sources. The underlying rationale for the program is to reduce the economy's reliance on fossil fuels, especially crude oil, and to encourage profitable alternative uses of farmlands.

Comments

Grain purchases by an alcohol producer generally would be exempt as a purchase for resale, even in the absence of this program. However, growers of organic products, such as wood, that are sold for direct use as fuel do benefit from this program. A detailed review of this program appeared in Volume I, Part Two, of our *Analysis of the 1987-88 Tax Expenditure Budget*. This review recommended that the program be maintained on the basis of tax equity, and the administrative savings to the Board of Equalization from not having to establish taxable values for the exempt items.❖

Agricultural, Timber, Municipal, and Industrial Waste By-Products

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6358.1 (a) (2).

Description

This program exempts from taxation the transfer of qualified waste by-products from (1) agricultural and forest-products operations, (2) municipal refuse, and (3) manufacturing activities. In order to qualify, these by-products must be used as fuel in an industrial facility in lieu of either oil, natural gas, or coal.

Rationale

This program provides an incentive for industry to use waste by-products as an alternative fuel. It accomplishes this to the extent that it reduces the cost of buying or using waste by-product fuels, thereby making them more economically attractive relative to conventional fuel sources. The underlying rationale for the program is to reduce the economy's reliance on fossil fuels, especially crude oil, and to encourage the more effective and complete utilization of scarce resources. The program also equalizes the taxation of waste fuel materials that are purchased with those that are self-generated.

Comments

This program was established by Ch 1248/80 (SB 1576, Nielsen), and was permanently extended by Ch 254/86 (SB 1083, Boatwright). The program was amended by Ch 1059/83 (SB 1031, Boatwright) to delete the original requirement that qualifying by-products be "delivered in bulk"; this amendment ensured that the program would apply to waste by-products consumed at the same site where they are generated, such as the burning of wood chips in a lumber mill.

A detailed review of this program appeared in Volume I, Part Two, of our *Analysis of the 1987-88 Tax Expenditure Budget*. This review recommended that the program be maintained on the basis of tax equity, and the administrative savings to the Board of Equalization from having to establish taxable values for the exempt items.◆

Use of Refiners' Gas

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6358.1 (b).

Description

This program exempts from taxation the use of "still gas" which has been produced as a by-product during the refining of purchased crude oil.

Rationale

The underlying rationale for the program is to equalize the tax treatment of still gas used by refiners who purchase their crude oil with those who use oil they produce themselves. The program also encourages resource conservation through more efficient use of crude oil supplies.

Comments

The use of still gas produced from proprietary (that is, nonpurchased) petroleum is not subject to the use tax, because the California Sales and Use Tax Law requires that a formal transfer of a product occur in order to "trigger" a tax levy.

This program was established in 1983 by Ch 1059/83 (SB 1031, Boatwright), as declarative of existing law under Ch 1248/80 (SB 1576, Nielsen), which provided a tax exemption for waste by-products derived from manufacturing activities. This program was permanently extended by Ch 254/86 (SB 1083, Boatwright).

A detailed review of this program appeared in Volume I, Part Two, of our *Analysis of the 1987-*

*88 Tax Expenditure Budget.*This review recommended that the program be maintained on the basis of tax equity and the administrative savings to the Board of Equalization from not having to establish taxable values for refiners' gas.❖

Animal Life

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$42
1990-91	44
1991-92	46

Authorization

California Revenue and Taxation Code Section 6358 (a).

Description

This program exempts from taxation the transfer of animal life, the products of which ordinarily constitute food for human consumption.

Rationale

This program provides tax relief to producers of animal-based food products, by eliminating sales and use taxes that ordinarily would apply to animals that are not purchased solely for resale. By reducing the cost of producing animal-based food items, the program benefits consumers to the extent that these lower production costs reduce retail food prices. As such, this program basically is an extension of the sales and use tax exemption for food. The underlying rationale for the program is that food is a basic necessity of life, and that its price should not be increased by taxation.

Comments

Purchases of dairy cows and of any livestock or poultry for breeding (or egg laying) purposes ordinarily would be subject to sales and use taxes in the absence of this program. This is because these animals are put to use by the purchaser, rather than simply fattened and resold, as with most beef cattle.❖

Animal Feed

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$92
1990-91	96
1991-92	101

Authorization

California Revenue and Taxation Code Section 6358 (b).

Description

This program exempts from taxation any transfer of animal feed which is fed to qualified animals. Qualified animals are those whose products either ordinarily constitute food for human consumption, or are to be sold in the regular course of business.

Rationale

This program provides several types of tax relief. First, it provides tax relief to consumers of animal-based food products, to the extent that sales and use taxes on animal feed ordinarily would be incorporated into the prices of these products. As such, this aspect of the program basically is an extension of the sales and use tax exemption for food. The underlying rationale for this aspect of the program is that food is a basic necessity of life, and its price, therefore, should not be increased by taxation.

The second type of tax relief provided by the program is to consumers of *nonfood* animal products, again to the extent that sales and use taxes on feed ordinarily would be incorporated into these products' prices. The rationale here is that the feed is a "component part" of an item which subsequently is itself subject to taxation and, therefore, should not be double-taxed. An example is the use of feed to raise animals, the pelts of which are used to make coats, which are subject to sales taxes.❖

Seeds and Annual Plants

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$12
1990-91	12
1991-92	13

Authorization

California Revenue and Taxation Code Section 6358 (c).

Description

This program exempts from taxation the transfer of seeds and annual plants whose products either ordinarily constitute food for human consumption, or are to be sold in the regular course of business.

Rationale

This program provides several types of tax relief. First, it provides tax relief to consumers of seed and plant-related food products, to the extent that sales and use taxes on seeds and plants ordinarily would be incorporated into the prices of such food products. As such, this aspect of the program basically is an extension of the sales and use tax exemption for food. The underlying rationale for this aspect of the program is that food is a basic necessity of life and its price, therefore, should not be increased by taxation.

The second type of tax relief provided by the program is to consumers of nonfood products that are derived from qualifying seeds and annual plants, again to the extent that sales and use taxes ordinarily would be incorporated into the prices of these seeds and plants. The rationale here is that these items are "component parts" of products which, themselves, are subsequently taxed and, therefore, should not be subjected to double taxation. An example is the purchase of flower seeds by a nursery in order to grow flowers, which themselves are taxed when sold to consumers.❖

Qualified Fertilizer

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$23
1990-91	24
1991-92	25

Authorization

California Revenue and Taxation Code Section 6358 (d).

Description

This program exempts from taxation the transfer of fertilizer to be used on land, if the land is used to produce either food for human consumption or other products to be sold in the regular course of business.

Rationale

This program provides several types of tax relief. First, it provides tax relief to consumers of food products grown with the help of fertilizer, to the extent that sales and use taxes on fertilizer ordinarily would be incorporated into the prices of these products. As such, this aspect of the program basically is an extension of the sales and use tax exemption for food. The underlying rationale for this aspect of the program is that food is a basic necessity of life, and its price, therefore, should not be increased by taxation.

The second type of tax relief provided by the program is to consumers of *nonfood* products which fertilizer helps produce, again to the extent that sales and use taxes on fertilizer ordinarily would be incorporated into these products' prices. The rationale here is that the fertilizer is a "component part" of an item which subsequently is, itself, subject to taxation and, therefore, should not be double-taxed. An example is the use of fertilizer by a nursery in growing flowers, which themselves are taxed when sold to consumers.

Comments

For the purposes of this program, the term "fertilizer" includes commercial fertilizers, agricultural minerals and manures, but does not include soil amendments. The latter are excluded on the basis that they do not constitute a "component part" of the grown products, but rather are capitalized into land values. Such soil amendments include hay, straw, peat, leaf mold, sand, potting mediums, and specified mineral and chemical constituents.◆

Food Products

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$1,500
1990-91	1,580
1991-92	1,680

Authorization

California Revenue and Taxation Code Sections 6359, 6359.2, and 6359.4.

Description

This program generally exempts from taxation the transfer of food products for home consumption (other than carbonated or alcoholic beverages).

The program does *not* extend to sales of most hot, prepared, take-out food items, meals, or to other take-out items, if eating facilities are furnished or if the food is sold by a "drive-in" and ordinarily consumed in a parking space that the vendor provides.

Vending Sales. Special rules apply to vending machine sales of otherwise nontaxable food items, such as candy. Generally, 33 percent of the receipts from these sales are taxed as an approximation of the portion of these sales that otherwise would be taxable because they are of items consumed on the same premises as the vending machine. Vending sales of any food item costing 15 cents or less, or of any bulk food items (such as nuts) costing 25 cents or less are fully exempt from taxation. This is accomplished by treating these retailers as the consumers of the items that they sell. Since the food products are exempt when purchased by the vendor (under the general food exemption), this treatment is equivalent to a full tax exemption.

Rationale

This program provides tax relief to consumers of food products to the extent that sales and use taxes ordinarily would be incorporated into the prices of these items. The underlying rationale for the program is that food is a basic necessity of life and, therefore, its price should be held to a minimum.

Comments

Although the basic rationale for this program is to exempt food products from taxation because they are a necessity of life, it should be noted that the term "necessity" is somewhat loosely, and even inconsistently applied.

For example, restaurant meals and hot takeout foods *are* taxed. This generally is justified on the grounds that they are luxuries, or at least a convenience, compared with cooking at home. However, some of these taxable foods also appear to be necessities. One example would be an inexpensive take-out hamburger purchased by a low-income individual who lacks adequate cooking facilities.

Alternatively, in the case of food products that *qualify* under this program, there is no attempt to limit the quality or cost of items. For instance, the program applies to high-grade products, such as filet mignon, which do not constitute a basic necessity.

The provision that deems 33 percent of vending machine sales to be taxable was added by Ch 1300/87 (SB 121, Maddy) and Ch 1029/88 (AB 3083, Cortese). The taxable percentage was 77 percent in 1988, 55 percent in 1989, and became 33 percent on a permanent basis starting January 1, 1990.❖

Candy and Confectionery Products

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$84
1990-91	89
1991-92	95

Authorization

California Revenue and Taxation Code Section 6359.

Description

This program generally exempts from taxation the sale or use of candy and other confectionery products for home consumption. This program is included within the overall food exemption and is subject to the same limitations.

Rationale

This program provides tax relief to producers of candy, and to candy consumers to the extent that sales and use taxes ordinarily would be incorporated into the prices of these items. The program is rationalized on the grounds that candy and confectionery items constitute food products by virtue of their nutritional contents and, as such, deserve the same tax exemption granted for food generally.❖

Bottled Water

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$27
1990-91	29
1991-92	31

Authorization

California Revenue and Taxation Code Section 6359.6.

Description

This program exempts from taxation the transfer or use of noncarbonated and noneffervescent bottled water, provided that the water is sold in individual containers having a size of at least one-half gallon.

Rationale

This program provides tax relief to the consumers of bottled water to the extent that sales and use taxes ordinarily would be incorporated into its price. The underlying rationale for the program is that water is a basic necessity of life. Many individuals use bottled water because of impurities and other related problems with the quality of their normal water supplies.

Comments

This program was established in 1980 by Ch 1348/80 (SB 85, Nejedly); however, it applied only to containers of at least one gallon in size. The minimum allowable container size was reduced to one-half gallon in 1984 by Ch 786/84 (SB 1554, Ellis).

Packaged sales of groups of individual water-filled containers are *not* exempt from taxation under this program (see 66. Ops. Attorney General. 24. January 27, 1983).❖

Packing Ice and Dry Ice

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$0.9
1990-91	1.0
1991-92	1.1

Authorization

California Revenue and Taxation Code Section 6359.7.

Description

This program exempts from taxation the transfer of ice and dry ice, when the ice is used or employed in packing and shipping qualified food products for human consumption.

Rationale

Proponents of this program argue that it is needed to equalize the tax treatment of packing ice and dry ice with that of various other competing cooling processes. These various other means of cooling (such as forced air and chilled water baths) are not directly subject to sales and use taxation because they are "processes" and not tangible personal property (as is ice.) As a result, the program's proponents argue that, by equalizing the tax treatment of ice with other cooling processes, it serves to reduce the relative costs of using ice and thereby enhance its attractiveness as a packing and shipping coolant. The program also has been rationalized on the grounds that coolants are needed to provide consumers with unspoiled food products, many of which are, themselves, exempt from taxation because they are viewed as basic necessities of life.

Comments

This program became operative on January 1, 1986 as provided by Ch 1045/85 (AB 1887, Areias). An earlier program had been in effect for ice used in interstate transportation only, until its repeal in 1979 by Ch 1150/79 (AB 66, Lockyer).

The rationale that this program is needed to equalize the tax treatment of ice with that of other cooling methods overlooks the fact that the equipment for these alternative coolant systems generally is subject to sales and use taxation at the time it is purchased. A detailed review of this program appeared in Part Two of our *Report on the 1988-89 Tax Expenditure Budget*. In our review, we found no evidence that this program is having any significant impacts on the basic economic competitiveness of the affected California industries or on prices paid by consumers. Accordingly, we recommended that this program be repealed.◆

Prescription Medicines

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$221
1990-91	244
1991-92	270

Authorization

California Revenue and Taxation Code Sections 6369 and 6369.1.

Description

This program exempts from taxation the sale or use of specified medicines and medical-related products used for treating the health problems of human beings. Items which qualify for the program include (1) prescription medicines dispensed by a registered pharmacist, (2) medicines furnished or sold by licensed health care professionals for their own patients, (3) medicines furnished by licensed health care facilities, and (4) medicines sold to the state or a local government. In addition, qualifying items include such medical products as prosthetic and orthotic devices, hemodialysis products, insulin syringes, sutures, bone screws, and artificial limbs and eyes.

Rationale

This program provides tax relief to consumers of certain medicines and medical-related products, to the extent that sales and use taxes ordinarily would be incorporated into the prices of these items. The underlying rationale for the program is that the price of medicines should not be increased by taxation because proper medical care and treatment is a necessity of life.❖

Specified Medical-Related Products

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$2.8
1990-91	3.0
1991-92	3.2

Authorization

California Revenue and Taxation Code Sections 6369.2 and 6369.5.

Description

This program exempts from taxation the sale and use of the following medical-related products for personal use as directed by a physician: (1) wheelchairs, crutches, canes, and walkers (including their replacement parts), and (2) medical oxygen delivery systems.

Rationale

This program provides tax relief to consumers of specified medical-related products, to the extent that sales and use taxes on these products ordinarily would be incorporated into their prices. The underlying rationale for the program is that such products are items of necessity to individuals who purchase them, and that their cost, therefore, should not be increased by taxation.

Comments

Qualifying "medical oxygen delivery systems" include, but are not limited to, liquid oxygen containers, high pressure cylinders, and regulators, when sold, leased, or rented to an individual for personal use under the direction of a physician.❖

Medical Alert Tags

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 6371.

Description

This program exempts from taxation the transfer of medical alert tags furnished by a qualified nonprofit organization. The term "medical alert tags" includes any tag worn by a person for the purpose of alerting other persons that the wearer has a medical disability or allergic reaction to certain treatment.

Rationale

This program provides tax relief to individuals who need to wear medical information tags because of health-related problems. The program does this to the extent that sales and use taxes on such tags ordinarily would be incorporated into their prices. The rationale for the program is that the price of such tags should not be increased by taxation because the tags are a necessity for many individuals with serious health problems.

Comments

This program was originally sponsored by the Medic Alert Foundation, a charitable nonprofit corporation engaged in gathering, storing, and furnishing information regarding the medical problems of members. When an individual subscribes to the Medic Alert Foundation, he or she has the option of purchasing either a bracelet or a necklace on which relevant medical emergency information is engraved. Similar products are available from related organizations.❖

Specified Medical Health Information

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6408.

Description

This program exempts from taxation the use of medical health information literature purchased by qualified organizations. Such qualifying organizations must be formed and operated for charitable purposes, be eligible for the welfare exemption (a property tax exemption available to nonprofit, charitable organizations), and be engaged in the dissemination of medical health information. In addition, the purchase of qualified literature must be made from the organization's national office or another branch of that organization. The *original* purchase of these materials, from a printer for example, is not covered by the exemption.

Rationale

This program provides tax relief for organizations providing educational health information, and thereby enables these organizations to use their limited resources more effectively for educational purposes. The underlying rationale for the program is that the dissemination of medical health information is socially beneficial.

Comments

The original proponent of this program was the American Heart Association. Prior to the inception of this program, sales and use taxes were levied on the medical information that the association distributed to its regional and local chapter affiliates.❖

Health and Safety Insignia and Educational Materials

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6409.

Description

This program exempts from taxation the transfer of health and safety insignia and educational materials routinely sold in connection with health, safety, and first aid classes. The program requires the insignia and materials to be sold or purchased by a national charitable organization which qualifies for the welfare exemption (a property tax exemption available to nonprofit, charitable organizations). In addition, the materials must be purchased from the organization's national office or another branch of that organization.

Rationale

This program offers tax relief to organizations providing specified health- and safety-related materials and educational information, and for individuals who might purchase them. Thus, the program encourages the wider dissemination of these materials and information. The rationale for the program is that such materials and information are socially beneficial and worthy of public support.❖

Printers' Aids

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6010.3.

Description

This program exempts from taxation the composed type and reproduction proofs which are made by a typographer for the preparation of printed matter. In addition, this program exempts from taxation the fabrication of reproduction proofs or impressed mats when the materials are transferred to a printer or publisher for use in printing.

Rationale

This program provides tax relief to the printing industry, to the extent that sales and use taxes on transfers of qualified printers' aids normally would be borne by printers. Traditionally, printers' aids often became the property of the customer, so that they were subject to sales tax. These aids, however, were used to make final printing materials, which also were taxed on their sale. This program thus reduces the degree of this sales tax "pyramiding" for the printing industry. It also tends to equalize tax treatment for printers' aids, regardless of the specific arrangements made regarding the transfer of printers' aids.

Comments

Many other industries are subject to tax pyramiding, but the printing industry has argued that it was particularly hard hit by the multiple application of the sales and use tax. Newer computerized printing and publishing methods produce few, if any, intermediate printer's aids, so that the revenue loss from this program should decrease over time.❖

Partnership Property Used to Produce Motion Pictures

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6010.4.

Description

This program exempts from taxation the use of property rented, leased, or otherwise furnished by a partnership to its members for the production of motion pictures under certain circumstances. In order to qualify for the program, the partnership must be formed by parties engaged in the production or distribution of motion pictures in order to reduce production costs by sharing equipment, studio facilities, and personnel. The exemption does not apply, however, if the partnership transfers title to any property to its members. The program does not exempt from taxation the original purchase of property by the partnership.

Rationale

This program provides benefits to some segments of the motion picture industry by reducing the costs they incur for using shared movie-making equipment and fabrication labor. It is rationalized on the grounds that it tends to equalize the taxation of equipment and fabrication labor provided in-house with the taxation of these items when several studios or independent producers share these resources. The program thus removes a tax advantage that otherwise would benefit integrated studios versus other producers.

Comments

The basic structure of the sales and use tax inherently benefits businesses that are vertically integrated because intracompany transfers of equipment and supplies are not a sale and, thus, are not taxed. This program singles out the motion picture industry for special treatment in this regard.◆

Newspapers, Periodicals, and Their Ingredients and Component Parts

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$105
1990-91	115
1991-92	123

Authorization

California Revenue and Taxation Code Sections 6362 (a) and 6362 (b).

Description

This program exempts from taxation the sale or use of newspapers, periodicals, and any tangible personal property that becomes an ingredient or component of them, provided that a newspaper or periodical is regularly published at average intervals not exceeding three months. Included under the program is the one-time use of photographs in newspapers.

Rationale

This program provides tax relief to the publishers of qualified newspapers and periodicals, and the consumers of these items. It does this to the extent that sales and use taxes levied on these products would increase the prices charged for them and/or reduce the net profits from publishing them. Proponents of this program contend that the contents of a newspaper or periodical are akin to an information *service* and, thus, the transfer of a newspaper or periodical is equivalent to the sale of a service. Because the transfer of services is exempt from sales and use taxation, these proponents thus argue that the transfer of newspapers and periodicals also should be exempt.

In the case of one-time use of photographs, the specific rationale for a tax exemption is that such items are tangible personal property which becomes an ingredient or component part of the newspapers in which they appear.

Comments

Magazines and periodicals account for two-thirds of the revenue loss shown above, but only a portion of that amount would be collected in the absence of this program. This is because many magazines and periodicals are published outside of California and then mailed to subscribers within California. Taxing these transactions requires that the publishers must have at least some minimum economic presence in California. For this reason, a portion of these interstate sales would not be taxable by California or would be difficult to collect.

California Board of Equalization Regulation 1590 excludes from this program any publication that consists of 90 percent or more advertising.❖

Leases of Motion Pictures

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$20
1990-91	20
1991-92	21

Authorization

California Revenue and Taxation Code Sections 6006 (g) (1) and 6010 (e) (1).

Description

This program exempts from taxation the qualified lease or rental of motion pictures, television programs, and tapes (except video rentals for private use).

Rationale

This program provides tax relief to the owners and users of motion pictures and television shows, to the extent that sales and use taxes levied on motion picture leases would be incorporated into the lease payments. The apparent rationale for the program is to encourage expansion of the market for motion pictures and tapes in California by reducing the cost of leasing such pictures, thereby promoting the economic health of the motion picture industry. Proponents of the exemption also argue that it is needed to provide tax equity between exhibitors of motion pictures and tapes versus other forms of entertainment, such as a live theater, that are not subject to the sales and use tax.

Comments

The estimated revenue loss shown above is based only on leases to movie theaters in California, because these transactions involve the transfer of a physical copy of the movie. Television programming, on the other hand, can be, and often is, transferred via satellite or phone lines, which would not be subject to taxation, even in the absence of this program. Consequently, the additional revenue that would be realized from taxing leases of television programming would be relatively small.

The tax equity rationale for this program fails to recognize that many forms of entertainment are subject to sales and use taxes. Examples include videocassette rentals, books, and games.❖

Master Tapes and Master Records

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6362.5.

Description

This program exempts from taxation qualifying transfers of master tapes and master records that are used by the recording industry in making sound recordings. The sales tax does apply, however, to purchases of the tangible *elements* of such master tapes and recordings (for example, the cost of the blank tape) when these are acquired from a recording studio by a tape or recording producer.

Rationale

This program provides tax relief for the producers of master tapes and records, to the extent that sales and use taxes ordinarily would be incorporated into the prices of these items. At the time this program was enacted, the program was rationalized on the basis that the value of a master tape or record was primarily attributable to the intangible element of the music or other information stored on the tangible medium. The proponents of this exemption argued that it was not proper for the state to tax the value of such intangible elements.

Comments

A recent court decision has created uncertainty as to whether master records and tapes would be taxable in the absence of this program. The California Court of Appeal, in May 1990, upheld a lower court ruling granting certain entertainers and others a refund of taxes imposed on a master recording prior to enactment of this program. The court found that the performances were the true objects of the transaction, rather than the master tapes themselves. In its decision, however, the Court of Appeal precluded the use of this case as a precedent, so that any other similar refund claims will have to be decided on their own merits.❖

Printed Advertising Materials

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Up to $50
1990-91	Up to $50
1991-92	Up to $50

Authorization

California Revenue and Taxation Code Section 6379.5.

Description

This program exempts from taxation the sale or use of catalogs, letters, circulars, brochures, and pamphlets consisting substantially of printed advertisements for goods and services. To qualify, these materials must be (1) printed to the special order of the purchaser and (2) mailed or delivered by the seller, seller's agent, or a mailing house through the United States Postal Service or by common carrier, to another person at no cost to the recipient.

Rationale

This program provides tax relief to California printers and retailers. The rationale for the program is to provide tax equity for California printers. When a California retailer contracts with an out-of-state printer to print its advertising, the printing job is not subject to sales tax. In the absence of this program, a similar contract with a California printer *would* be subject to sales tax. Program proponents argue that the program is necessary to make California printers competitive with out-of-state printers.

Comments

This program was established by Ch 1515/86 (SB 2527, Robbins), and took effect on January 1, 1987. An alternative way to provide tax equity for California printers in the absence of this program would be to apply the *use* tax to printed advertising materials purchased from out-of-state printers by California firms. In cases where the out-of-state printer sends the advertising material directly to California recipients, there had been concern that imposing the use tax would unconstitutionally interfere with interstate commerce. That concern appears to have been erased by a 1988 decision of the U.S. Supreme Court (*D.H. Holmes Co. v. McNamara*, 48 U.S. 24, 100L Ed 2d 21, 108 S Ct 1619). In that case, the court unanimously upheld Louisiana's imposition of use tax on catalogs printed outside the state for a Louisiana retailer and delivered directly to prospective customers in Louisiana.

We estimate the total value of all catalog, directory, and printed advertising products generated for use in California to be approximately $2 billion. If all such products were subject to taxation, the state sales tax liability would be approximately $100 million. However, this figure dramatically overstates the revenue loss to the state due to this program, for two reasons. First, an unknown number of these products are already subject to taxation. For example, catalogs that are *sold* to consumers are taxed, as are many other advertising materials. In addition, an unknown portion of these products would not be subject to taxation, even if this program were repealed. For example, according to the California Board of Equalization (BOE), advertising inserts in newspapers would continue to be exempt from taxation under the exemption for newspapers and periodicals. As a result, the actual revenue loss from this program is unknown, but is probably in the tens of millions of dollars annually. The BOE estimates the loss at up to $50 million annually.❖

Qualified Motion Pictures and Qualified Production Services

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$3
1990-91	3
1991-92	4

Authorization

California Revenue and Taxation Code Section 6010.6.

Description

This program exempts from taxation charges for qualified production services (fabrication labor) used in the production of a motion picture (including videos, or any other commercial audiovisual works). These services include the production of special effects, sound, editing, and photography, regardless of whether the service is performed under the producer's supervision or done independently. The exemption does not include the production of duplicates or release prints, however.

Additionally, the program exempts transfers of all or part of qualifying motion pictures, or any interest or rights to them (including partially finished work and intermediary materials). To qualify, the motion picture must either be (1) sold before it is first exhibited or broadcast to its general audience or (2) transferred to any persons holding exploitation rights which they gained prior to the first exhibition.

These exemptions do not apply to (1) the transfer of raw film or videotape stock, (2) the transfer of release prints or tapes for exhibition or broadcast, or (3) rentals or leases of videocassettes, videotapes, or videodiscs for private use.

Rationale

This program has several rationales. First, it provides an incentive for retaining motion picture production activities in California by reducing the industry's tax burden.

A second rationale is that the program simplifies tax administration. Before this program was established, the taxability of charges for special effects and other production services depended on whether those services were performed by studio employees or contractors supervised by the producer (in which case they were not taxable) versus by contractors operating independently (in which case they were taxable). Taxation was complex because it was difficult to distinguish among the various contractual relationships.

A third rationale is to create tax equity between (1) studio employees and contractors who perform the same kinds of work and (2) integrated producers that produce a finished work and those that specialize in one segment of the work, such as filming or postproduction editing.

Comments

Fabrication Labor. Although services themselves are not subject to the sales and use tax, fabrication labor used to make an item of tangible property generally is subject to tax. For example, charges by a tailor to make a suit are taxable. even if the customer provides the cloth. This provides tax equity between custom-made products and off-the-shelf products. However, there is no tax on fabrication labor if it is provided by employees of the same company that uses the finished product (since no sale or transfer of property occurs), or, in many cases, if the labor is performed under the supervision and subject to the approval of the customer.

The creation of special effects for motion pictures usually involves the production of tangible property (a film or video product) that is an intermediary product used to incorporate the special effect into the final motion picture. In the absence of this program, the sale of that intermediate product to a producer by a contractor who is not supervised by that producer generally would be taxable.

Sales of Motion Pictures. Sales of completed motion pictures prior to their commercial exhibition are considered a sale for resale and would not be taxable, even in the absence of this program. Sales of rough footage or other intermediary products for a motion picture in progress generally would be taxable in the absence of this program, however.

This program was established by Ch 1157/88 (SB 1405, Roberti).◆

Mobile Transportation Equipment Leases

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6006 (g) (4) and 6010 (e) (4).

Description

This program exempts from taxation the lease or rental of certain mobile transportation equipment used in the transportation of persons or property. Qualifying equipment includes railroad cars and locomotives, buses, trucks, truck tractors, truck trailers, dollies, bogies, chassis, reusable cargo containers, aircraft, ships, and tangible personal property which is or becomes a component part of such equipment. Equipment which does *not* qualify for the program includes one-way rental vehicles, passenger vehicles, and trailers and baggage containers designed to be hauled by passenger vehicles. The purchase of mobile transportation equipment by the lessor, however, is generally subject to sales and use tax.

Rationale

This program provides tax relief to users of qualifying transportation equipment, to the extent that sales and use taxes on equipment leases and rentals would increase prices to equipment users. According to the California Board of Equalization, the program has several rationales. One involves the administrative complexities of determining the portion of leasing payments that is related to interstate commerce activities, which are exempt from taxation. Another relates to the difficulty of separating out the portion of lease payments associated with the provision of related services, such as maintenance, which themselves are nontaxable.

Comments

Existing law allows lessors of mobile transportation equipment to *elect* to pay tax on rental receipts, rather than on the equipment's cost at the time of purchase. However, this option is available only to lessors who make no use of the equipment other than renting or leasing it.◆

Vessels That Transport Over 1,000 Tons

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	–
1990-91	–
1991-92	–

Authorization

California Revenue and Taxation Code Section 6356.

Description

This program exempts from taxation the sale of certain vessels sold by their builder. In order for the program to apply, the vessel involved must be capable of transporting cargoes of more than 1,000 tons. The program does not, however, exempt such vessels from the use tax.

Rationale

The program was originally intended to eliminate a tax "penalty" for purchases of vessels within the state by equalizing the taxation of ships purchased within the state with those purchased outside the state but for use within the state. At the time this program was enacted, it was thought that the purchase of a vessel from an out-of-state builder for use within the state could not be taxed by the State of California, due to limitations under the U.S. Constitution of state taxation of interstate commerce.

Comments

The original rationale was superseded by a 1942 federal court ruling involving the taxability of vessel purchases. Specifically, in the case of *Los Angeles Lumber Products v. Board of Equalization (45 Fed. Supp. 77)*, the court ruled that the U.S. Constitution does not prohibit a ship purchased out of state for in-state use from being taxed by California. Given this, purchasers would have no tax-based incentive to buy their ships out of state in the absence of the program. As a result, the only effect of the program is to eliminate the shipbuilder's responsibility to collect sales tax for vessels to be used within California (vessels used in interstate or foreign commerce would be exempt in any case). Instead, the buyer of the vessel is responsible for paying the use tax if it applies. Consequently, this program currently has no revenue effect.❖

Vehicles for Physically Handicapped Persons

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6369.4.

Description

This program exempts from taxation the sale and use of items and materials used to modify vehicles for physically handicapped persons. The program also exempts from taxation the portion of the price of a vehicle attributable to handicapped modifications. In order to qualify, the vehicle purchaser must be eligible for a disabled license plate or placard for disabled parking.

Rationale

This program provides tax relief to physically handicapped persons who must rely on specially modified vehicles, such as those with wheelchair lifts and special steering devices. It provides such relief to the extent that sales and use taxes ordinarily would be incorporated into the cost of the modifications, and to the extent that these costs are then borne by handicapped persons. The underlying rationale for the program is that access to vehicles with special modifications is a necessity for many handicapped persons, and one that can impose especially onerous financial burdens on them since their income-earning potential often is restricted.❖

New Trucks and Trailers for Out-of-State Use

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6388 and 6388.5.

Description

This program exempts from taxation the sale or use of new or remanufactured trucks, truck tractors, trailers, semitrailers, trailer coaches, and auxiliary dollies purchased in California for use outside the state or in interstate or foreign commerce.

All of the above types of vehicles and equipment qualify for the tax exemption if the vehicle is (1) purchased by an out-of-state resident from an out-of-state dealer, (2) delivered by the manufacturer to the purchaser within California, (3) taken out of the state within 30 days, and (4) registered in another state.

A somewhat broader exemption applies only to trailers and semitrailers. These vehicles may be purchased from either an in-state or out-of-state dealer, and they may be delivered by either the manufacturer or dealer within California. The exemption applies if they are (1) purchased for out-of-state use or for interstate or foreign commerce, (2) taken out of the state within a specified time period, and (3) registered in another state. If the trailer or semitrailer is manufactured out-of-state, the purchaser has 30 days to take it out of California. If the vehicle is manufactured in California, the purchaser has 75 days to remove it from the state. The purchaser does not have to be an out-of-state resident.

Rationale

This program benefits California manufacturers of trucks and trailers and California dealers who sell trailers and semitrailers. In the absence of this program, purchases of qualifying equipment for out-of-state use from California manufacturers or from California dealers (for trailers and semitrailers) could be subject to the sales or use tax if delivery is taken at the manufacturer's or dealer's California location. Program proponents argue that such a tax would discourage these purchases. The rationale for the program is to stimulate the California trailer-coach manufacturing and remanufacturing industry.

Comments

By making delivery outside California, the manufacturer or dealer could arrange to avoid any California sales or use tax liability on the transaction, even in the absence of this program. This is because the transaction would be classified as an interstate sale, which is not taxable. Given this, the actual revenue loss due to this exemption probably is relatively small. The primary effect of the program is to facilitate sales by California truck and trailer manufacturers and dealers and to reduce their costs of delivering vehicles.❖

Cargo Containers

Sunset Date: January 1, 1994

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6388.6.

Description

This program exempts from taxation qualified transfers of cargo containers. In order to qualify for the program, a container must be used in interstate commerce, produced in state, and delivered to an in-state purchaser, and be subsequently moved out of the state within 30 days. In addition, the purchaser must supply various information to the manufacturer regarding the container's use, and the container itself must satisfy various requirements regarding its size and physical characteristics.

Rationale

This program has been rationalized on two grounds. First, the program provides a tax incentive for the cargo container manufacturing industry to locate in California. It does this by reducing the prices for which such containers may be profitably sold, thereby increasing their marketability. Second, the program tends to equalize the tax treatment of cargo containers with that of trailers and semitrailers. (Trailers and semitrailers sold to out-of-state businesses are exempt from taxation under California Revenue and Taxation Code Sections 6388 and 6388.5.)

Comments

State law also exempts cargo containers which are used in ocean commerce from property taxation.

This program originally was established in 1980 by Ch 1290/80 (AB 2769, Sterling), and its initial sunset date was extended from 1984 to 1994 by Ch 1050/83 (AB 1943, Tanner).❖

Partial Exemption for Low-Emission Motor Vehicles

Sunset Date: January 1, 1995

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	--
1990-91	--
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 6356.5.

Description

This program exempts from taxation the incremental costs of purchasing a new low-emission vehicle (LEV). This incremental cost is the difference between the cost of a LEV and the cost of a comparable conventional gasoline or diesel vehicle. The program also exempts from taxation the full cost of equipment purchased to convert conventional vehicles to LEVs. To qualify for the exemption, the vehicle model or equipment must be certified by the Air Resources Board (ARB), and the State Energy Resources Conservation and Development Commission must determine the incremental cost for each vehicle model. In addition, the vehicle or equipment must meet certain labeling and documentation requirements. LEVs may be either (1) gasoline- or diesel-fueled vehicles with half or less than half the amount of hydrocarbon emissions normally allowed or (2) vehicles using alternative fuels, such as methanol, that contribute no more to ozone formation than a gasoline-fueled LEV.

Rationale

The program provides tax relief to purchasers of LEVs or LEV conversion equipment. The goal of this program is to reduce air pollution by lowering the cost of new or converted LEVs. A second rationale is that vehicles which use alternative forms of fuel can reduce the state's dependence on foreign sources of fuel.

Comments

This program was established by Ch 990/89 (SB 1006, Leonard). In order for this program to become operative, two events must occur: (1) the ARB must issue a list of qualifying LEVs and (2) the California Energy Commission must determine the incremental cost of the vehicles on that list, and report that determination to the California Board of Equalization (BOE). The ARB issued its list of vehicles in October 1990. The Energy Commission has not yet reported its determination of incremental costs to the BOE, but is expected to do so by 1992. Thus, there will not be any immediate revenue loss under this program.

The list approved by the ARB consists of numerous existing automobile models that already are on the market. Energy Commission staff indicate that none of the vehicle models on the initial list have any incremental cost associated with them, as they are already priced similarly to other conventional gas- or diesel-powered vehicles. Thus, initial revenue losses under this program are expected to be minor.

New ARB regulations adopted in October 1990 will require increasing use of LEVs that meet increasingly strict emission standards, beginning in the mid-1990s, so that some revenue loss could begin in 1992 and grow in subsequent years. Based on estimates by the ARB, these future LEVs could have incremental costs ranging from a few hundred to a few thousand dollars per vehicle. Therefore, the potential revenue loss to the state could run in the millions of dollars annually, if the partial exemption for LEVs is extended beyond the present sunset date of January 1, 1995.❖

Leases of Specified Linens

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6006 (g) (2) and 6010 (e) (2).

Description

This program exempts from taxation the sale and use of linen supplies and similar articles. To qualify for the program, these supplies and articles must be provided under a lease agreement that includes recurring laundering and cleaning services. Linens exempt under this program are taxable at the time of purchase by the lessor.

Rationale

This program gives tax relief to providers and consumers of leased linen. Its apparent rationale is that most of the price charged for linen supplies represents the cost of the laundering and cleaning *services*, which would be exempt if provided separately.

Comments

Generally, lessors have the option of paying tax on their original purchase price or on their lease receipts. Consequently, this provision requires taxation of leased linen only on the basis of its original purchase price. It also clarifies that laundering and cleaning by the lessor do not constitute remanufacturing of the linens, which would require taxation of the lease receipts.❖

Leases of Household Furnishings

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Sections 6006 (g) (3) and 6010 (e) (3).

Description

This program exempts from taxation the lease of household furnishings, when the furnishings are leased along with a lease of the living quarters in which they are to be used. The furnishings are taxable, however, at the time of purchase by the lessor.

Rationale

According to the California Board of Equalization, this program exists to facilitate tax administration. Taxing the rental of furnishings in living quarters would require registering and auditing landlords, who generally are not sellers of any other taxable goods. Also, it would be difficult to determine what portion of rent is for the furnishings.

Comments

Generally, landlords pay tax when they purchase furniture, and would not be taxed on their furniture rental receipts, even in the absence of this program. This is because of the broader provision that allows lessors to choose whether to pay tax on their original purchase or on their lease or rental receipts. Consequently, the revenue loss due to the program is minor.❖

Sales Price of Factory-Built Housing

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 6012.7.

Description

This program exempts from taxation 60 percent of the sales price of qualified factory-built housing, such as modular housing and sectionalized housing.

Rationale

This program attempts to equalize the sales and use tax treatment of factory-built housing with that of conventional housing. When a contractor builds a *conventional fixed-foundation home,* he or she normally pays sales and use taxes on the tangible property that becomes a part of the home, such as lumber, paint, and wallboard. The home sale itself, however, is not subject to the sales tax. Thus, the value of the home not due to the materials embodied into it is exempt from taxation.

This program applies the same approach to taxing *factory-built housing* when sold by a manufacturer or dealer. Specifically, data from the industry indicate that about 40 percent of the sales price of modular housing represents the value of materials. Thus, this program excludes from taxation the remaining 60 percent of the sales price not due to materials.

Comments

California Board of Equalization (BOE) Regulation 1521 generally treats the purchase and installation of modular buildings as construction contracts for sales and use tax purposes. Consequently, the manufacturer pays tax on materials, and the purchaser pays tax only on the value of fixtures (such as an air conditioner or stove). According to the BOE, the total tax liability under this regulation is similar to the tax liability under this program. Therefore, this program does not significantly affect tax revenues compared with the board's regulatory interpretation of general sales tax law.◆

Sales Price of New Mobilehomes

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$11
1990-91	12
1991-92	12

Authorization

California Revenue and Taxation Code Sections 6012.8 and 6012.9.

Description

This program exempts from taxation 25 percent of the sales price of a new mobilehome to the retailer, provided that the home is sold by the retailer for installation on a foundation as a residence. The sale of the mobilehome by the retailer to the homeowner is fully tax-exempt.

Rationale

This program provides a measure of tax equity between mobilehomes used on a permanent site, with conventional and factory-built housing. It does this by recognizing that a portion of the retail value of both conventional and factory-built housing is exempt from sales and use taxation. Specifically, in the case of qualified factory-built housing, the exemption is equal to 60 percent of the consumer's purchase price. In the case of conventional housing, the difference between a house's selling price and the cost of taxable materials to the builder is tax-exempt.❖

Used Mobilehomes

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$30
1990-91	32
1991-92	33

Authorization

California Revenue and Taxation Code Section 6379.

Description

This program exempts from taxation the sale or use of any used mobilehome that is subject to the property tax.

Rationale

This program provides tax relief to the seller of a used mobilehome, and to its purchaser to the extent that the reduced tax liability is reflected in lower selling prices. The rationale for the program is to equalize treatment of mobilehomes with that of conventional "stick-built" housing, whose resales are not subject to sales taxation.

Comments

Any new mobilehome purchased after 1980 is automatically placed on the property tax roll, and therefore would not be subject to sales tax upon resale.

However, for mobilehomes purchased *new prior* to 1980, the mobilehome owner may choose whether to treat the mobilehome as property subject to the property tax, or as a vehicle. In the latter case, the owner would pay an annual licensing fee, and the buyer would be liable for use tax upon resale of the mobilehome.❖

Custom Computer Programs

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$56
1990-91	60
1991-92	64

Authorization

California Revenue and Taxation Code Section 6010.9.

Description

This program exempts from taxation the sale or use of custom computer programs, other than a basic operational program (including a control program). In addition, a program's documentation and storage media also are exempt from taxation.

Rationale

The rationale for this program is that sales of qualified custom computer programs are primarily service-type transactions and, therefore, not subject to taxation.

Comments

This program was established in 1982 by Ch 1274/82 (AB 2932, Vasconcellos). That measure stated it was the Legislature's finding and declaration that the sales of custom programs, other than basic operational programs, are service transactions not subject to any sales and use taxes. The measure further stated that the use of any storage media in the transfer of custom computer programs is only incidental to the true objective of the transaction, which is the performance of a service. As such, the Legislature declared that the measure was declaratory of, and not a change in, existing law.

The resale of a custom computer program is subject to tax, however, because the program was not prepared to the special order of the purchaser (*Touche Ross & Co., v. State Board of Equalization,* 203 Cal.App.3d 1057, review denied).◆

California Gold Medallions

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$0.1
1990-91	0.1
1991-92	0.1

Authorization

California Revenue and Taxation Code Section 6354.

Description

This program exempts from taxation the sale or use of commemorative "California Gold" medallions.

Rationale

This program provides an incentive for individuals to purchase commemorative "California Gold" medallions, to the extent that the taxation of such medallions ordinarily would be incorporated into the price charged for them.

The program also equalizes the tax treatment of these medallions with that of monetized bullion, nonmonetized bullion, and certain coins and medallions. California Gold medallions are not exempt from taxation under Section 6355 of the Revenue and Taxation Code, as are these other metallic transactions (in values of $1,000 or more). Proponents of this program argue that California Gold medallions are comparable to these other items (such as South Africa's Kruegger-and), because all can be used as investments.

Comments

This program gives California Gold medallions an advantage over bullion coins by exempting all sales, not just those for $1,000 or more.

The Department of General Services was required by Ch 826/82 (AB 676, Kelley) to design a series of commemorative gold medallions meeting certain specifications.❖

Monetized Bullion, Gold and Silver Bullion, and Numismatic Coins

***Sunset Date:** January 1, 1994 for gold and silver bullion only*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6355.

Description

This program exempts from taxation the sale or use of monetized bullion (coins whose value is essentially the same as that of the metal they contain), nonmonetized gold and silver bullion, and numismatic coins (these have value beyond their metal content due to rarity or aesthetic appeal), including gold medallions struck under the authority of the American Arts Gold Medallion Act. To qualify for the program, individual transactions must have a market value of $1,000 or more.

Rationale

This program provides tax relief to purchasers and sellers of qualifying coins and bullion to the extent that taxes on them would increase their price to buyers or reduce proceeds to sellers.

The program is rationalized on two basic grounds. First, many buyers of coins or bullion could avoid California sales tax by making purchases from dealers in other states, either in person or by mail. Although they would be liable for use tax on these purchases in the absence of this program, as a practical matter, the tax is rarely collected on these types of transactions. Thus, program proponents argue that the actual revenue loss from this program is minor, and that the exemption promotes economic activity in California from coin and bullion sales, as well as enabling buyers to deal with local businesses, whose merchandise can be examined and whose reputation can be verified, rather than depending on potentially unreliable or unscrupulous out-of-state businesses.

Second, proponents argue that the program increases tax equity by equalizing tax treatment of coins and bullion with competing investment vehicles, such as stocks and real estate, which are not subject to the sales or use tax.

Comments

We reviewed this program in detail in our *Report on the 1988-89 Tax Expenditure Budget* (Report 88-20, December 1988), pages 71-76. We concluded that, in the absence of this program, most larger sales of bullion (in either monetized or nonmonetized form) would shift to out-of-state dealers, and the state would collect relatively little additional revenue unless changes are made in federal laws that make collection of taxes on these interstate transactions more feasible. However, we recommended repealing the exemption for numismatic coins, because this exemption clearly conflicts with the state's general policy of applying sales and use taxes to other collectibles, such as artworks and jewelry.

The exemption for nonmonetized gold and silver bullion was to have sunsetted on January 1, 1991, and the threshold for the exemption would have changed to a total *face* value, rather than *market* value, of $1,000 at that time. However, these changes were delayed until January 1, 1994 by Ch 1042/90 (SB 677, Beverly).❖

Returnable Containers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6364 (c).

Description

This program exempts from taxation the transfer of *returnable* containers, when sold with their contents in connection with a retail sale of the contents, or when resold for refilling.

Rationale

This program provides tax relief to consumers of products sold in returnable containers, to the extent that sales and use taxes on such containers ordinarily would be passed on in the form of higher product prices. The program can be rationalized on the grounds that the "price" charged for a returnable container often is a deposit, and applying the sales tax on each transaction could result in cumulative total sales taxes that eventually might amount to more than the value of the container itself. Thus, the program removes a disincentive to the use of returnable containers.❖

Containers Whose Contents are Tax-Exempt

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6364 (b).

Description

This program exempts from taxation the transfer of filled containers whose contents are not subject to the sales and use tax.

Rationale

This program provides tax relief to consumers of tax-exempt goods that are sold in containers (such as most food products), to the extent that taxes on the value of such containers ordinarily would be incorporated into the prices paid by these consumers. The program also encourages the use of containerized packaging, and thereby enhances the profitability of this industry. The main rationale for the program appears to be that it lowers the prices at which food and other tax-exempt goods may be sold to consumers. It also simplifies tax administration by eliminating the need to separately state the container prices.

Comments

This program provides an indirect subsidy to consumers who retain empty containers for subsequent use. Examples of this include the use of plastic milk cartons as water jugs and plastic butter containers as kitchen food-storage bowls.❖

Original Artworks and Displays for Specified Museums

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6365 and 6366.4.

Description

This program exempts from taxation the sale or use of original works of art which are purchased (1) by a qualified nonprofit organization, (2) by a state or local government entity, or (3) for donation to a qualified government entity or nonprofit organization. The exemption applies only to art purchased to become a permanent part of the collection of a qualified museum, local government entity or nonprofit corporation.

To qualify, a museum must either: (1) have a significant portion of its space open to the public without charge, (2) be open to the public without charge for not less than six hours per month, during any month when the museum is open to the public, or (3) be open to a segment of the student or adult population without charge. For a local government entity to qualify it must purchase or commission art for public display in buildings, parks, plazas, or other public areas. The areas must be open to the public at least 20 hours per week for at least 35 weeks of the year. In the case of a nonprofit corporation, there are a variety of additional qualifying requirements.

This program also exempts museum pieces purchased for or by the San Diego Aerospace Museum or the California Museum of Science and Industry. The exemption applies only to items which have value as museum pieces. It does not cover display cases, shelving, lamps or other property used in operation of the museum.

Rationale

This program provides an incentive for individuals or organizations to donate, and for government agencies and nonprofit organizations to acquire, works of art that will be made available to the public to enjoy. It does this to the extent that sales and use taxes on artwork ordinarily would increase the cost of acquiring it. The program's underlying rationale is that art and the displays provided by the San Diego Aerospace Museum and by the California Museum of Science and Industry provide valuable cultural and educational benefits, which are worthy of public financial support.

Comments

Separate provisions were established to cover the San Diego Aerospace Museum and the California Museum of Science and Industry because some of their museum pieces would not necessarily be called "works of art," and thus would not qualify under the artwork exemption. These separate provisions extend the exemption to all of the museum pieces of these two museums.❖

Sale-Leasebacks Involving Certain Governmental Entities

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6010.08, 6010.10, 6010.11, 6018.8, and 6368.7.

Description

This program exempts from taxation the transfer of certain transportation, pollution control, or alternative energy equipment when these transfers constitute sale-leasebacks or similar arrangements with designated public agencies for financing purposes. The initial purchase of the equipment is *not* exempt from sales or use tax, however. In order to qualify, the equipment transfer must fall into one of the following categories:

- Transfers of project property to the California Alternative Energy Source Financing Authority and leases by the authority back to project-participating parties.
- Transfers of pollution control equipment and facilities to the California Pollution Control Financing Authority and leases by the authority back to project-participating parties.
- Transfers or leases of mass commuting vehicles (such as buses and rail transit cars) between transit operators and parties providing financing under a "safe harbor" lease arrangement under the federal tax laws.

- Transfers of commuter vehicles (including railcars and locomotives, bus and van fleets, and ferryboats) by the California Department of Transportation and leases of these vehicles back to the department under sale-leaseback arrangements authorized by California Government Code Section 14060 et seq.

Rationale

These programs provide tax relief to purchasers of alternative energy and pollution control equipment who receive financing assistance from state revenue bond authorities. The programs also provide tax relief to transit agencies and the California Department of Transportation for transit and commuter vehicles financed through qualifying sale-leaseback arrangements.

The programs have two rationales. First, it is argued that alternative energy, pollution control, and transit programs are beneficial to society and, therefore, merit public financial support. The second rationale is that, because the exempt transactions are not authentic sales or leases but merely "paper" transactions to obtain favorable financing terms, they should not be taxed.

Comments

These programs predate enactment of Ch 558/90 (AB 3382, Baker), which provides a general exemption from sales and use taxes for property transfers made under qualifying acquisition sale-leaseback arrangements. In the absence of these special programs, many of the specifically exempted transactions probably would qualify for the general exemption (or could be structured to do so). In addition, some transactions exempted under these programs might not be deemed by the courts to be taxable sales or leases, even in the absence of both the special and general sale-leaseback exemptions under the precedent established by *Cedars-Sinai Medical Center v. State Board of Equalization* (162 Cal.App.3d 1182).❖

Motor Vehicle Fuel Used in Airplanes

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$3
1990-91	4
1991-92	4

Authorization

California Revenue and Taxation Code Section 6357.

Description

This program exempts from taxation the transfer of qualified motor vehicle fuel used to propel aircraft, except for aircraft jet fuel. To qualify, the fuel must be subject to the motor vehicle fuel license tax.

Rationale

This program provides tax relief to owners and users of certain aircraft. The rationale for the program relates to the reason why motor vehicle fuel became subject to the sales and use tax in 1972. Prior to that time, such fuel was subject only to motor vehicle fuel excise taxes. In 1972, however, fuel also became subject to sales and use taxation as a means of raising revenues for transportation-related purposes, including support of highways and mass transit. Because air transportation does not benefit from the use of these revenues, motor vehicle fuel used in airplanes remained exempt from sales and use taxation.

Comments

Jet aircraft fuel is not subject to the motor vehicle fuel tax. It is subject to a special aircraft jet fuel tax of 2 cents per gallon.❖

Fuel Sold to Air Common Carriers for International Flights

Sunset Date: January 1, 1994

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$5
1990-91	9
1991-92	10

Authorization

California Revenue and Taxation Code Section 6357.5.

Description

This program exempts from taxation the sale and use of fuel and petroleum products used by air common carriers on flights with a first destination outside the United States. Under California Revenue and Taxation Code Section 6385 (c), any fuel sold to a common carrier for use outside the state *after* the first out-of-state destination is exempt from taxation, so that the net effect of this program is to exempt fuel used on the "first leg" of an international flight.

Rationale

This program benefits domestic producers of jet fuel and airlines that have international flights originating in California. It does so by reducing the price of fuel purchased in California for these flights. The program is rationalized on the basis that it equalizes the tax treatment of domestic fuel producers with that of foreign fuel producers. Current federal law prohibits states from taxing imported fuel brought into the state under customs bond and transferred to common carriers for use in foreign commerce. By applying a similar exemption to domestically produced fuel, the program reduces the relative costs of using domestic fuel, making it more competitive with foreign fuel.

Comments

This program was added by Ch 1227/88 (SB 1942, Craven), and became operative January 1, 1989. The program will sunset January 1, 1994. Additionally, if the federal prohibition on taxing foreign fuel used in foreign commerce is repealed, this program will also be repealed at that time.

Opponents to this program argue that, while the federal prohibition on taxing foreign fuel does place domestic fuel producers at a competitive disadvantage, the problem should not be addressed by a California state tax exemption on domestic fuel. Instead, efforts should be made to have the federal prohibition repealed.

The primary reason for the increase in the revenue loss from 1989-90 to 1990-91 is the increase in the price of petroleum-based products.❖

Meals and Food Products Served in Schools

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$42
1990-91	44
1991-92	47

Authorization

California Revenue and Taxation Code Section 6363.

Description

This program exempts from taxation the transfer of qualified meals and food products that are furnished or served to students in schools (including colleges and universities). In order to qualify for the program, the food must be provided by a public or private school, a school district, a student organization, a parent-teacher organization, or certain blind persons. The program does not apply to meals or food products sold for consumption in a place for which there is an admission charge, except for national and state parks and monuments.

Rationale

This program provides tax relief to students who consume meals and food products provided by qualified persons and organizations, to the extent that taxes levied on such meals and food products ordinarily would increase their prices. The program's rationale is that proper student nutrition should be encouraged and, therefore, the price of the food should not be increased by taxation.❖

Hot Food Products Served to Airplane Passengers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$2
1990-91	2
1991-92	2

Authorization

California Revenue and Taxation Code Section 6359.1.

Description

This program exempts from taxation the transfer of hot prepared food which is either (1) sold by caterers and other vendors *to* airlines or (2) sold or served to passengers *by* airlines. The program applies to air carriers engaged in interstate or foreign commerce.

Rationale

This program provides tax relief to the consumers of food on airplanes, to the extent that taxes on such food ordinarily would increase the prices charged for air travel. The program's proponents have argued that it is appropriate because providing food service is incidental to an airline's main service, which is to provide air transportation. According to this argument, air travelers are "captive eaters," having no choice but to consume whatever food products an airline makes available to them. Accordingly, it is argued that their meals should not be subject to taxation.

The program also simplifies tax administration by eliminating the need to allocate meals by state on interstate flights between California and other states.❖

Meals Served to Patients and Residents of Health Care Facilities

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$45
1990-91	49
1991-92	52

Authorization

California Revenue and Taxation Code Section 6363.6.

Description

This program exempts from taxation the sale or use of meals and food products which are served to patients or residents of any of the following: (1) a hospital or other health facility, (2) a community care facility, (3) a residential facility for persons 62 years of age or older that does not separately charge for meals, or (4) alcohol or drug abuse treatment facilities.

Rationale

This program provides tax relief to consumers of meals and food products served at qualified health care facilities, to the extent that sales and use taxes levied on such products ordinarily would be incorporated into the prices charged for them. The underlying rationales for the program are that (1) providing proper nutrition for residents of health care facilities should be encouraged and, therefore, the price of food in such facilities should not be increased by taxation; and (2) residents of these facilities do not have the alternative of cooking at home.

Comments

Alcohol and drug abuse recovery facilities were added by Ch 278/87 (AB 538, Seastrand) and Ch 919/89 (SB 990, Watson).❖

Meals Provided to Qualified Low-Income Senior Citizens

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6374.

Description

This program exempts from taxation meals and food products served to low-income elderly persons by a nonprofit organization under a program funded by the state or the U.S. Government. To qualify for the program, a meal must be sold at, or below, cost.

Rationale

This program provides tax relief to low-income senior citizens who consume qualified meals, to the extent that sales and use taxes levied on such food ordinarily would be incorporated into its prices. The underlying rationale for the program is that providing proper nutrition to low-income senior citizens should be encouraged, and, therefore, the price of food served to qualifying individuals should not be increased by taxation.

Comments

Many meal programs for low-income elderly persons do not charge for the meals, and those meals would not be subject to tax, even in the absence of this program.❖

Meals Prepared in Common Kitchen Facilities for Qualified Senior Citizens

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6376.5.

Description

This program exempts from taxation meals or food products furnished to and consumed by qualified persons 62 years of age or older. The program applies to food consumed by senior citizens who reside in a condominium and own equal shares in a common kitchen, and for whom food is served on a regular basis.

Rationale

The program provides tax relief to senior citizens living in housing supplying room and board, to the extent that sales and use taxes levied on supplied food products ordinarily would be incorporated into the prices charged to these individuals. The program also equalizes the tax treatment of food served to senior citizens living in independent settings with that of persons living in health care facilities. The underlying rationale for the program is that providing proper nutrition to senior citizens should be encouraged, and, therefore, the price of the food served to qualifying individuals should not be increased by taxation.❖

Meals and Food Products Served by Religious Organizations

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6363.5.

Description

This program exempts from taxation qualified meals and food products that are served by a religious organization, or under its auspices. To qualify, the revenue obtained from serving the meal or food must be used in carrying on the functions and activities of the organization. In addition, only those organizations which qualify for the religious (property tax) exemption may qualify for this program.

Rationale

This program provides an incentive for individuals to contribute financial support to qualified religious organizations by reducing the prices they are charged for meals at fund-raising events. This occurs to the extent that sales and use taxes on such meals ordinarily would be incorporated into their prices. The fundamental rationale for this exemption is that religious organizations undertake various socially beneficial activities that are deserving of public support.

The program also provides tax relief for needy persons who are provided meals at nominal costs by religious organizations, again to the extent that sales and use taxes ordinarily would be incorporated into the prices charged for these meals. Because the program reduces the price and/or cost of providing a meal to a needy person, the program also encourages qualified organizations to provide such meals. The underlying rationale for this aspect of the program is that providing meals to needy persons is a socially beneficial activity.

Comments

A "qualified" religious organization is defined as one which is exempt from property taxes under Article XIII, Section 3(f) of the California State Constitution. This property tax exemption applies to buildings, land on which they are situated, and equipment, provided they are used exclusively for religious worship.❖

Food Stamp Purchases

***Sunset Date:** Upon repeal of federal prohibition on taxation of food stamp purchases.*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$4
1990-91	4
1991-92	5

Authorization

California Revenue and Taxation Code Section 6373.

Description

This program exempts from taxation all purchases made with food stamps. When both food stamps and cash are used to purchase goods, the amount of the food stamps is applied to the cost of taxable items first.

Rationale

California enacted this program to comply with the Federal Food Security Act of 1985, which prohibits any state from participating in the Food Stamp Program if that state taxes food stamp purchases.

California generally exempts food products from the sales and use tax, but some food purchases allowed under the food stamp program are not covered under California's general exemption (such as carbonated sodas). Thus, a separate provision was needed to exempt such items when purchased with food stamps.❖

Health Care Professionals Treated as Consumers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6018, 6018.4, 6018.5, 6018.7, and 6020.

Description

This program provides a partial tax exemption for qualified health care items by treating various licensed health care professionals as if they were the consumer (rather than the retailer) of items that they provide to their patients and clients as part of their professional services. As such, tax is paid on the price that these professionals *pay*, rather than the price that they *charge*, for these items. The program applies to the following professions and items:

- Optometrists, physicians, surgeons, and dispensing opticians with respect to ophthalmic materials, including eyeglasses and contact lenses.
- Chiropractors, with respect to vitamins, minerals, dietary supplements, and orthotic devices.
- Podiatrists, with respect to prosthetic materials and inlays, including special footgear.
- Hearing aid dispensers, with respect to hearing aids.
- X-ray providers, with respect to materials and supplies for medical and dental x-rays, except for purely cosmetic purposes.

Rationale

This program provides tax relief to persons who purchase qualified items from health care professionals. This relief occurs to the extent that sales and use taxes levied on the full retail value of such products (versus their cost to health care professionals) ordinarily would increase their prices. The program is rationalized on the grounds that these products are a component of good health care, which is a basic necessity, and, therefore, their prices should not be subject to full taxation.

Comments

This program and others like it, which define the providers of goods as consumers, result in the *partial* exemption of such products from taxation. The amount of the exemption is tied to the value added to the product's retail price by the provider. The basic cost of the product to the provider, however, *is* subject to sales and use taxation.❖

Veterinarians Treated as Consumers

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6018.1.

Description

This program treats a licensed veterinarian as a consumer (as opposed to a retailer) of the drugs and medicines used or furnished in the performance of his or her professional services. The program thus partially exempts the retail value of such items from taxation.

Rationale

This program provides tax relief to the clientele of veterinarians. It does this to the extent that sales and use taxes levied on drugs and medicines provided to this clientele would increase the prices of such items. The amount of the tax relief depends on the difference between the price of such items to consumers and the cost of such items to veterinarians. The underlying rationale for the program is that medicines and drugs prescribed for animals are a necessity for these creatures and, therefore, that the price of the medicines should not be subject to full taxation.

Comments

The term "drugs and medicines" includes substances necessary for the diagnosis, cure, mitigation, treatment, or prevention of animal diseases. It excludes such items as shampoos, pet foods, and vitamins. The largest uses of veterinary drugs are totally exempt from taxation, however. This is because California Board of Equalization Sales Tax Regulation 1587 (2) (b) and (c) includes medicated feeds and drugs purchased to formulate medicated feeds under the general exemption for animal feeds. Consequently, the revenue loss from this program is probably relatively small.❖

Aircraft for Common Carriers or for Use by Foreign Governments or Nonresidents

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6366 and 6366.1.

Description

This program exempts from taxation the sale or use of aircraft which are to be used either as common carriers or outside of California. The program also exempts from taxation tangible personal property sold to an aircraft manufacturer and incorporated into such aircraft.

Rationale

This program allows the California airplane industry to reduce the prices at which airplanes may be profitably sold, thereby making the industry more competitive.

Comments

Although billions of dollars of sales are exempted from taxation under this program, little of that forgone tax liability would be realized in the program's absence. This is because aircraft sold to common carriers easily could be delivered to them outside of California. In that case, the transaction would be an interstate or international sale that is not subject to California taxation. There would be a compelling incentive to arrange out-of-state delivery in most cases because the amount of tax avoided could be several million dollars on a modern commercial jetliner.❖

Trailers And Semitrailers Moved to Place of Sale

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6410.

Description

This program exempts from taxation the use, storage, or other consumption in California of new or used semitrailers that (1) are not currently registered in any state and (2) are operated in the state for not more than five days as part of a continuous trip to a place where the vehicle will be offered for sale. To qualify for the exemption, the trailer or semitrailer must have obtained a one-trip permit issued by the California Department of Motor Vehicles. The current cost of the permit is $35.

Rationale

This program provides tax relief to the operators of trailers and semitrailers operating under a one-trip permit. Several rationales have been advanced for the program.

First, when this program first was established in 1986, the proponents offered the rationale that operators should not be charged, in essence, twice for their use of roads. Their view was that double-charging would occur in the absence of the program because operators of laden trailers would be required to pay for both (1) a one-trip permit and (2) use taxes based on the rental or sale value of the trailer.

Another suggested rationale for this program is that it simplifies tax administration by relieving tax authorities from locating and assessing use taxes on one-trip operators.

Comments

Neither of the above two rationales supporting this program is entirely satisfactory. The double taxation rationale fails to recognize that the use tax and the one-trip permit fee are for two separate purposes. In the case of the rationale relating to administrative simplicity, its significance is limited because use taxes could be assessed at the same time operators are issued their one-trip permits.

In the absence of this program, the state probably would realize relatively little revenue gain. This is because simply moving an empty trailer to a place of sale would not constitute a use that would be subject to tax. The effect of this program is to make it economically feasible for these trailers to carry freight when they are moved. In many cases, the earnings from this freight carriage would be less than the use tax, and trailer owners would move their vehicles unladen if the exemption were not available.❖

Qualified Watercraft and Their Component Parts

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6368 and 6368.1.

Description

This program exempts from sales and use taxation the sale, lease, or rental of a qualified watercraft and its component parts (including parts used in repairing or maintaining the vessel). In order to qualify for the program, the craft must either be (1) used in interstate or foreign commerce for the transportation of property or persons for hire, (2) used for commercial deep sea fishing operations outside of California's territorial waters, or (3) used 80 percent of the time in transporting for hire property or persons to vessels or offshore drilling platforms located outside of California's territorial waters.

Rationale

This program allows California watercraft builders and dealers, and vessel maintenance and repair businesses to reduce the prices at which their products may profitably be provided, thereby making the California industry more competitive.

Comments

In order for a vessel to qualify as a deep sea fishing vessel, the operator's gross receipts from commercial fishing operations must be at least $5,000 per year.❖

Partial Local Tax Exemption for Fuel Used by Airborne Common Carriers

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	None
1990-91	None
1991-92	None

Authorization

California Revenue and Taxation Code Sections 7202 and 7203.

Description

This program partially exempts fuel used by air common carriers from *local* sales and use taxes. The program's tax exemption is limited to fuel which is (1) subject to the *state* sales or use tax and (2) used outside of the county in which the fuel is purchased. The amount of the exemption equals 80 percent of the tax liability under the Bradley-Burns Uniform Local Sales and Use Tax Law (this is equivalent to applying a tax rate of 0.25 percent instead of the regular uniform local tax rate of 1.25 percent). The program provides a full exemption from any additional transaction and use taxes imposed by special taxing jurisdictions (these vary in amount in different counties and may result in additional local tax rates totaling up to 1 percent).

Under the basic common carrier exemption for the state sales and use tax, fuel purchased in California and used after an aircraft's first out-of-state stop is exempt from all state and local tax. Additionally, all fuel used by an air common carrier on a flight with a foreign first stop is exempt from taxation (until January 1, 1994).

Example

A commercial airliner takes on fuel at Los Angeles International Airport (LAX), makes its first stop in Chicago, and then continues to New York.

- *Fuel consumed between LAX and the Los Angeles County line* would be subject to full state and local sales and use taxes.
- *Fuel used between the county line and Chicago* would be subject to the full state tax rate, but only a portion of the local tax rate.
- *Fuel used between Chicago and New York* would be *fully exempt* from all California state and local sales and use taxes.

Rationale

This program provides tax relief to the commercial air carrier industry and its customers. The program is justified on three grounds: (1) that consumers should not pay a local sales and use tax on property consumed outside of the local taxing jurisdiction, (2) that California airports will enjoy a competitive advantage over those out-of-state airports that have higher taxes, and (3) that the program equalizes competition between California airports located in counties with differing tax rates.

Comments

Until January 1, 1988, this program also applied to fuel used by ships in interstate or foreign commerce.

Because this program provides no *state* tax exemption, there is no state revenue loss. According to the California Board of Equalization, this program resulted in a *local* revenue loss of $15 million in 1987-88.❖

Vehicles, Vessels and Aircraft Transferred Within a Family

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6285.

Description

This program exempts from taxation the transfer of vehicles, vessels, and aircraft when the property is sold by the purchaser's parent, grandparent, child, grandchild, spouse, or brother or sister if the sale is between two minors, provided the seller is not engaged in the business of selling that type of property.

Rationale

This program provides tax relief to persons who purchase vehicles, vessels, and aircraft from immediate family members. The program has two rationales. First, it is based on the view that families should be treated as units, so that transactions between family members should not be taxed. Second, it facilitates tax administration because intrafamily transactions are not at "arms length," and, thus, the price paid could be difficult to determine and may not reflect the market value of the vehicle, vessel, or aircraft.❖

New Vehicles Sold to Foreign Residents

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$0.1
1990-91	0.1
1991-92	0.1

Authorization

California Revenue and Taxation Code Section 6366.2.

Description

This program exempts from taxation the sale or use of any new, noncommercial vehicle manufactured in the United States which is purchased by a foreign resident for shipment outside of the U.S. The purchaser must (1) be a foreign resident, (2) arrange for purchase through an authorized dealer in the foreign country before arriving in the United States, and (3) obtain an "in-transit" permit from the California Department of Motor Vehicles which is valid for up to 30 days. The retailer must ship or drive the vehicle out of the United States prior to the expiration of the in-transit permit.

Rationale

The program's intent is to promote the purchase and export of American-made passenger vehicles and to increase tourism in the state. The program benefits foreign tourists by reducing the cost of purchasing an American-made car in California. Foreign countries currently provide similar programs for American citizens to purchase and operate vehicles overseas prior to their being shipped here.

Comments

This program was established by Ch 762/89 (SB 442, Kopp) and became operative on January 1, 1990. The Department of Motor Vehicles currently charges $60 for an in-transit permit.❖

Occasional Sales

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Major
1990-91	Major
1991-92	Major

Authorization

California Revenue and Taxation Code Sections 6006.5 and 6367.

Description

This program exempts "occasional sales" from taxation. An "occasional sale" is defined as either of the following types of transactions:

- The transfer of tangible personal property (except vehicles, vessels, and aircraft) when the seller is not required to hold a seller's permit. (A seller need not hold such a permit if he or she makes less than three sales for a substantial amount of money in a 12-month period).
- Any transfer in which substantially all of the property held by an entity is transferred, provided that the real or ultimate ownership of such property is substantially similar to that which existed before the transfer. (This type of transfer occurs most commonly in the acquisition or merger of corporations.)

Rationale

This program exists in order to simplify tax administration. By exempting sales made by persons with a small number of sales, the program greatly reduces the number of persons and businesses that must register and file tax returns with the California Board of Equalization. Many of these additional sales would generate little additional revenue. For sales of entire businesses, the program's rationale is that these transactions are primarily financial, as opposed to retail, even though the transfer of tangible property generally is included. The program also provides significant tax relief to those involved in certain transactions, although this is a side effect and not a rationale.

Comments

This exemption constitutes a major tax expenditure program. It recognizes that enforcing sales tax collections by individuals making small private sales (such as a garage sale) is not feasible. However, there is no limit on the value of any individual occasional sale, so that a seller can make large (though infrequent) sales without incurring a tax liability.❖

Occasional Sales of Vehicles, Vessels, or Aircraft

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6282 and 6283.

Description

This program provides a sales tax exemption for occasional sales of vehicles, vessels or aircraft by certain retailers. Specifically, any seller who is not required to hold a seller's permit for such sales by reason of the number, scope or character of the sales is exempt from the payment of the tax. The program does not apply to sales of vehicles by a retailer who is licensed under the California Vehicle Code as a manufacturer, remanufacturer, dealer or dismantler.

Rationale

The rationale for this program is to simplify administration of the sales tax. Sales of vehicles, vessels and aircraft by individuals or businesses that do not regularly deal in these items would be difficult to identify and tax because the seller may not be registered or the sale is outside the seller's regular sphere of activities.

Comments

The program does *not* provide a use tax exemption. The buyer must pay use tax when registering the vehicle, vessel or aircraft unless some other exemption applies.❖

Occasional Sales of Other Products by Hay Producers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6006.5 (c).

Description

This program exempts a producer of hay from liability for sales and use taxes on occasional sales of tangible personal property other than hay. To qualify, the sales must not be of such number, scope, and character that they would be taxable if the producer were not also selling hay.

Rationale

This program provides tax relief to the consumers of tangible personal property, such as tractors, sold by hay producers. The program is rationalized on the grounds that it equalizes treatment for sales tax purposes of hay producers and other farmers. In the absence of this program, a farmer who is required to hold a seller's permit because some of his or her hay sales are taxable (for example, sales to private horse owners), would also be required to pay taxes when he or she sells on an occasional basis any implements used in producing the hay. (This is because all of the sales at retail of a person holding a seller's permit are subject to the sales and use tax.) However, as program proponents point out, other farmers, such as lettuce producers who conduct no taxable retail sales, do not have to hold a seller's permit and, consequently, do not have to collect sales tax on occasional sales of their farm equipment. This program extends this tax treatment to hay farmers.

Comments

Other businesses such as manufacturers, which generally hold seller's permits, are subject to the sales tax upon sales of tangible assets of their business.❖

Membership Fees Charged by Consumer Cooperatives

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6011.1 and 6012.1.

Description

This program exempts from taxation the membership fees charged by consumer cooperatives. The imputed value of labor provided to a cooperative in lieu of monthly membership fees also is tax-exempt.

In the absence of this program, the California Board of Equalization would consider cooperative membership fees (both monetary and in-kind payments) as part of the purchase price of goods sold by consumer cooperatives and, therefore, taxable.

Rationale

This program provides tax relief to members of consumer cooperatives, to the extent that sales and use taxes levied on membership fees ordinarily would increase the costs of belonging to, and buying from, such cooperatives. At the time the program was adopted, proponents argued that the membership fees cooperatives levy are not directly related to the prices they charge for products. Rather, they argued that cooperatives are akin to organizations such as sports clubs, whose membership fees are not directly related to the frequency of facility use. Thus, the program's proponents argue that it provides tax equity between the cooperatives and other organizations such as private clubs.❖

Operators of Specified Clothes Cleaning and Dyeing Businesses Treated as Consumers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6018.6.

Description

This program defines an operator of a qualified state-licensed clothes cleaning or clothes dyeing business as the consumer (as opposed to the retailer) of the materials and supplies used or furnished in altering clothing. The program also exempts the value of these alterations from the sales tax. To qualify for the program, the business involved may receive no more than 20 percent of its gross receipts from the alteration of garments.

Rationale

This program provides tax relief to the customers of cleaners, to the extent that it has the effect of reducing the prices for clothing alterations charged to these consumers. According to the California Board of Equalization, the basic rationale for this program is that it simplifies the process of tax administration. This is because, in the absence of the program, many small cleaning establishments would be required to register as retailers, even though clothing alterations are an incidental part of their overall operations.❖

Vehicles, Vessels, and Aircraft Included in the Sale of a Business

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6281.

Description

This program exempts from taxation the transfer of certain types of vehicles and other property under specified circumstances. The program applies, among others, to certain mobilehomes, commercial coaches, vehicles, vessels, and aircraft, when such property is included in the sale of an entire business that includes the transfer of substantially all the assets of that business.

Rationale

This program provides tax relief to owners of businesses that are sold or reorganized. The program's rationale is that the transfer of the business assets is only incidental to the sale of the business.

Comments

This program is identical to the "occasional sale" exemption provided for the transfer of other property in the sale of an entire business. The occasional sale exemption, however, specifically excludes vehicles, vessels, and aircraft, which are addressed in this exemption.❖

Veterans' Groups Treated as Consumers of the Flags They Sell

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 6359.3.

Description

This program defines nonprofit veterans' organizations as consumers of the U.S. flags they sell, provided that the proceeds of the sales are used exclusively to further the purposes of the veterans' organization. As consumers, such organizations pay sales tax on the price they *pay* rather than on the price they *charge* for the flags they sell, resulting in a partial tax exemption.

Rationale

This program provides an incentive for persons to support the activities of nonprofit veterans' organizations by granting tax relief to those who purchase U.S. flags sold by the organizations. The program has the effect of partially exempting the retail value of such flags from taxation, thereby increasing their marketability. The underlying rationale for the program is the view that the purposes and activities of veterans' organizations are worthy of public financial support.❖

Nonprofit Operators of Vending Machines Treated as Consumers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 6359.45(a).

Description

This program treats as consumers certain operators of vending machines, that dispense items selling for 15 cents or less. In order to qualify for the program, an operator must be a nonprofit, charitable, or educational organization.

Rationale

This program provides tax relief to qualifying vending machine operators and their customers, to the extent that sales and use taxes levied on the full retail price of dispensed items (versus their cost to operators) would ordinarily increase their prices and reduce their marketability. There exist several underlying rationales for the program. One is that the levying of sales and use taxes on individual vending machine products is impractical, since the exact amount of the tax cannot be conveniently incorporated into the coinage charge. Another is that qualifying organizations provide socially beneficial services, and, therefore, their fund-raising efforts and other activities are worthy of public financial support.

Comments

The effect of this program is limited to nonfood items. Food items sold in vending machines for no more than 15 cents (or 25 cents for bulk products) are effectively exempt from taxation, regardless of whether the vendor is nonprofit or profitmaking.❖

Vendors of Library Photocopies Treated as Consumers

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6359.45 (b).

Description

This program defines certain libraries or their contracted vendors as the consumers of photocopies sold through coin-operated photocopying machines. Consequently, libraries pay sales tax on the purchase of the photocopy machine and supplies rather than on the sales price of a photocopy. This has the effect of partially exempting the retail value of a photocopy from taxation. The program applies to any library district, municipal library, or county library. The photocopies must be sold from a machine located at the library facility in order to qualify for the exemption.

Rationale

This program provides tax relief to qualifying libraries and their patrons by reducing the costs of providing photocopying services. It does this to the extent that sales and use taxes on the full retail value of photocopies ordinarily would be incorporated into the price charged for them. The program has several rationales. One is that the levying of sales and use taxes on individual machine-sold photocopies is impractical, since the exact amount of the tax cannot be conveniently incorporated into the coinage charge. Another is that photocopy services serve a worthy public goal of enabling library patrons to make better use of library facilities and information.❖

Sellers of Prisoner-of-War Bracelets Defined as Consumers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	None
1990-91	None
1991-92	None

Authorization

California Revenue and Taxation Code Section 6360.

Description

This program defines qualified sellers as consumers of bracelets commemorating American prisoners of war. To qualify for the program, a seller must be an organization which (1) is formed and operated for a charitable purpose and (2) qualifies for the welfare (property tax) exemption. In addition, the organization's profits must be used exclusively to further the purposes for which it has been established.

Rationale

This program provides tax relief to qualifying bracelet-distributing charitable organizations and their patrons. It accomplishes this by reducing the costs or prices at which such bracelets may be provided or sold, thereby increasing the scope of their distribution. The program's underlying rationale is that the distribution of commemorative prisoner-of-war bracelets furthers the effort to locate and identify prisoners of war.

Comment

The California Department of Veterans Affairs indicates that, to its knowledge, prisoner-of-war bracelets are no longer being sold.❖

Qualified Youth Groups Treated as Consumers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6361.

Description

This program treats qualified youth group organizations as consumers of the food products, nonalcoholic beverages, and certain other items that they sell. This has the effect of fully (in the case of most food products, which are not subject to the sales tax when purchased by these groups, but could be subject to sales tax when resold by them) or partially (for other items for which the sales tax on the purchase price is less than the sales tax on the resale price) exempting the retail value of these products from taxation. Nonfood items must be made by members of the organization in order to receive this treatment. In order to qualify for the program, a group must (1) use its profits exclusively to further its purpose(s), (2) conduct sales only on an intermittent or irregular basis, and (3) be included in one of the following categories:

- Nonprofit groups that are nondiscriminatory and provide a program of competitive sports or promote good citizenship.
- Groups sponsored or affiliated with a qualifying educational institution.
- Specific named groups, including the YMCA, Boy Scouts, and Girl Scouts.

Rationale

This program provides tax relief to qualifying youth organizations and to individuals and businesses who purchase products they sell. It accomplishes this by reducing the costs and prices at which these products can be provided and sold, thereby making them more marketable and increasing their sales potential. The program thus has the effect of giving incentives for such organizations to undertake fund-raising activities and for patrons to support them. The program's rationale is that the objectives and activities of the qualifying organizations are socially desirable and worthy of public financial support.

Comments

Youth groups often operate food stands at sports events and fairs or organize fundraising meals in order to support their activities. Many of these food sales would be taxable in the absence of this program. This is because the food is sold in a hot, prepared form (such as hamburgers or hotdogs), as a meal, or for onsite consumption at an event. Since the food supplies purchased by these organizations are not taxable under the general food exemption, this program results in a full exemption for their sales to consumers (with the exception of carbonated beverages). The program also applies to nonfood items that are made by members of the organization itself, in which case the group pays sales tax on the materials and supplies that it uses, but the finished item is not taxable.

Chapter 116, Statutes of 1990 (AB 520, Klehs), eliminated a previous requirement that youth groups that were not specifically named in statute were required to obtain prior approval from the California Board of Equalization in order to qualify for this program.❖

Qualified Student Organizations Treated As Consumers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6361.5.

Description

This program defines qualified student organizations as consumers of the yearbooks and catalogues they distribute. Consequently, the organizations pay sales tax on their purchase price of such items rather than on the price at which they resell them. This has the effect of partially exempting from taxation the retail value of these items. The program applies to any public or private school, school district, county office of education, or student organization.

Rationale

This program provides tax relief to student organizations and students, to the extent that sales and use taxes on the full retail value (versus acquisition cost) of yearbooks and catalogues ordinarily would increase their prices. The rationale for the program is that such catalogues and yearbooks are a fundamental part of the schooling experience, and, therefore, the costs of such items should not be increased by taxation.❖

Replacements for Destroyed Museum Exhibits

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6366.3.

Description

This program exempts from taxation the sale or use of replacement exhibits for a qualified museum or for a public art display of the state or a local government. The program requires that the property be acquired to replace property physically destroyed by a calamity within three years after its occurrence, and that it be purchased and used exclusively for display purposes within the museum. To qualify, a museum must either (1) have a significant portion of its space open to the public without charge, (2) be open to the public without charge for not less than six hours per month during any month when the museum is open to the public, or (3) be open to a segment of the student or adult population without charge. In addition, the museum must be operated by or for a local or state government entity, or by a qualified nonprofit organization.

Rationale

This program provides tax relief to qualified museums after they have incurred damage from disasters, including fire, flooding, or earthquakes. This relief occurs to the extent that sales and use taxes levied on qualified property ordinarily would be incorporated into the prices paid by museums. The program's rationale is that museums provide a valuable cultural and educational service and, as such, they are worthy of public financial support.

Comments

Generally, *original* artwork purchased by a museum is exempt from tax whether or not it replaces any damaged property. This program also covers copies of artwork and museum pieces other than artwork.◆

PTAs, Co-Op Nursery Schools, and Friends of the Library Treated as Consumers

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6370.

Description

This program treats as consumers nonprofit Parent-Teacher Associations (PTAs), Friends of the Library (or equivalent organizations), and nonprofit parent cooperative nursery schools. As consumers, such organizations pay taxes on the price they *pay* rather than on the price they *charge* for items they sell to raise funds. This has the effect of partially exempting from taxation the retail value of such items. The program requires that any profits derived from the sales of such property be used for furthering the purposes of the organization.

Rationale

This program provides tax relief to qualifying organizations and their patrons, to the extent that taxation of the full retail price of the property these organizations sell would increase their prices and reduce their sales potential. The program thus provides an incentive for organizations to operate, and patrons to support, qualifying activities.

The program's underlying rationale is that the goals and activities of these organizations are socially desirable, and thus worthy of public financial support.❖

Nonprofit Organizations Treated as Consumers When Performing Auxiliary Services for Museums

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 6370.5.

Description

This program treats nonprofit organizations that perform auxiliary services to any city or county museum as the consumers of goods sold by those organizations at qualified rummage sales. As consumers, such organizations pay tax on the price they *pay* rather than on the price they *charge* for items they sell to raise funds. The effect of this is to limit the amount of sales and use taxes levied on such property. In order for the program to apply, the property must be sold at an annual rummage sale which must have been held during each of the five consecutively preceding years, and profits from the sale must be used exclusively for furthering the purposes of the organization.

Rationale

This program provides tax relief to qualified charitable organizations and their patrons, and (indirectly) to the museums which they support. It does this to the extent that the partial sales and use tax exemption on rummage sale property stimulates the sales of this property, and thereby increases the amount of funds which charitable organizations and museums are able to raise from rummage sales. The program is rationalized on the grounds that museum-related activities are socially beneficial and deserving of public financial support.

Comments

This program results in a full tax exemption for donated items sold at these rummage sales.◆

Sales and Donations by Charitable Organizations

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6375.

Description

This program exempts from taxation the sale or use of goods made, prepared, assembled, or manufactured by qualified charitable organizations. In order for the program to apply, an organization must qualify for the welfare (property tax) exemption and be engaged in the relief of poverty and distress. In addition, the organization's sales and donations are exempt only if they are made principally to assist purchasers or donees in poverty or distress.

Rationale

This program provides tax relief to charitable organizations and their clientele, to the extent that it reduces the prices and costs of providing property to disadvantaged persons. The program also provides an incentive for individuals to purchase merchandise sold by charitable organizations. It does this by removing the sales tax on such merchandise, thereby reducing the prices at which the merchandise can be sold. To the extent that the organization's sales are increased as a result, the amount of funds available for the relief of poverty and distress is increased.

The program's underlying rationale is that the qualifying organizations provide a socially desirable service in making property available to distressed persons and, therefore, are deserving of public financial support.

Comments

This program provides a tax exemption for sales in stores operated by Goodwill Industries and similar organizations. In practice, the exemption applies to all sales in these stores, and no attempt is made to determine whether the purchaser is needy or not.

Donations were included in this program by Ch 1447/89 (SB 874, Doolittle). Previously, charities that purchased goods tax-free using their resale permit found that they became liable for tax when they donated these goods, because making a gift constituted a taxable use of the property.❖

Property Loaned to Educational Programs

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6404.

Description

This program exempts from taxation the loan by retailers of certain tangible personal property to qualified educational institutions.

Specifically, the program exempts:

- Loans of tangible personal property to school districts for educational programs.
- Loans of motor vehicles to the University of California or the California State University system for exclusive use in an approved driver education teacher preparation certification program.
- Loans of vehicles to an accredited private or parochial secondary school for exclusive use in an approved driver education and training program.
- Loans of motor vehicles to a veterans' hospital or other nonprofit institution to provide instruction in the operation of specially equipped motor vehicles to disabled veterans.

Under existing law, if a retailer makes use of property that is ostensibly held for sale, he or she ordinarily must pay use tax on the wholesale price of the property. *Loans* of such property are considered "uses" of the property by the retailer and, therefore, are taxable unless otherwise exempted.

Example

In the absence of this program, an automobile retailer who loans a vehicle at no cost to a high school driver training course would pay use tax on the dealership's cost of the vehicle. This is because most retailers are considered "consumers" of merchandise that they use themselves or loan to others. This program exempts from taxation such loans to qualifying educational institutions.

Rationale

This program provides tax relief to qualified educational institutions and the students who use the qualified loaned property. It does this to the extent that exemption of sales and use taxes on such loans enables those educational institutions to service more students because of reduced loan costs. In addition, students who pay fees for the affected programs may pay less because of reduced costs. The underlying rationale for the program is that providing equipment and vehicles to educational institutions is a desirable social goal worthy of public financial support.❖

New Clothing Donated to Elementary School Children

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6375.5.

Description

This program exempts from taxation the sale of new children's clothing when the clothes are sold to a qualified nonprofit organization. In order for the program to apply, the clothes must be distributed without charge to needy elementary school children.

Rationale

This program provides tax relief to nonprofit corporations which distribute free clothes to children. It does this to the extent that sales and use taxes levied on the clothes sold to the organization ordinarily would be incorporated into the prices it is charged. The underlying rationale for the program is that such tax relief increases the amount of clothing which nonprofit organizations may acquire with their available resources, and thereby enables them to better meet the needs of the children they service. The program exists in recognition of the fact that providing such clothes is a socially beneficial activity worthy of public financial support.

Comments

This program is similar to the general exemption for sales and donations by charitable organizations. However, it does differ in three ways. First, the exemption applies to purchases by, rather than sales or use by, the charity. Thus, it is useful to charities that do not have resale permits. Second, there is no requirement that the donating charity qualify for the welfare exemption under the property tax. Third, there is no requirement that the charitable organization prepare, assemble, or make the donated items.❖

First $400 of Overseas Purchases Hand-Carried into California

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$0.6
1990-91	0.6
1991-92	0.6

Authorization

California Revenue and Taxation Code Section 6405.

Description

This program exempts from the use tax the first $400 of purchases made by state residents in a foreign country and personally hand-carried into California. Only one such exemption can be claimed for any 30-day period, and purchases sent or shipped into California do not qualify for the exemption.

Rationale

This program provides tax relief to state residents returning from overseas with purchases that otherwise would be subject to the use tax. The exemption was enacted as part of a new state program which seeks to collect use taxes on foreign purchases. Such taxes generally had not been collected prior to 1990 due to administrative difficulties.

The program is rationalized on both administrative and equity grounds. First, the exemption recognizes that the state's efforts to collect the use tax on foreign purchases is dependent on the federal government's duty collection procedures. The Customs Service recently began to provide the state with customs declarations filed by returning Californians. The Federal Customs Service does not require payment of duties on the first $400 of foreign purchases and keeps no useable record of travelers entering the state with purchases of less than $400. Consequently, the state has no cost-effective means at present to collect use tax from travelers declaring less than $400 of foreign purchases. Obviously, the state could attempt to collect the use tax on the first $400 of purchases brought into the state by travelers who are subject to customs duties. The exemption in this case is rationalized on equity grounds. Program proponents argue that it is not fair to tax someone bringing $400 or more worth of goods into the state from a foreign country based on the full value when someone bringing in $399 would not be billed for any tax.

Comments

The California Board of Equalization started collecting customs declarations on October 1, 1990, and expects to send out 29,000 billings annually for use tax on customs declarations. This program, which was established by Ch 1533/90 (SB 2455, Morgan), exempts $400 of the taxable purchases from each billing, for a state revenue loss of $19 per billing. Consequently, the total annual revenue loss to the state on these billings would be about $550,000 on a full-year basis.◆

Use Tax Exemption for Charitable Donations Made by Sellers

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6403.

Description

This program provides a use tax exemption for property donated by any seller to specified educational institutions, charitable organizations, and nonprofit museums located in California.

Rationale

This program provides tax relief to sellers who donate property to educational and charitable organizations and museums. Generally, a person who is in the business of selling (a "seller") and buys goods solely for resale does not pay sales or use tax on their purchases. Rather, tax is collected only on retail sales -- that is, sales to someone who will actually make final use of the goods. If, however, property originally bought for resale is instead used by the seller rather than resold, the seller must pay use tax. This includes donations of property, which are considered a "use" of the property by the seller. This program exempts sellers from paying use tax on items donated to qualifying organizations. The program's intent is to give added incentive to donate property to nonprofit organizations and museums, the rationale being that such organizations serve a public purpose and are deserving of public financial support.

Comments

This program was enacted by Ch 905/88 (SB 2508, McCorquodale) and originally applied only to persons engaged in retail sales activity who donated property. The program was expanded by Ch 1387/89 (SB 1226, Campbell), however, to include all sellers (including wholesalers). Chapter 1387 also restricted the program to donations used exclusively for display in the case of nonprofit museums, and required qualifying museums to meet minimum standards for public access.❖

Option to Pay Tax on Cost Rather than Lease Receipts

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6006 (g) (5) and 6010 (e) (5).

Description

This program provides that owners of property engaged in the business of leasing that property to others may choose to pay sales tax based on the *purchase price* that they paid for the property, rather than pay use tax on their *lease receipts*. To qualify, property must be leased in substantially the same form as it was acquired by the lessor. This program does not apply, however, to the rental of video cassettes, which are taxed solely on the basis of rental receipts under California Revenue and Taxation Code Section 6006(g)(7).

Rationale

This program provides tax relief to lessors and lessees of qualified property. The rationale underlying the program is to facilitate the compliance of the lessor with the state sales tax code and to simplify tax administration. The program accomplishes these ends by allowing businesses to pay the sales tax once, upon the purchase of the item, rather than requiring the lessor to pay the tax repeatedly based on the property's rental receipts.

Comments

Under this program, a lessor can choose the most advantageous tax strategy for any specific situation. The California Board of Equalization indicates that lease receipts are chosen as the basis of tax for about 75 percent of all leased property. This approach is preferred by car rental companies, for example. Most rental cars are resold after a year or two, so that rental receipts for these cars are significantly less than their purchase price. Thus, paying tax on the rental receipts results in a smaller total tax liability for the rental company than paying tax based on the purchase price. Secondly, paying tax on lease or rental receipts reduces the amount of capital required for lessors to purchase property initially. Alternatively, paying sales tax on the purchase price, rather than on lease receipts, generally would result in a smaller tax liability for property that is leased for its full economic life.❖

Tax Liability on "Bad Debts"

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 6055 and 6203.5.

Description

This program exempts retailers from paying sales and use taxes due on accounts which have been determined to be uncollectible.

Rationale

This program provides tax relief to businesses which have incurred financial losses due to their inability to collect money from customers who have not paid their bills. The underlying rationale for the program is that businesses, especially small firms, can suffer considerable hardships when they are unable to collect money from customers who have purchased goods using credit. Such financial losses can impair a firm's ability to pay taxes, since the funds to pay these taxes normally are collected from its customers.

Comments

The above-cited rationale for this program is strongest when retailers can show that they have executed proper caution when granting credit to consumers. In the absence of such care, however, the rationale loses strength.❖

Sale-Leaseback Arrangements

Sunset Date: January 1, 1995

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 6010.65.

Description

This program exempts from sales and use taxation any transfer of the title to, or lease of, property under a qualifying "acquisition sale-leaseback." An acquisition sale-leaseback is a financing arrangement wherein the purchaser of property sells that property to a third party and then leases it back from that third party. These transactions generally are "on paper" only and do not involve any physical transfer of the property. In order to qualify for this program, an acquisition sale-leaseback must be consummated within 90 days of the first functional use of the property, and the sales or use tax must have been paid on the initial purchase of the property.

Rationale

The program reduces the cost of acquiring property financed through sale-leaseback arrangements. It does so by eliminating sales tax on the sale to the lessor or, alternatively, use tax on the lease payments to the lessee. The rationale for the program is that qualifying sale-leasebacks are financing arrangements similar to a mortgage. On that basis, it is argued that taxing the sale-leaseback transaction, in addition to taxing the initial purchase of the property, would amount to double taxation.

Comments

Most sale-leaseback transactions probably would be exempt from sales and use taxes, even in the absence of this program. This is because the courts have ruled (prior to the establishment of this program) that no taxable sale occurs when the sole object of a sale-leaseback is to obtain financing for the purchase of equipment (*Cedars-Sinai Medical Center v. State Board of Equalization, 162 Cal.App.3d.1182*). The program was enacted by Ch 558/90 (AB 3382, Baker), in part to simplify tax administration by setting a specific 90-day window in which sale-leasebacks must be completed in order to be tax-exempt.❖

Partial Exemption for Factory-Built School Buildings

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 6012.6.

Description

This program exempts from taxation 60 percent of the sales price of qualified factory-built school buildings. Additionally, it specifies that the place of sale is the retailer's place of business, regardless of whether the sale includes installation or the building is placed on a permanent foundation.

Rationale

The intent of the partial exemption is to equalize tax treatment of factory-built school buildings with that of site-built buildings. Generally, the sales and use tax applies only to the building materials used to construct a site-built building, rather than to the full price of the completed building. The Legislature determined that approximately 40 percent of the sales price of a factory-built school building represents the value of the building materials and, thus, the remaining 60 percent of the price of such school buildings should be exempt from taxation.

This program is consistent with the 60 percent exemption which also applies to factory-built housing.

Comments

This program was enacted by Ch 816/89 (AB 1051, Leslie) and Ch 4029/90 (AB 763, Leslie).

The California Board of Equalization (BOE) adopted regulations a few months prior to enactment of this program which classified essentially all installations of modular buildings, including factory-built school buildings, as construction projects so that they would be taxed as if constructed on the site. Under that treatment, a purchaser, such as a school district, pays sales tax only on the value of fixtures and equipment supplied with the building. The manufacturer pays sales or use tax on the materials used to make the building, but no tax is applied to the value added by the manufacturer. According to the BOE, the total tax liability for manufactured buildings under this regulation is similar to the tax liability under this program (that is, about 40 percent of the total value is taxed). Therefore, this program has no significant impact on the amount of tax revenue compared with the board's regulatory interpretation of general sales tax law.

Under the board's regulations, however, the local share of sales tax revenues would have been allocated to the localities where the manufacturer's suppliers were located and to the locality where the building was installed. The main purpose of enacting this program was to ensure that the city and county in which the building manufacturer is located continue to receive the local portion of the sales tax.❖

Endangered Animal and Plant Species

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 6366.5.

Description

This program exempts from taxation the sale or use of endangered animal or plant species, provided that the buyer and seller are both nonprofit zoological societies.

Rationale

The intent of this program is to provide tax relief for zoos that breed and exchange animals and plants of endangered species (primarily animals). Some zoos specialize in the development and breeding of certain animal species. Prior to enactment of this program, zoos had been assessed back taxes for making animal exchanges. The program's rationale is that it is a worthy public goal to encourage zoos to breed and exchange endangered species.

Comments

This program does not apply when zoological societies purchase animals or plants from forprofit sources. This program was established by Ch 937/89 (AB 804, Peace) and became operative January 1, 1990.❖

Other State Taxes

Index

Other State Taxes — An Overview

The remaining state tax expenditure programs discussed in this compendium include those associated with the insurance tax and with excise taxes on alcoholic beverages, cigarettes and tobacco products, and fuels. Depending on the specific tax involved, the California Board of Equalization (BOE), the State Controller, and the Department of Insurance have various responsibilities for the administration of these taxes. Excise taxes on alcoholic beverages, cigarettes and tobacco products, and gasoline are collected from the manufacturers or distributors of these products. These taxes do not apply to goods that are sold for export from California. The insurance tax is collected directly from the insurance companies.

Alcoholic Beverage Tax

The alcoholic beverage tax rate is 4 cents per gallon for beer, 1 cent per gallon for most wines, and $2 per gallon for most distilled spirits. Special per-gallon rates apply to sparkling wines (30 cents), fortified wines (2 cents), and distilled spirits over 100 proof ($4).

Cigarette and Tobacco Products Tax

The tax on cigarettes is 35 cents per pack. This amount consists of a base tax rate of 10 cents and a surtax of 25 cents, which was imposed by Proposition 99 and became effective January 1, 1989. Tax rates for other tobacco products are adjusted each year. This adjustment ensures that taxes on other tobacco products are the same as a proportion of their wholesale prices as the combined cigarette tax rate is as a proportion of the wholesale price of cigarettes.

Motor Vehicle Fuel License Tax

Commonly called the gasoline tax, this tax is imposed on gasoline and certain other motor vehicle fuels, other than diesel fuel. On August 1, 1990, the tax rate per gallon increased from 9 cents to 14 cents as a result of approval of Proposition 111 at the June 1990 primary election. The tax rate will increase by an additional 1 cent each January 1 until it reaches 18 cents per gallon in 1995.

Aircraft Jet Fuel Tax

This tax is collected from aircraft jet fuel dealers at the rate of 2 cents per gallon.

Use Fuel Tax

This tax is imposed primarily on diesel fuel. The tax rate is the same as for the motor vehicle license (gasoline) tax. However, the use fuel tax is collected from the dealer, or from the fuel user (such as a trucking company) if the user has a use permit. In order to qualify for a use permit, a user must operate commercial vehicles with an unladen weight of at least 7,000 pounds. Instead of paying tax at the pump, users with such permits file monthly returns with the BOE. They are required to pay tax only on the fuel they use within California.

Insurance Tax

This tax is imposed at a basic rate of 2.35 percent on the amount of gross premiums for insurance sold in California. In addition, the BOE may impose an additional levy on the amount of gross premiums in order to hold the state "harmless" to revenue losses brought about as a result of limitations on insurance premium rates that were imposed under Proposition 103 (approved by the state's voters in June 1988). For taxes due in 1991-92, this additional levy was set at 0.11 percent, thereby making the total insurance tax rate 2.46 percent. Ocean marine insurers are taxed on underwriting profits rather than gross premiums. The insurance tax is in lieu of all other state and local taxes on insurance companies except license fees and property taxes.

Out-of-state insurers operating in California pay additional "retaliatory tax" if the effective tax rate imposed by their home states on California insurance companies operating in them is higher than the tax rate imposed in California on these California firms. ❖

Use of Alcoholic Beverages In Trades, Professions, and Industries

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 32052.

Description

This program exempts from the alcoholic beverage tax the sale of alcohol, distilled spirits, or wine used in the trades, professions, or industries. Such uses typically include cases where alcohol is used as part of a production or treatment process of some sort, such as in pickling processes or the production of gasohol. To qualify, the sale must be made by a distilled spirit manufacturer, brandy manufacturer, rectifier, industrial alcohol dealer, or wine grape grower.

Rationale

This program provides tax relief to the purchasers of exempted items, to the extent that excise taxes levied on them ordinarily would be incorporated into their prices. The underlying rationale for the program is the view that the alcoholic beverage tax is intended to be a tax on alcohol only when it is consumed as a *beverage*, and that other uses of alcohol should not generally be subject to the tax. ❖

Beer Consumed by Brewers' Employees

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 32172.

Description

This program exempts from the alcoholic beverage tax the consumption of beer, when the beer is (1) consumed by the employees of a brewer and (2) consumed on the premises of the brewer.

Rationale

This program provides tax relief to brewers by relieving them of paying taxes on the beer which their employees consume in-house. The underlying rationale for the program appears related to the administrative problems involved with documenting and measuring the volume of in-house beer consumption.

Comments

California Board of Equalization Regulation 2551 limits the amount of this exemption to the maximum amount allowed by federal alcoholic beverage tax regulations. ❖

Distilled Spirits Used in the Manufacture of Food Products

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 32214.

Description

This program exempts from the alcoholic beverage tax the sale of distilled spirits that are used in the manufacture of food products.

Rationale

This program provides tax relief to the producers and consumers of food products that use distilled spirits in their preparation, to the extent that excise taxes levied on such distilled spirits ordinarily would be incorporated into the prices of the food products. The underlying rationale for the program is the view that the alcoholic beverage tax is intended to be a tax on alcohol only when it is consumed as a *beverage,* and that other uses of alcohol should not generally be subject to the tax.

Comments

Some foods use brandy, rum, or other distilled spirits as a flavoring, and little or no alcohol remains in the food after baking or other processing. Alcohol also is used as the base for a variety of flavoring extracts.

This program is applied by granting a tax credit for any taxes paid on distilled spirits used in the qualified manufacture of food products. The program specifies that the manufacturer's use of alcohol in food must conform to certain federal regulations. ❖

Distilled Spirits Used for Research and Medical-Related Purposes

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 32053.

Description

This program exempts from the alcoholic beverage tax the sale of (1) ethyl alcohol used for scientific research, or by any hospital or sanitarium and (2) alcohol used in medicinal, pharmaceutical, antiseptic, or selected other products.

Rationale

This program provides tax relief to the users of alcohol for the above-exempted purposes, including the consumers of products made with such alcohol, to the extent that excise taxes on this alcohol ordinarily would increase costs and prices for these uses. The underlying rationale for the program is the view that the alcoholic

beverage tax is intended to be a tax on alcohol only when it is consumed as a *beverage,* and that other uses of alcohol should not be subject to the tax. This program also can be rationalized on the grounds that the exempted uses of alcohol are for socially beneficial purposes, and, therefore, their cost should not be increased by taxation. ❖

Distributions to United States Armed Forces and the Veterans Administration

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$32
1990-91	32
1991-92	31

Authorization

California Revenue and Taxation Code Section 30102.

Description

This program exempts from the cigarette tax the distribution of cigarettes to the United States Armed Forces and to the United States Veterans Administration.

Rationale

This program provides a tax incentive for the armed forces and Veterans Administration to purchase cigarettes in California, as opposed to outside of California. It does this to the extent that the cigarette tax would make California cigarette prices sufficiently high to cause these entities to purchase cigarettes outside of California. This, in turn, would reduce economic activity in California related to the distribution and retailing of cigarettes.

The program also has been rationalized on the grounds that it grants tax relief to various members of the armed forces and patrons of the Veterans Administration by enabling them to acquire their cigarettes at reduced costs. It has been argued that such persons are deserving of this public subsidy because of their present or past service to their country.

Comments

The U.S. Armed Forces and Veterans Administration are such large purchasers of cigarettes that they can cost-effectively purchase low-cost cigarettes in one state for subsequent sale in a higher-cost state, provided that the interstate price differential exceeds the interstate shipment costs.

The courts have held that this program applies to cigarette sales through military commissaries and exchanges, but not sales to U.S. officers' clubs and officers' messes (52 Ops. Atty. Gen. 164, 8-29-69).

The estimated revenue loss cited above is based on data from the California Board of Equalization (BOE). The estimate includes expenditures under the other cigarette tax expenditure programs, such as distributions to veterans' institutions and small cigarette shipments. This is because these transaction types are not reported separately to the BOE. According to the BOE, however, sales to the military comprise the majority of all exempt cigarette sales.

The tobacco industry benefits from this program to the extent that the program increases demand for tobacco products. ❖

Distributions to Veterans Institutions

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 30105.5.

Description

This program exempts the sale or gift of federally tax-free cigarettes or other tobacco products, when delivered directly from the manufacturer to either a Veterans Home in the State of California, or a hospital or domiciliary facility of the U.S. Veterans Administration. To qualify for the program, the cigarettes must be for gratuitous issue to veterans receiving hospitalization or domiciliary care.

Rationale

This program provides a tax incentive for qualified institutions to provide cigarettes and other tobacco products to their patrons, to the extent that taxes on these items ordinarily would be incorporated into the prices that these institutions have to pay for them. The underlying rationale for the program is that the provision of free cigarettes and other tobacco products to hospitalized veterans is deserving of public financial support, due to the military services that such individuals have provided to their country.

Comments

The tobacco industry benefits from this program to the extent that the program increases demand for tobacco products. ❖

Small Shipments of Cigarettes Transported Into California

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 30106.

Description

This program exempts from the cigarette tax the distribution of cigarettes transported into California from out of state, provided that the total shipment does not exceed 400 cigarettes. The program requires that the cigarettes either be intended for consumption by the individual bringing them into the state, or that they have been obtained at one time or another from the U.S. Veterans Administration, or exchanges or commissaries of branches of the armed forces.

Rationale

This program provides tax relief to consumers of qualifying small-shipment cigarettes. The program's rationale is that the revenues derived from taxing these small shipments are insufficient to justify incurring the administrative costs of collecting the tax.

Comments

There is no similar exemption for other tobacco products. However, Revenue and Taxation Code Sections 30431 and 30432 allow transportation of individual quantities of other tobacco products valued at $25 or less and on which tax has not been paid, without a transporter's permit or invoices. ❖

Natural Gasoline

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 7401 (a) (1).

Description

This program exempts from the motor vehicle fuel license tax the distribution of natural gasoline.

Rationale

This program provides tax relief to producers and users of natural gasoline, to the extent that excise taxes levied on such gasoline ordinarily would be incorporated into its production costs and/or sales price. The program is rationalized on the grounds that unblended natural gasoline generally cannot be used in vehicles which use public highways and airport facilities that are supported by the proceeds of the motor vehicle fuel tax.

Comments

"Natural gasoline" is not the same as the "gasoline" that is commonly sold for use in automobiles. Rather, it is a naturally occurring liquid which often is present in crude oil. Generally, natural gasoline cannot be used directly in automobiles. However, natural gasoline may be blended with crude oil distillates during the production of motor vehicle fuel. In this case, the natural gasoline becomes indirectly taxed as a component part of the motor fuel. ❖

Ship or Aircraft Fuel Ultimately Distributed to the United States Armed Forces

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 7401 (a) (4) and 7401 (a) (5).

Description

This program exempts from the motor vehicle fuel tax the qualified distribution of motor fuel to the armed forces. To qualify for this program, the fuel must be (1) used in a ship or aircraft or (2) used outside of California. The program extends to motor fuel that is distributed to a third party prior to distribution to the armed forces.

Rationale

The basic rationale for this program is that revenues from the motor vehicle fuel tax are directed toward the maintenance of public highways and airports, and these transportation facilities are not used by the vehicles whose fuel use is exempted from taxation under this program. It also has been suggested that the program may increase the purchase of military fuel in California, at least in some circumstances, by reducing its price relative to prices charged in other states. To the extent that this occurs, the program may have some (probably limited) positive economic effects on California fuel producers, distributors, and retailers. ❖

Motor Fuel Used Off-Highway

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 8101 (a).

Description

This program exempts from the motor vehicle fuel tax any motor fuel used for purposes other than operating motor vehicles on public streets and highways.

The program operates via a refund mechanism, whereby the fuel is taxed when purchased and then the purchaser must apply for a refund for qualifying off-road fuel use. Fuel uses that qualify for refunds include use in farm tractors and irrigation pumps, electric generators, and vehicles operated solely on private property (such as within an amusement park). Fuel used by off-road recreational vehicles that are licensed for use on public lands and motor vehicle fuel used in boats are not eligible for this program, however. Fuel use by construction equipment is addressed in a separate exemption.

Rationale

This program provides tax relief to fuel consumers who are not using the fuel to operate vehicles on the public streets and highways. The underlying rationale for the program is that the proceeds of the motor vehicle fuel tax are used generally for the construction and maintenance of public streets and highways. The rationale for not exempting fuel used by off-road recreational vehicles licensed for use on public lands is that the estimated amount of revenues collected on that fuel is allocated to special funds that support off-highway recreational activities. Likewise, the estimated amount of tax paid on motor vehicle fuel used in boats is transferred annually to the Harbors and Watercraft Revolving Fund for the support of various boating programs.

Comments

There are many minor fuel uses that qualify for a tax refund but for which refunds are not requested. Fuel used in home lawnmowers is one example. The Agriculture Fund receives an annual transfer of the estimated amount of *unrefunded* motor vehicle fuel tax for on-farm fuel uses (equal to $9.1 million in 1990-91), pursuant to California Revenue and Taxation Code 8352.5. ◆

Motor Fuel Sold to Consulate Officers and Employees

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 7401 (a) (6), 8101 (e), and 8106.1.

Description

This program exempts from the motor vehicle fuel tax fuel sold to an officer or employee of a foreign consulate when specified conditions are met. In order to qualify, the program requires that the sale must be charged to a credit card held by the consulate and certified by the U.S. State Department, and the fuel must be used in a consular vehicle registered with the State Department. Furthermore, the program only applies to consulates of foreign governments that are exempt from taxes by treaty or who provide a similar tax exemption to U.S. diplomats on a reciprocal basis.

Rationale

This program provides tax relief to foreign governments.

According to the California Board of Equalization, this program helps fulfill the terms of treaties and reciprocal arrangements between the U.S. and countries with consulate employees stationed in the U.S. Under the terms of such treaties and arrangements, U.S. consulate employees are not subject to tax on fuel consumed in foreign countries, and foreign consulate employees are not subject to taxes on fuel consumed in the U.S.

Comment

Chapter 1528, Statutes of 1990 (SB 2196, Garamendi), recently revised and updated this program. That legislation requires qualifying sales to be made using certified credit cards in order to prevent abuse of this exemption. ◆

Motor Vehicle Fuel Used in Airplanes

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$3
1990-91	4
1991-92	4

Authorization

California Revenue and Taxation Code Section 8101.5.

Description

This program exempts from taxation the transfer of qualified motor vehicle fuel used to propel aircraft, except for aircraft jet fuel.

Rationale

This program provides tax relief to owners and users of certain aircraft. The underlying rationale for the program is that the proceeds of the motor vehicle fuel tax are generally used for the construction and maintenance of public streets and highways. Because air transportation does not benefit from the use of these revenues, motor vehicle fuel used in airplanes is exempt.

Comments

Aircraft jet fuel is not subject to the motor vehicle fuel tax. It is subject to the aircraft jet fuel tax of 2 cents per gallon. ❖

Motor Fuel Used in Public Transit Vehicles

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 8101.6.

Description

This program partially exempts from the motor vehicle fuel tax the distribution of motor vehicle fuel used in propelling qualified passenger-carrying vehicles. The program reduces the tax on such fuel by 6 cents per gallon, compared with the general tax rate of 15 cents per gallon in 1991. To qualify for the program, the vehicles involved must be used in transporting persons for compensation, and must be used by the following:

- A transit district, transit authority, or city owning or operating a transit system.
- A private entity providing specified transportation services.
- Certain passenger stage corporations subject to the jurisdiction of the Public Utilities Commission.

Rationale

This program provides a tax incentive to encourage the operation and use of qualified public transit services, to the extent that fuel excise taxes ordinarily would increase the costs and prices of such services. The underlying rationale for the program is to expand the state's reliance on public transit, thereby reducing traffic congestion and air pollution, and lessening the need for increased highway vehicle capacity. ❖

Aircraft Jet Fuel Used by Common Carriers and the Military

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$70
1990-91	70
1991-92	70

Authorization

California Revenue and Taxation Code Section 7374.

Description

This program exempts from the aircraft jet fuel tax all fuel used by common carriers, the military, and persons engaged in the business of constructing or reconstructing aircraft.

Rationale

This program provides tax relief to qualified users of jet fuel and their customers, to the extent that taxes on such fuel ordinarily would be incorporated into its price and the prices charged for using planes burning such fuel.

According to the California Board of Equalization, the underlying rationale for the program relates to the fact that the tax on jet fuel is used to finance small municipal airports, which are used primarily by private aircraft owners. Large airports are funded primarily by landing fees and other user charges. This program exempts common carriers and the military from paying the tax on jet fuel because they receive limited benefits from the facilities supported by this tax.

Comments

The aircraft jet fuel tax is imposed upon aircraft jet fuel dealers at the rate of 2 cents per gallon. ❖

Fuel Used For Race Cars

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	None
1990-91	None
1991-92	None

Authorization

California Revenue and Taxation Code Sections 7304 and 8604.

Description

This program exempts from taxation inflammable liquids that are specifically manufactured for racing motor vehicles, and that are distributed and used for racing motor vehicles at a racetrack.

In the absence of this exemption, distributors of fuel manufactured specifically for race cars would be required to collect the tax from fuel purchasers. However, any person using such fuel in off-road vehicles would be eligible for a tax refund. Under this program, distributors are exempted from collecting the tax in the first place. Although this program does not ultimately affect motor vehicle fuel tax revenues, it does result in reduced sales tax revenues. This is because the sales tax is imposed on the entire price of the fuel, which ordinarily would include the motor vehicle fuel tax.

Rationale

This program provides tax relief to race car owners and operators by reducing the use tax they pay on fuel used in operating racing vehicles. The exemption from the motor vehicle fuel tax is rationalized on the grounds that such vehicles are operated off-road, and hence do not benefit from the street and highway improvements funded by the tax.

Comments

Other operators of vehicles that are not used on public highways must pay the motor vehicle fuel tax, and then apply for a refund of the tax, if they qualify.

The exemption under Section 8604 is a parallel exemption under the use fuel tax. ◆

Liquefied Petroleum Gas

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$0.8
1990-91	2.1
1991-92	2.7

Authorization

California Revenue and Taxation Code Section 8651.5.

Description

This program provides a partial exemption from the use fuel tax to purchasers of liquefied petroleum gas (LPG). It does this by setting a reduced tax rate of 6 cents per gallon on LPG, compared with the general use fuel tax rate of 15 cents per gallon in 1991, which will increase in annual one-cent increments to 18 cents per gallon in 1994.

Rationale

This program provides a tax incentive for the use of LPG, rather than gasoline, in order to encourage the use of alternative fuel sources, which produce lower levels of air pollutants. In addition, the program has been rationalized on tax equity grounds. Each gallon of LPG has about 75 percent of the energy content of a gallon of gasoline. At the time that this program was established and prior to August 1990, the general use fuel tax rate on gasoline and diesel fuel was 9 cents per gallon, so that the 6-cents rate on LPG (67 percent of the general rate) approximately equalized the tax on LPG and gasoline in terms of energy content.

Comments

The primary reason for the growth in the estimated revenue loss in 1990-91 and 1991-92 is that the tax rate on LPG (6 cents per gallon) remains fixed by law, while the general tax rate is increasing from 9 cents per gallon in 1989-90 to 16 cents per gallon by January 1992. The increase in the general tax rate is the result of legislation adopted in 1989 and the passage of Proposition 111 at the June 1990 primary election. Therefore, the revenue loss per gallon of LPG will increase from 3 cents to 10 cents during this period.By 1994, the tax rate on LPG (6 cents per gallon) will be only one-third of the rate of the tax on gasoline (18 cents per gallon), so that the benefit provided by this program will be much larger than the amount needed to equalize tax treatment of LPG with gasoline on the basis of relative energy content.

The revenue estimate cited above is based on data from the California Board of Equalization (BOE). The estimate also includes the revenue loss due to the lower rate on liquefied natural gas (as opposed to just petroleum gas). This is because the two transactions are not reported separately to the BOE. According to the BOE, however, LPG represents the majority of sales at 6 cents per gallon. ❖

Ethanol Or Methanol

***Sunset Date:** January 1, 1994*

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$0.2
1990-91	0.2
1991-92	0.3

Authorization

California Revenue and Taxation Code Section 8651.8.

Description

This program provides a partial exemption from the use fuel tax to purchasers of ethanol or methanol. In order to qualify for the program, the fuel cannot contain more than 15 percent gasoline or diesel fuels (the remainder of the fuel must be ethanol or methanol). Specifically, the program provides that the tax on such alcohol fuels shall be one-half the rate imposed on diesel fuels (which is the same as the rate imposed on gasoline).

Rationale

This program provides a tax incentive for the use of ethanol and methanol, in order to make the California economy less dependent on conventional petroleum products and to reduce the level of air pollution. In addition, the program has been rationalized on tax equity grounds. Each gallon of methanol or ethanol fuel has about half the energy content of a gallon of gasoline or diesel fuel. Thus, this program approximately equalizes the tax on alcohol fuels with the tax on diesel and gasoline fuels, based on their energy content (which determines how far a vehicle can travel on a gallon of fuel).

Comments

Unlike the special tax rates for liquefied petroleum gases, liquefied natural gas and compressed natural gas, the special tax rate for alcohol fuels is set at a percentage of the general tax rate on diesel fuel and gasoline, rather than at a specific number of cents per gallon. Consequently, the tax on alcohol fuels maintains its approximate energy equivalence with the tax on gasoline and diesel fuels regardless of changes in the tax rate for gasoline and diesel fuels. The revenue loss per gallon of alcohol fuel grows, however, as the tax rate on gasoline and diesel fuel increases. In 1989, the tax on alcohol fuels was 4.5 cents per gallon versus 9 cents per gallon for gasoline and diesel fuels. In 1991, the tax on alcohol fuels will be 7.5 cents per gallon compared with 15 cents per gallon for gasoline and diesel fuels. ❖

Natural Gas

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$0.1
1990-91	0.3
1991-92	0.4

Authorization

California Revenue and Taxation Code Section 8651.6.

Description

This program provides a partial exemption from the use fuel tax to purchasers of compressed natural gas (CNG) or liquefied natural gas (LNG). It does this by setting a reduced tax rate of 7 cents per 100 cubic feet of CNG or 6 cents per gallon of LNG, compared with the general use fuel tax rate of 15 cents per gallon in 1991 (which will increase in annual one-cent increments to 18 cents per gallon in 1994).

Rationale

This program provides a tax incentive for the use of natural gas rather than gasoline in motor vehicles.

The rationale underlying the program is to encourage the use of alternative fuel sources, in order to make the California economy less dependent on conventional petroleum products and to reduce air pollution.

Comments

The primary reason for the growth in the estimated revenue loss in 1990-91 and 1991-92 is that the tax rate on LNG (6 cents per gallon) and on CNG (7 cents per 100 cubic feet) remains fixed by law, whereas the general tax rate is increasing from 9 cents per gallon in 1989-90 to 18 cents per gallon by January 1994. Therefore, the revenue loss per gallon of LNG will increase from 3 cents to 10 cents during this period, and the revenue loss per 100 cubic feet of CNG will increase from

2 cents to 9 cents. By 1994, the tax rates on LNG and CNG will be 12 cents and 11 cents, respectively, both well below the 18-cents tax rate per gallon of gasoline. The energy content of a gallon of LNG or of 100 cubic feet of CNG is similar to that of a gallon of gasoline, so that this program is not rationalized on the grounds of equalizing tax treatment on the basis of relative energy content.

The estimated revenue loss cited above is based on data from the California Board of Equalization (BOE). The estimate includes only the revenue loss due to the lower rate on CNG. The revenue loss on LNG is included in the estimate for the partial exemption on liquefied petroleum gas (LPG). This is because the LNG and LPG transactions are not reported separately to the BOE. ◆

Weight-Based Flat Tax Rate for Liquefied Petroleum Gas and Natural Gas Fuels

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$1
1990-91	1
1991-92	1

Authorization

California Revenue and Taxation Code Section 8651.7.

Description

This program allows the owner or operator of a vehicle fueled by liquefied petroleum gas (LPG), liquefied natural gas (LNG), or compressed natural gas (CNG) to pay the use fuel tax at an annual flat rate based on the weight of the vehicle. The flat rate varies from $36 for passenger cars and any other vehicles weighing 4,000 pounds or less, to a maximum of $168 for vehicles weighing 12,001 pounds or more.

The total amount of tax generated by these flat rates is roughly equivalent to the total amount of tax that would be paid at the per-gallon tax rates for these fuels, assuming that vehicles are driven a typical number of miles each year and have typical fuel efficiency. For example, the flat rate of $36 for a passenger car equals the amount of tax at 6 cents per gallon that would be paid if an LPG-fueled car were driven 12,000 miles at an average fuel efficiency of 20 miles per gallon.

For these typical assumptions, the flat-rate tax provides a partial exemption from taxation to the same extent as is provided by the special per-gallon rates for these fuels. The value of the partial exemption provided by the flat-rate tax may be greater or lesser than the value of the partial exemption provided by the special per-gallon rates, however, for vehicles that use more or less fuel each year than the typical vehicles on which the flat rates are based.

Rationale

This program has the same basic rationales as the special per-gallon tax rates for LPG and LNG and the special rate per 100 cubic feet for CNG – namely, encouraging the use of alternative fuels, reducing air pollution, and (for LPG) equalizing taxation with gasoline on an energy-content basis. The program's tax savings and simplified reporting procedures also provide an incentive for taxpayers to convert engines to these alternative fuel sources. Furthermore, the program simplifies the administration of the use fuel tax.

Comments

Flat rates are fixed, while the general tax rate on gasoline and diesel fuels is increasing from 9 cents per gallon in 1989-90 to 18 cents per gallon in 1994. Therefore, the revenue loss per vehicle under this program is increasing rapidly in a manner similar to the revenue losses from the special per-gallon (or per-100 cubic feet) rates on LPG, LNG, and CNG. ❖

Tax Exemption for Construction and Agricultural Machinery

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 8652 (b).

Description

This program exempts from the use fuel tax the fuel used to propel construction equipment operated within the confines of a construction project, and certain machinery used in agricultural operations. To qualify, the equipment can be only incidentally operated on the highways, and must be exempt from vehicle registration under the California Vehicle Code.

Rationale

This program provides tax relief to the operators of qualified construction equipment and agricultural equipment that only incidentally use the highways. The underlying rationale for the program relates to the fact that the use fuel tax primarily funds public street and highway construction and maintenance. Since equipment that only intermittently uses the streets and highways does not generally benefit from these improvements, taxing the fuel used to propel such equipment is viewed as inappropriate.

Comments

In theory, it would be possible to impose the use fuel tax on that *portion* of fuel used in moving construction equipment and agricultural machinery on the highways. However, the revenues collected under such an approach probably would not offset the costs of administering it. ❖

Uses of Fuel for Purposes other than Transportation

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 8652 (c).

Description

This program exempts from the use fuel tax fuel used for a purpose other than to propel a motor vehicle on streets and highways in California. Typical examples of exempt uses would include fuel used in electric generators or by railroads. As interpreted by Rule 1316 of the California Board of Equalization (BOE), the program also applies to fuel used by power take-off equipment on trucks, such as rotary cement mixers, air conditioners, or garbage compressors.

Rationale

This program provides tax relief to the operators of qualified equipment. The underlying rationale for the program relates to the fact that the use fuel tax primarily funds highway construction and maintenance. Because the qualifying equipment does not directly benefit from the highways, taxing the fuel used to operate such equipment is viewed as inappropriate. ❖

Off-Highway Operations of Motor Vehicles

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 8653.

Description

This program exempts from the use fuel tax fuel that is used in the operation of a motor vehicle off the highway.

Rationale

This program provides tax relief to the operators of off-highway vehicles. The rationale underlying the program relates to the fact that the use fuel tax funds street and highway construction and maintenance. Because vehicles operated off the highway do not directly benefit from the use of the tax revenues, levying the use fuel tax on such vehicles is viewed as inappropriate. ❖

Operators of Local Transit Services and School Buses

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$11
1990-91	19
1991-92	25

Authorization

California Revenue and Taxation Code Section 8655.

Description

This program partially exempts operators of local transit services and school buses from the use fuel tax. Specifically, it permits qualified entities to pay a 1-cent-per-gallon tax instead of the normal tax.

In order to qualify for the program, the entity must be either (1) a transit district, (2) a school or community college district, or (3) a private entity providing local public transportation services in an urban or suburban area. These latter entities also must meet certain criteria and either (1) be a passenger stage corporation subject to the jurisdiction of the Public Utilities Commission; (2) provide transportation services under contract to a public agency, or school or community college district; or (3) be a common carrier operating over a route entirely within a single city. The program does not include carriers of charter parties.

Rationale

This program provides tax relief to the above specified local transportation agencies and providers. It also provides relief to public transportation users to the extent that the reduced tax liability is reflected in lower transit fares. The rationale underlying this program is that it promotes the establishment, maintenance, and use of public transportation systems by lowering their operating costs. In the case of school buses, this program is rationalized on the grounds that it supports the public education system by reducing the portion of budgeted funds needed for student transportation, thereby increasing the amount available for classroom educational uses.

Comments

The primary reason for the growth in the estimated revenue loss in 1990-91 and 1991-92 is that the special 1-cent-per-gallon fee established by this program remains fixed, while the general use fuel tax rate is increasing from 9 cents per gallon in 1989-90 to 18 cents per gallon by January 1994. ◆

Out-of-State Sightseeing Tour Buses

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$0.1
1990-91	0.1
1991-92	0.1

Authorization

California Revenue and Taxation Code Section 8608(6).

Description

This program relieves qualified sightseeing tour operators of the requirement to obtain a use fuel tax permit from the California Board of Equalization (BOE). The effect of this is to exempt such operators from any tax liability associated with their consumption of fuel within the state that has been purchased elsewhere. To qualify, the fuel must be used by an out-of-state passenger carrier whose operations consist solely of round-trip sightseeing tours originating and terminating outside of California. In addition, any fuel purchased within California must be used solely for propulsion of the sightseeing vehicle, and tax must be paid on it.

Rationale

This program provides tax relief to the operators of out-of-state sightseeing tour buses, to the extent that the fuel they bring *into* the state exceeds that taken *out* of the state. Before the advent of this program, out-of-state tour bus operators were required to report the actual amount of fuel brought into California, purchased in California, and taken out of California. If the amount brought in exceeded that taken out (indicating net use of out-of-state fuel in California) the operator was required to pay a tax on the difference. Alternatively, the operator could claim a tax refund if the fuel taken out of the state exceeded that brought in.

This program relieves the qualified tour bus operators from having to register with and report to the BOE regarding net use of fuel in California that is purchased out of state. Thus, although the user pays tax to the vendor on the fuel *purchased* in California, there is no tax on any net use of fuel purchased out of the state.

The underlying rationale for the program is two-fold. First, it simplifies state tax administration and saves the state money, to the extent that the costs of collecting the tax would have exceeded the revenues generated. Second, it relieves tour-bus operators of burdensome paperwork requirements.

Comments

Prior to this program, failure to register with the BOE could result in a fine of $500 for tour-bus operators. ❖

Public Agencies Operating Vehicles on Military Reservations

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 8654.

Description

This program exempts from the use fuel tax certain fuel used in a motor vehicle owned by a county, city, district, or other political subdivision. The program applies to fuel used to operate qualifying vehicles over a highway that is constructed and maintained by the United States, and that is within a military reservation. If the motor vehicle is operated on one continuous trip both over such a highway and over a public highway located outside the military reservation, only the fuel used to operate the vehicle on the public highway is subject to the tax.

Rationale

This program provides tax relief to qualified agencies operating motor vehicles on military bases. The apparent rationale for this program is that the roads on military bases are not supported by use fuel tax revenues. This rationale, therefore, holds that public agencies, which may have to enter military bases to provide certain services, should be relieved of the use fuel tax on the portion of their fuel used on such roads. ❖

Operation of Vehicles on United States Department of Agriculture Roads

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 8653.1.

Description

This program exempts from the use fuel tax fuel used to operate a motor vehicle on any highway that is under the jurisdiction of the United States Department of Agriculture (USDA). In order to qualify for the exemption, the user must pay, or contribute to, the cost of the highway's maintenance or construction under an agreement with the USDA.

Rationale

This program provides tax relief to the qualified users of USDA roads, such as logging roads in national forests. The underlying rationale for the program relates to the fact that the use fuel tax primarily funds state highway construction and maintenance. Since these funds do not go to improve USDA roads, taxing the portion of fuel used on such roads is viewed as inappropriate. Limiting the exemption to individuals who contribute to road maintenance serves to confine favorable tax treatment to heavy users of USDA roads, such as logging trucks. ❖

Employee Pension and Profit Sharing Plans

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$31
1990-91	27
1991-92	27

Authorization

California Revenue and Taxation Code Section 12202.

Description

This program provides a partial exemption from the insurance tax to employee pension and profit sharing plans. The state's taxes on life insurance, disability insurance, and annuity contracts ordinarily are imposed on premiums at a rate of 2.35 percent. This tax rate is adjusted annually by the Board of Equalization so as to hold state revenues harmless from the effects of insurance premium rate limitations imposed by Proposition 103, adopted in the November 1988 general election. The rate for 1989 and 1990 was 2.37 percent. Under this program, however, qualified insurers pay these taxes at the lower rate of 0.5 percent.

Rationale

This program provides tax relief to insurers that serve employee pension and profit sharing plans. It also provides relief to the individuals contributing to such plans, to the extent that the reduced taxes are reflected in lower insurance premiums. The underlying rationale for the program is to encourage employers to provide insurance coverage under such plans by lowering the cost of the premiums they pay. ❖

Fraternal Benefit Societies

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$3
1990-91	4
1991-92	4

Authorization

California Insurance Code Section 10993.

Description

This program exempts from the insurance tax any insurance issued by a fraternal benefit society. Fraternal benefit societies include organizations such as the Elks and the Knights of Columbus.

Rationale

This program provides tax relief to fraternal benefit societies. It also provides relief to the individuals who are insured by such organizations, to the extent that the reduced taxes are reflected in lower premiums. The rationale for this program is that fraternal benefit societies are charitable and benevolent institutions and, as such, they and their members are deserving of public financial support. ❖

Nonprofit Hospital Service Corporations

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$263
1990-91	376
1991-92	450

Authorization

California Insurance Code Section 11493.5.

Description

This program exempts from the insurance tax any insurance issued by a nonprofit hospital service corporation. Nonprofit hospital service corporations include institutions such as Kaiser Permanente, as well as nonprofit health maintenance organizations (HMOs) and preferred health provider plans.

Rationale

This program provides tax relief to nonprofit service corporations. It also provides relief to the individuals and organizations who are insured by such corporations, to the extent that reduced insurance taxes are passed on to these policy holders in the form of lower premiums.

The rationale for the program is that nonprofit hospital service corporations are deserving of public financial support by virtue of their nonprofit status. ❖

Local Property Tax

Index

The Local Property Tax — An Overview

The local property tax applies to both real property and personal property. The annual amount of tax on a property is calculated by multiplying the local property tax rate by the property's taxable assessed value.

Proposition 13 Limitations

Article XIII A of the California Constitution, which was adopted as Proposition 13 in 1978, limits property tax rates and restricts the reassessment of most real property.

Tax Rates. The total property tax rate cannot exceed 1 percent of assessed value, except for tax rates necessary to finance qualifying voter-approved debt. The tax rate is the same for real property and for personal property. For 1989-90, the statewide average property tax rate was 1.067 percent, according to the California Board of Equalization (BOE).

Reassessments. County assessors generally reassess real property at its current market value whenever it is sold or otherwise changes ownership. Real property also is reassessed to reflect the market value added to it by any new construction. Absent a change of ownership or new construction, however, the assessed value of most real property may not be increased, except for an annual inflation adjustment of up to 2 percent.

The restrictions on reassessments do not apply to any personal property. Nor do they apply to real property that is owned by public utilities, railroads, or pipeline companies, which are assessed by the BOE rather than by the county assessors. Personal property and state-assessed property are reassessed at their current full market value each year.

Approval of Exemptions

Article XIII of the California Constitution authorizes the Legislature to enact statutory tax exemptions for personal property by a two-thirds vote of each House. However, exemptions for real property must be specifically authorized by the State Constitution, so that exemptions of real property require voter approval.

Vehicles

Vehicles that are registered for highway use are not taxed under the property tax. Instead, they are subject to vehicle license fees that include a tax based on vehicle value. The property tax does apply to airplanes, boats, and vehicles that are not registered for highway use.

Impact on State Finances

Although local entities – cities, counties, school districts, and special districts – receive all property tax revenues, property tax expenditures can increase *state* costs in two ways. First, under the school apportionment program, the state generally makes up for any loss of property tax revenue to school districts. Therefore, the state generally incurs a cost equal to about 36 percent (the average school share of property taxes) of the total local revenue loss from property tax expenditures. Second, reductions in local revenues increase the need for state funds to maintain essential programs that are carried out by local governments, especially counties. ❖

Real Property Belonging to a State, County, or City Government

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII, Section 3, and California Revenue and Taxation Code Section 202 (a) (4).

Description

This program exempts from the property tax real property owned by the state or a local government (including special districts). Property owned by a city or county, but located outside of its boundaries, may be taxable, however, under Article XIII, Section 11 of the California Constitution. Property owned by the State Compensation Insurance Fund (SCIF) does not qualify for this exemption.

Rationale

This program provides tax relief to the state and local governments. According to the California Board of Equalization, the basic rationale for the program is that it increases the efficiency of government. For example, in the absence of this exemption, local governments would be required, in essence, to pay property taxes to themselves. It also is arguably more efficient for the state government to transfer funds directly to local governments, rather than for local governments to incur the administrative costs associated with collecting taxes on property owned by the state government.

Comments

Special provisions apply to the tax treatment of possessory interests, extraterritorial property, and property owned by the SCIF.

Possessory Interests. Use of tax-exempt government property for a private purpose generally results in a taxable possessory interest. For example, a lessee would have a taxable possessory interest for leased space that is used for a shop or public restaurant in a government building, and would be required to pay property taxes based upon the value of the possessory interest.

Extraterritorial Property. Any property (including water rights) located in Inyo or Mono counties and owned by a local government outside those counties is taxable if it was assessed in 1966 (for Inyo County) or 1967 (for Mono County). This provision primarily applies to property owned by the Los Angeles City Department of Water and Power in the Owens Valley. In other counties, real property located outside the boundaries of the owning local government is taxable if it was taxable when acquired by the local government or, for new construction, if it replaces a previously taxable improvement. Special formulas apply to the assessment of these properties.

State Compensation Insurance Fund. The SCIF is a semi-independent nonprofit agency, which was created by the state in 1919. The SCIF provides workers' compensation insurance to local public agencies, to state agencies requiring excess coverage, and to private companies. The SCIF also is required by law to be the insurer of last resort for high-risk companies. The SCIF is fully supported out of its premium structure. The SCIF maintains a headquarters office building in San Francisco and has district offices statewide. The exclusion of the SCIF from this program appears to reflect the Legislature's desire to ensure that all of the SCIF's costs are reflected in its premium structure, in order to ensure parity between the SCIF and private insurance providers.❖

Real Property Leased by a Nonprofit Corporation to a Governmental Entity

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 231.

Description

This program exempts from the property tax real property which is owned by a nonprofit corporation and leased to a government entity. The property must be used exclusively by the government for specified governmental purposes, and must be located within the boundary of the leasing government. The lease arrangement also must ultimately transfer ownership of the property to the government. Property leased by the State Compensation Insurance Fund does not qualify for this program.

Rationale

This program essentially extends the property tax exemption generally available to government-owned property, to property owned by nonprofit corporations that governments have created as capital-outlay financing vehicles. For example, a government may create a "dummy" nonprofit corporation to issue tax-exempt securities to finance acquisition of a capital facility, which the government entity then lease-purchases. The underlying rationale for the program is that such nonprofit corporations are, for all practical purposes, an "arm" of the government. Therefore, these corporations should share the tax-exempt status granted to regular government entities.

Comments

Technically, this program is based on the exemption granted for charitable property in the California Constitution. Nonprofit corporations are deemed to be charities operating for the benefit of general governmental purposes.

Chapter 489, Statutes of 1990 (SB 2309, Leroy Greene), expanded this program to include golf courses leased to governmental entities.❖

Real Property Leased by a Charitable Organization to a Governmental Entity

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 214.6.

Description

This program exempts from the property tax real property which is owned by an organization qualifying for the welfare exemption, but which is leased by a government agency. The welfare exemption provides that property which is used by a qualified charitable organization exclusively for its own charitable purposes is exempt from the property tax. This program extends this tax exemption to property which is leased by such organizations to a government entity.

Rationale

This program provides an incentive to qualified charitable organizations to enter into leases of property to a governmental agency. The purpose of the program is to facilitate sale-leaseback arrangements between otherwise tax-exempt charitable organizations and government agencies. Such sale-leaseback arrangements are often undertaken by local governments as an alternative to borrowing funds for capital improvements.

The tax exemption gives the charitable organization an incentive to raise funds for its charitable purposes through leases with government agencies, since the organization will thereby incur no property tax. It also makes the government a more attractive lessor than other lessors in the eyes of the organization, since property leased to these other lessors *would* generally be taxable.❖

Real Property Owned by a Volunteer Fire Department

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 213.7.

Description

This program exempts from the property tax real property which is both owned by a volunteer fire department and used exclusively for the department's purposes. For property to qualify, the fire department must have official recognition and at least partial financial support from a local government agency in whose jurisdiction the department is located. Qualifying property is deemed by this program to be used for charitable purposes and, therefore, is granted tax-exempt status under the welfare exemption in the California Constitution.

Rationale

This program provides tax relief to volunteer fire departments. The underlying rationale for the program is that volunteer fire departments are deserving of public support by virtue of the services they render to the community.❖

Personal Property Used by an Organization Incorporated by the U.S. Congress (Civil Air Patrol)

Sunset Date: March 1, 1995

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 213.6.

Description

This program exempts from the property tax personal property owned and operated by an organization incorporated by an act of the United States Congress, provided that the organization's purpose is to (1) assist in government efforts to deal with emergencies and (2) provide aviation and aerospace education and training. In addition, the organization must qualify for a federal income tax credit under Section 501 (c) (3) of the Internal Revenue Code.

Rationale

This program extends the property tax exemption for real property owned or used by a governmental agency, to personal property (such as aircraft) owned by qualifying independent organizations that are fulfilling specific public service functions.

The program was enacted specifically to grant tax relief to the Civil Air Patrol. Prior to 1970, the California Board of Equalization (BOE) considered the Civil Air Patrol a corporation owned by the United States. In that year, however, the BOE decided that the patrol was independent of the

U.S. government and, therefore, was not exempt from California property taxes.

According to the BOE, the only property for which the exemption provided by this program qualifies, and is claimed, is property owned and used in connection with the Civil Air Patrol.❖

Real Property Owned by a Transit Development Board

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII, Section 3, and California Revenue and Taxation Code Section 201.1.

Description

This program exempts from the property tax real property which is owned by a qualified nonprofit entity, provided that the entity is solely owned by a transit development board. Property located outside of the board's boundaries is not exempt from the tax.

Rationale

This program provides tax relief to nonprofit entities owned by transit development boards. The program basically extends the current exemption for real property owned or used by a governmental agency to those nonprofit entities on the rationale that it reduces the cost of government and that these nonprofit entities really are the same as the government entities that own them.

Comments

This program initially was implemented to provide tax relief to the San Diego and Arizona Eastern Railroad. This company was created in the 1970s by the San Diego Metropolitan Transit Development Board, which was interested in acquiring the right-of-way for urban rail mass transit.

The manner in which the railroad was purchased ceded ownership to the nonprofit corporation. The transit authority made the purchase in this manner in order to avoid a laborious and expensive title search, and to comply with certain restrictions imposed by the federal Interstate Commerce Commission.

In 1980, the California Board of Equalization (BOE) determined that the railroad was subject to property taxes because it was not owned by a government agency. Thus, without this program, the BOE would require taxation of the railroad's property.❖

Aircraft Owned by a Government Agency

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 5331 and 5332.

Description

This program exempts from the property tax any aircraft owned by the United States or a foreign government, or by the state or any local government agency. The program, however, does not include foreign commercial carriers, even if government-owned.

Rationale

This program has two rationales. First, it simply recognizes that aircraft owned by the United States or a foreign government generally are immune from taxation under federal law and treaties. Second, the program extends the general exemption for property owned by a local government within its own boundaries to include aircraft based at airports outside the owning jurisdiction. This eliminates tax inequities that otherwise would occur because some local agencies do not have suitable airport facilities available within their own jurisdiction.❖

Federal Real Property Used Exclusively for Migratory Fowl

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 254.2.

Description

This program exempts from the property tax federal property used exclusively for any of the following: (1) refuges for migratory water fowl, (2) promotion or protection of migratory water fowl, or (3) migratory water fowl public shooting grounds.

Federal property is generally exempt from the property tax, but property leased to a private party may transfer a possessory interest. A possessory interest is the right to use the property and, under California law, is subject to the property tax. For example, if a private contractor operated a water fowl shooting ground on property leased from the federal government, the contractor ordinarily would be required to pay property tax on his or her possessory interest in the property. This program exempts the contractor from paying property taxes on such property.

Rationale

This program provides tax relief to the operators of public water fowl shooting grounds that are located on federal property. The rationale underlying the program is not evident.❖

Bonds Issued by a State or Local Government Agency

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	None
1990-91	None
1991-92	None

Authorization

California State Constitution Article XIII, Section 3 (c), and California Revenue and Taxation Code Section 208.

Description

This program exempts from the property tax bonds issued by the state or local government agencies and held by businesses.

Rationale

This program originally was adopted to provide a tax incentive for businesses to purchase California state and local government bonds instead of bonds issued by the private sector or other states. Such bonds are used extensively to finance the acquisition by California governments of capital equipment and facilities. The rationale for exempting government bonds from the personal property tax was that the exemption increases the bonds' after-tax values relative to other bonds, thereby promoting their sale.

Subsequent to the establishment of this program, however, an exemption was enacted for *all* financial assets (California Revenue and Taxation Code Section 212). Thus, in the absence of this program, qualifying bonds would be tax-exempt anyway.❖

Property Used Exclusively for Hospital, Educational, Museum, Scientific, or Charitable Purposes (the "Welfare Exemption")

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$197
1990-91	221
1991-92	248

Authorization

California State Constitution, Article XIII, Sections 4 (b) and 5, and California Revenue and Taxation Code Sections 214 through 214.14, 215.2, and 215.5.

Description

This program exempts from the property tax specified real and personal property used exclusively for religious, hospital, educational, museum, scientific, or charitable purposes (including bingo games). The property must be owned and operated by nonprofit corporations that meet specified requirements. The program also applies to real property that is under development and that ultimately will be used for the exempt purposes. Any possessory interest in government property held by a qualifying organization for qualifying purposes also is tax-exempt.

Hospital property represents the single largest category of property qualifying for this program. Other examples of qualifying property include the following:

- Property used exclusively for purposes associated with a nursery school, or school of less than collegiate grade.
- Property of a nonprofit educational radio or television station that does not sell advertising time.
- Real property used exclusively for the preservation of native plants or animals, biotic communities, or geological formations of scientific or educational interest.
- Museum property, including museum restaurants and gift shops.
- Property of nonprofit educational organizations generally.
- Specified property used exclusively for housing and related facilities for low-income, elderly, or handicapped families.

Rationale

This program provides tax relief to the qualifying organizations. The rationale for the program is that these organizations fulfill a socially valuable function in providing property and services to the public and, therefore, are deserving of governmental financial assistance.

Comments

The estimated revenue loss cited above excludes losses due to the "religious" exemption, which we have included under the program that exempts church and religious property.

The California State Constitution authorizes the Legislature to exempt property used exclusively for nonprofit hospital or charitable purposes.

Charitable purposes, as defined by statute, now include a wide range of activities performed by nonprofit organizations for public benefit.❖

Real Property Used Exclusively for Religious Worship or Religious Purposes

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$58
1990-91	61
1991-92	64

Authorization

California State Constitution, Article XIII, Sections 3 (f), 4 (b), 4 (d), and California Revenue and Taxation Code Sections 206, 206.1, 206.2, and 207.

Description

The California Constitution [Article XIII, Section 3 (f)] directly exempts from taxation property used for religious worship. This is known as the "church exemption." The church exemption includes facilities for sacramental activities (such as weddings and funerals), church administrative offices, and facilities for religious instruction (like Sunday schools).

In addition, Article XIII, Sections 4 (b) and 4 (d) of the Constitution, *authorizes* the Legislature to exempt property used for religious purposes generally and for church parking. Under this broader "religious exemption," the Legislature has exempted from the property tax real property owned or leased exclusively for religious worship or other specified religious purposes. Under this program, church parking lots, social halls and community centers, retreats, nurseries and preschools, and parochial K-12 schools are exempt from the property tax.

Rationale

This program provides tax relief to religious organizations by exempting from taxation property used for religious purposes, church parking lots, and parochial schools. The purpose of the program is to promote the establishment and maintenance of houses of worship and related activities, by reducing their operating costs. The rationale offered is that religious institutions should be free from financial burdens imposed by government to the maximum possible extent.

Comments

The religious exemption is included within the broader "welfare exemption" that covers property owned by qualifying nonprofit organizations and used for charitable, religious, or hospital purposes. Property owned by religious organizations and used primarily for charitable, rather than religious, purposes usually qualifies for a property tax exemption under the welfare exemption. The religious exemption generally does not apply to parsonages. ❖

Real Property Transferred Within the Same Religious Denomination

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 62 (k).

Description

This program exempts from reappraisal taxable property (for example, property which is not used for religious purposes) transferred between specified corporations belonging to the same religious denomination. The transferring and receiving corporations must be a corporation sole (that is, a corporation represented by an individual who has independent legal decision-making authority), religious corporation, or public-benefit corporation, and the same denomination's laws, rules, regulations, or canons must regulate the transferor and transferee.

In an hierarchical church, such as the Roman Catholic Church, each diocese is a corporation sole. Thus, in the absence of this program, a transfer of property from one diocese to another could trigger a property tax reassessment. This program provides that the transferred property retains the value ascribed to the property prior to the transfer.

Rationale

This program was sponsored by the California Catholic Conference to clarify that transfers of property between dioceses are exempt from reappraisal. The rationale behind the program is that the larger religious denomination, not the corporation sole, should be considered the owner of the property for tax purposes.

Comments

Religious property owned by a religious organization is not affected by this program, because such property is exempt under Revenue and Taxation Code Section 214. However, many religious organizations own residences or income properties which are affected by this program.❖

Cemetery Property

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII, Section 3 (g), and California Revenue and Taxation Code Section 204.

Description

This program exempts from the property tax qualified property owned by a nonprofit corporation which is (1) used or held for depositing the human dead or (2) used for the care and maintenance of the property used for depositing the dead.

The program does not, however, apply to undeveloped property held for future use.

Rationale

This program provides tax relief to nonprofit corporations that sell and maintain cemetery plots, and to the individuals who purchase the plots. According to the California Board of Equalization, the primary rationale for the program is that such facilities provide a valuable public service function and, therefore, are deserving of governmental support.

In addition, the program simplifies administration of the property tax. Once in use, individual plots have little market value and, therefore, would generate minimal property tax revenues. Moreover, there are potentially significant problems involved with tax collection, particularly for older plots where an heir may no longer exist. The revenues generated from a property tax on individual plots probably would not, therefore, offset the costs of assessing and collecting the tax.❖

Privately Owned Real Property Used by a Public Library or Free Museum

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII, Section 3 (d), and California Revenue and Taxation Code Section 202 (a) (2).

Description

This program exempts from the property tax privately owned real property used by a public library or a free museum.

Rationale

This program provides tax relief to public libraries and free museums by reducing their property tax liabilities. The program also provides an incentive for the establishment and maintenance of such institutions to the extent that it reduces their operating costs.

According to the California Board of Equalization (BOE), in the case of public libraries, the exemption primarily applies to land or structures leased by a government for the operation of a public library. This is a common arrangement for the establishment of smaller branch libraries. In the absence of the exemption, the owner of the land would be liable for property tax. This liability would be passed on to government in the form of higher rents. The exemption for public libraries exists to facilitate the leasing of land for the government operation of such facilities.

In the case of museums, the rationale behind the program is that such entities perform a public service, and, therefore, are worthy of public financial support.

Comments

According to the BOE, the exemption for free museums is not widely used, as most private museums in California charge an admission fee. However, nonprofit museums generally can qualify for the welfare exemption as scientific or educational institutions. Public museums would be exempt as government property in the absence of this program.❖

Real Property Used by Public Schools, Colleges, and Universities

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII, Section 3 (d), and California Revenue and Taxation Code Sections 202 (a) (3) and 203.

Description

This program exempts from the property tax real property used exclusively for public schools, community colleges, state colleges, and state universities (including the University of California). The exemption also applies to off-campus facilities owned or leased by an apprenticeship program sponsor, provided that these facilities are used exclusively by the public schools for specified classes.

Rationale

This program provides tax relief to public educational institutions by eliminating the tax on their properties. Thus, the program promotes the establishment and maintenance of such institutions to the extent that the exemption reduces their operating costs. The basic rationale for the program is that these institutions are governmental entities and, therefore, should not be subject to taxation.

Comment

College bookstores that earn unrelated business income (income from a business activity unrelated to their exempt purpose, such as income from the sale of real estate) which is taxable under the federal income tax may also be subject to property taxes based on the proportion of that taxable income to total income under Ch. 1606/88 (SB 2407, Alquist).❖

Real Property Owned by Private Colleges and Seminaries

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$48
1990-91	52
1991-92	57

Authorization

California State Constitution, Article XIII, Section 3 (e), and California Revenue and Taxation Code Section 203.

Description

This program exempts from the property tax buildings, land, equipment, and securities used exclusively for educational purposes by private nonprofit colleges and seminaries. (Public educational institutions are also exempted from the property tax by Article XIII, Section 3 (d) and by Revenue and Taxation Code Section 202.) Qualifying institutions must meet specified admission requirements, and must confer upon their graduates at least one academic or professional degree based on a program of at least two years in liberal arts studies, or three years in professional studies.

Rationale

This program provides tax relief to private colleges and seminaries and to their students, to the extent that the program reduces educational operating costs, which are, in turn, passed on in the form of lower tuition and student fees. The rationale behind the program is that it promotes the establishment and operation of nonprofit educational institutions by reducing their operating costs. It also provides an incentive for students to pursue a college degree to the extent that it reduces their educational costs.

Comments

College bookstores that earn unrelated business income (for example, investment income) which is subject to federal income taxation may also be subject to property taxes under Ch 1606/88 (SB 2407, Alquist). The property tax liability under these circumstances would be equal to the total property tax liability of the bookstore (in the absence of the exemption) multiplied by the bookstore's ratio of unrelated business income to total income.

Most of the exempt property value under this program is located in Los Angeles and Santa Clara counties.❖

Real Property Owned by Designated Institutions

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII, Section 4 (c), and California Revenue and Taxation Code Section 203.5.

Description

This program exempts from the property tax real property owned by the California School of Mechanical Arts, California Academy of Sciences, and Cogswell Polytechnical College. It also exempts property held in trust for the Huntington Library and Art Gallery.

Rationale

This program provides direct tax relief to the above-cited institutions. It also provides relief to their students, to the extent that the lower property taxes are reflected in lower tuition and student fees. The rationale behind the program is to encourage the development and operation of the specified institutions, and reflects the view that these institutions are deserving of public financial support.

Comments

The above constitutional provision authorizes the Legislature to implement this program, which it has done. The exemption affects all property owned by these institutions, including property that is held for income production and which, therefore, would not qualify for the welfare exemption.❖

Personal Property Used in the Management of State Colleges

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 202.5.

Description

This program exempts from the property tax personal property used in the management of state colleges, but *owned* by an auxiliary nonprofit corporation or student body organization. In order to qualify, the Director of Education must have entered into a contract with the corporation or organization under which services are provided or equipment is leased.

Rationale

This program essentially extends the tax relief provided under the college exemption to student body organizations and other nonprofit entities that provide services or lease equipment to state colleges. It also provides tax relief to the state colleges, to the extent that any property tax savings are passed on to the colleges in the form of lower costs. The rationale behind the program is to promote the establishment and maintenance of such organizations by lowering their operating costs.❖

Personal Property Used or Owned by a Student Bookstore

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 202.7 and 203.1.

Description

This program exempts from the property tax personal property used or owned by a nonprofit corporation which operates a student bookstore affiliated with a nonprofit college or seminary, or with the University of California.

Rationale

This program provides tax relief to nonprofit corporations, such as student body organizations, which operate bookstores for nonprofit colleges or seminaries. It also provides tax relief to bookstore customers, to the extent that lower operating costs are reflected in lower prices for books and student supplies. The rationale behind the program is that it promotes the establishment and maintenance of nonprofit bookstores by reducing their operating costs, which in turn can help to lower the costs to students of obtaining a college education. This rationale reflects the belief that such results are worthy of public financial support.

Comments

Bookstores' inventory would be exempt in the absence of this program under the business inventory exemption.❖

Personal Property Owned by a Student Body Organization

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 202.6.

Description

This program exempts from the property tax personal property owned or used exclusively by a qualified student body organization, as specified in the California Education Code. To qualify, the student body organization must be organized within a community college or public school.

Rationale

This program provides tax relief to specified student body organizations. The underlying rationale for the program is that these organizations play a supportive role in educational institutions through their fund-raising and social activities and, as such, are deserving of public financial support.❖

Real Property Owned by a Veteran (Veteran's Exemption)

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$0.03
1990-91	0.03
1991-92	0.03

Authorization

California State Constitution, Article XIII, Sections 3 (o), 3 (p), 3 (q), and 3 (r), and California Revenue and Taxation Code Sections 205 and 205.1.

Description

This program exempts from the property tax up to the first $4,000 of assessed value of real property owned by a veteran. Veterans may not claim both this exemption and the homeowners' exemption on the same piece of property. Most U.S. veterans qualify for the program. In addition, property owned by a veteran's widow or widower may qualify for the exemption as long as he or she remains unmarried. A deceased veteran's parents also may qualify.

Rationale

This program is intended to provide tax relief to qualified veterans and their families. The rationale for the program is that veterans have served their country and, therefore, are deserving of certain governmental benefits.

Comments

According to the California Board of Equalization (BOE), this exemption has not been claimed frequently since the homeowners' exemption became available. This is because the homeowners' exemption has the greater value to the taxpayer. The BOE also points out that, when this exemption is claimed, it most commonly is claimed on boats and airplanes.

Previous requirements that veterans must have resided in California when they were inducted into the armed services were deleted by Proposition 93, approved in the November 1988 statewide general election. Similar residency requirements in other states have been judged unconstitutional by the federal courts.❖

Disabled Veteran's Principal Residence

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$5.2
1990-91	5.6
1991-92	5.9

Authorization

California State Constitution, Article XIII, Section 4 (a), and California Revenue and Taxation Code Section 205.5.

Description

This program exempts from the property tax a portion of the assessed value of the principal residence owned by a disabled veteran, or by the disabled veteran's unmarried surviving spouse. The value of the exemption varies with the disability and the claimant's income. The program generally exempts up to $40,000 of assessed value for veterans who have lost two or more limbs or are blind in both eyes. Totally disabled veterans (as determined by the U.S. Veterans' Administration) receive exemptions of up to $100,000 of assessed value. The maximum exemption amounts above increase to $60,000 (in the case of blindness or loss of two limbs) and $150,000 (for total disability), for low-income disabled veterans or surviving spouses. Program participants cannot also claim the general veteran's property tax exemption or the homeowner's exemption. The larger exemption for totally disabled veterans and surviving spouses terminates on January 1, 1996, a change which will affect property taxes due in 1996-97 and thereafter.

Rationale

This program initially was designed to provide tax relief to disabled veterans who must install special ramps and fixtures. The program was intended to eliminate the tax on such specially installed improvements. In 1974, however, the program was extended to apply to a portion of the assessed value of a disabled veteran's principal residence, regardless of whether the home has special features.

The rationale for the program is two-fold. First, it is thought to be inequitable for veterans to pay property tax on residential improvements required by a service-related injury. Second, disabled veterans, by virtue of their service to their country, are thought to be entitled to certain publicly provided benefits.

Comments

The higher exemption amounts for totally disabled veterans would have sunsetted on January 1, 1991, but were extended until 1996 by Ch 1077/89 (SB 320, Royce). This measure also increased the totally disabled exemption from $100,000 to $150,000 for low-income veterans or surviving spouses. According to the California Board of Equalization, most veterans who claim this exemption do so on the basis of total disability.

Proposition 110, adopted at the June 1990 statewide primary election and implemented by Ch 1494/90 (AB 3843, Cannella), provides an exemption from assessment as new construction for disability-related modifications made to the home of *any* severely and permanently disabled person. A veteran may benefit from this assessment exemption in addition to this program.❖

Specified Real Property Owned and Used by a Veterans Organization

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 215.1.

Description

This program exempts from the property tax real property owned by a qualified nonprofit veterans organization. To qualify, the organization must have been chartered by the United States Congress, and organized and operated for charitable purposes. The exempt property must be used *exclusively* for *charitable* purposes. This provision, therefore, extends the welfare exemption to property used by veterans organizations *exclusively for charitable purposes.* For example, property used primarily for veterans social activities would not qualify.

Rationale

This program provides tax relief to qualified veterans groups by relieving them of taxes on their real property. The rationale behind this program is to promote charitable activities by qualifying veterans organizations.❖

Personal Property Owned and Used by Specified Veterans Organizations

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 215.

Description

This program exempts from the property tax qualified personal property owned and used by a nonprofit veterans organization, provided that the organization has been chartered by the United States Congress. To qualify, the property must be used exclusively to further the goals of the veterans organization.

In the absence of this program, personal property used by veterans organizations *exclusively for charitable purposes* would be exempt under Revenue and Taxation Code Section 214. Thus, this program extends the exemption to property used to *further the goals of a veterans organization*, which may not be exclusively charitable goals.

Rationale

The rationale for the program is that veterans, by virtue of their military service, deserve to have their veterans organizations receive certain publicly provided benefits.❖

Vessels

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution Article XIII, Section 3 (1), and California Revenue and Taxation Code Section 209.

Description

This program exempts from the property tax vessels which (1) have a carrying capacity in excess of 50 tons and (2) transport freight or passengers.

Rationale

According to the California Board of Equalization, this program is rationalized on tax equity grounds. In the absence of the exemption, a vessel would be taxed only if it were in port on the property tax lien date (March 1 of each year). As a result, shipping schedules would determine which vessels were taxable each year, and some vessels might pay no property tax, even though they might spend as many days per year in California ports as other vessels on which taxes would be levied.

Proponents of the program also argue that it removes a tax disincentive for maritime shippers to use California ports. This is because both Washington and Oregon have similar exemptions, and these states have ports which compete, to some extent, for business with California's ports. Thus, the program's proponents argue that, in its absence, some maritime shipping through California ports would be diverted to other northwestern ports, such as Seattle.

Comments

This program was first implemented in California in 1914 and the exemption is provided for directly by the State Constitution. An alternative way to approach the tax-equity issue regarding mobile vessels would be to tax them based on the average number of days per year that they are docked in California ports. Such treatment would be analogous to the way that railroad cars and airplanes are taxed, which is based on the percentage of time that they are in the state. The revenue loss from this exemption probably is significant in those counties with major ports.◆

Documented Vessels

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$2.5
1990-91	2.5
1991-92	2.5

Authorization

California Revenue and Taxation Code Section 227.

Description

This program allows a "documented vessel" to be assessed for property taxation at 4 percent of its full cash value, provided that it is employed *exclusively* for any of the following purposes: (1) taking fish or other living resources from the sea for commercial purposes, (2) providing instruction or conducting research, or (3) transporting at least seven people as a commercial passenger fishing ship. A "documented vessel" is defined under the program as a vessel which has a valid marine document issued by the U.S. Bureau of Customs, or that is registered by the California Department of Motor Vehicles.

Rationale

This program provides tax relief to the owners of qualifying documented vessels. It does this by authorizing their assessment at 4 percent of value, instead of the normal 100 percent, which results in a much lower effective rate of tax on them. The program has been rationalized on the grounds that the economic viability of the commercial fishing industry is susceptible to significant fluctuations on a year-to-year basis, and the tax relief provided by this program helps to maintain the health of the industry. It does this by reducing costs to vessel owners. Implicit in this argument is the notion that maintaining the health of the commercial fishing industry is important to society, and that the cost of this program is offset by the increased stability of the industry resulting in improved access to its products.

Comments

The economic viability of the California fishing industry depends on a great many different factors, including weather, the availability of fish, and various other determinants of fishing-related costs and revenues. In a 1979 review of this program, we concluded that the property tax exemption had only a minor impact on the viability of the fishing industry, relative to these other factors (see *The Economic and Fiscal Impacts of California's Property Tax Assessment of Sportfishing Vessels*, Legislative Analyst's Office, April 1979, Report No. 79-9).❖

Vessels Under Construction

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 209.5.

Description

This program exempts from the property tax any vessels of at least 50 tons carrying capacity or 100 tons displacement during the time they are being constructed. The program also exempts from taxation property which will be incorporated into such vessels. The program applies only to vessels which are built by their ultimate users. Vessels which are built for resale are exempt under another provision of the law, because they are classified as "business inventory."

Rationale

This program provides tax relief to the shipping and shipbuilding industry. In addition, proponents argue that this program provides a tax incentive for shipping companies to undertake vessel construction projects in California ports, especially since both Washington and Oregon provide a similar tax exemption for vessels under construction. These proponents argue that, in the absence of the program, the California shipping industry, and related port activities, might be at a competitive disadvantage relative to their counterparts located elsewhere on the West Coast.❖

Cargo Containers Used in Ocean Commerce

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 232.

Description

This program exempts from the property tax qualified cargo containers principally used in transporting cargo in ocean commerce. A cargo container is defined as a specially designed receptacle which facilitates the carriage of goods by vessels and other means, and has a displacement of more than 1,000 cubic feet. This program does not apply to any cargo-carrying vehicle subject to registration under the California Motor Vehicle Code.

Rationale

This program provides tax relief to the owners of cargo containers which, it has been argued, gives an incentive for shippers to use California ports instead of other ports in the Pacific Northwest (such as Portland and Seattle). The program encourages the use of California ports to the extent that the exemption of cargo containers lowers the cost of using California ports relative to other ports, and to the extent that this cost savings is not offset by other factors. The actual volume of trade that would be diverted to non-California ports in the absence of this program would depend on such factors as (1) the sensitivity of shippers' demands for California port use to changes in the cost of using such facilities and (2) the actual magnitude of the increase in such costs attributable to the property taxation of cargo containers.

Comments

The economic and fiscal impacts of this program were reviewed in 1978 by our office (see *The Economic and Fiscal Impacts of California's Cargo Container Property Tax Exemption,* Legislative Analyst's Office, Report 78-5, March 1978, 35 pages). This study concluded that, while it was impossible to measure accurately the amount of trade diversion or changes in shipping rates attributable to this program, elimination of the program would most likely result in a positive net fiscal impact on California state and local governments. Because of the many changes that have occurred in shipping activity during the past decade, however, the current applicability of this report's findings is unknown.❖

Air Carrier Ground-Time

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$0.5
1990-91	0.5
1991-92	0.6

Authorization

California Revenue and Taxation Code Section 1152 (c).

Description

This program exempts from the property tax a portion of the time during which aircraft are located in-state, but are out of service. Ordinarily, the taxation of aircraft is based on the percentage of time an aircraft is physically located in the state, either on the ground or flying above it, and the proportion of its total arrivals and departures that take place in the state. However, this program permits out-of-service days to be excluded from this calculation. Specifically, for out-of-service periods exceeding 30 consecutive days, the amount of time after the first seven days is excluded.

Rationale

This program provides a tax incentive for airlines to have their airplanes serviced within the state. Because routine servicing can be done on airplanes at or near many different airports, including those located outside of California, it is argued that the absence of this program could cause some airlines to have these services performed elsewhere, particularly in states that do not include servicing time in determining property taxes. On the West Coast, for example, both Washington and Oregon exclude time spent within the state for servicing when computing property taxes on airplanes.❖

Aircraft Being Repaired

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 220.

Description

This program exempts from the property tax any aircraft which is in California on the property tax lien date (each March 1) solely for the purpose of being overhauled, modified, serviced, or repaired. Aircraft normally based in California, or which service California airports, do *not* qualify for the program.

Rationale

This program provides tax relief to aircraft owners who bring their craft into California to be overhauled, modified, serviced, or repaired. According to the California Board of Equalization, this program effectively applies primarily to aircraft which *must* be serviced or repaired by a California manufacturer. The program is justified on the grounds that it would be inequitable to tax aircraft which ordinarily are not operated in California, and which happen to be in California on the lien date solely for servicing or modification.

Proponents of the program also argue that it provides an incentive for airlines to repair their craft in California and, as such, promotes the California aircraft repair industry. To the extent that aircraft repairs need to be made by an aircraft's manufacturer, this program also could promote California's aircraft manufacturing industry.❖

Private Railroad Car Repair Days

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 11294.

Description

This program provides a partial property tax exemption for private railroad cars, based on the number of days such cars are in the state but are undergoing repairs. For the purposes of this program, a private railroad car is any passenger or freight car which is not owned by a railroad company. Such cars ordinarily are owned by leasing companies, or by railroad car manufacturers who lease the cars to railroad companies. The state assesses and collects the property tax on private railroad cars from the lessor in lieu of the local property tax. The revenue from this tax is deposited in the state General Fund.

The state computes the tax liability of the railroad car company by estimating the average number of each class of car physically present in the state in any year, based on the number of days railroad cars actually spend in the state. For example, if six flat cars spent 120 days each in the state, the California Board of Equalization would assess the tax on the average value of two flat cars.

This program provides that the number of days spent within the state for repair purposes in any year does not count as time-in-state for purposes of the property tax assessment formula. The number of servicing days excluded from the computation cannot exceed 90 days per car per year, unless the claimant provides substantiation of the necessity of the additional days.

Rationale

This program provides a tax incentive for the repair and servicing of private railroad cars in California. The proponents of the program argue that, if this repair and servicing time were taxable, certain railroad cars would be taken out of the state to be serviced. It is argued that, by exempting the repair and servicing time, California's railroad car service industry is not at an economic disadvantage relative to the out-of-state service industry.❖

Real Property Under an Open-Space Contract (the "Williamson Act")

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$138
1990-91	147
1991-92	156

Authorization

California State Constitution Article XIII, Section 8, and California Revenue and Taxation Code Sections 421 through 430.5.

Description

This program provides a partial exemption for restricted open-space lands. Owners of eligible properties must enter into a contract with the city or county in which the land is located that prohibits any development or use of the property that is not consistent with its use as farmland, open space, or wildlife habitat. These contracts run for 10 years and are automatically extended each year so that 10 years always remains on the contract, unless the property owner or the local government objects. In return for this restriction, the property is assessed in a special manner that generally reduces the amount of tax levied on it. Specifically, the assessment is based only on the income that the property can generate in its restricted use, and the assessed value is derived from this anticipated income stream using a statutory formula. The program applies to land and living improvements (such as vines and orchards), but not to other improvements (such as farmhouses and barns).

Rationale

This program provides a tax incentive for the conservation of farmlands, open space, and wildlife habitat lands by reducing the property tax on land that is restricted for these purposes.

Comments

Prior to the adoption of Article XIII A of the California Constitution (Proposition 13), properties could be reassessed annually based on their highest and best use. For example, the assessed value of a farm in an urbanizing area could be based on the land's development potential for a shopping center or housing tract. The resulting property tax burden could have increased the cost of maintaining the farming operation to the point that alternative types of development became an economic necessity. An original argument for this program was that it removed this incentive to develop farmland and other types of open space. Under Proposition 13, however, reassessments occur only when a change in ownership or new construction takes place. In the absence of either of these events, a property's assessed value remains constant, except for an annual inflation adjustment of up to 2 percent. Consequently, for existing property owners, an increase in the development potential of their property no longer increases their taxes. Furthermore, Proposition 13 generally limits the property tax rate to 1 percent of assessed value so that, in most cases, property taxes have a small financial impact and only marginally affect decisions to buy or develop real estate. For these reasons, a property tax reduction, such as this program provides, is unlikely to change current or future decisions regarding the development or preservation of open-space lands, and the program now functions essentially as a subsidy to owners of restricted open-space lands.

The amount of the tax reduction that the program provides for any specific property depends on the difference between the assessed value computed under this program and the normal assessed value under Proposition 13. Statewide, the program reduces property taxes on open-space lands by about one-half on average. Typically, rangelands and grazing lands receive the largest percentage reduction in property taxes – 90 percent in some cases. On the other hand, there may be little reduction in property taxes for intensively cultivated farmlands that produce substantial income and that would have a low assessed value under Proposition 13 (because ownership of these properties has not changed and little new construction has occurred since 1975).

The annual Budget Act provides an appropriation to reimburse cities and counties for their approximate revenue loss associated with these contracts. The subvention amount is based on the type of land, rather than the actual property tax loss. The 1990 Budget Act provided $14.6 million for these subventions in 1990-91.❖

Growing Crops

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII, Section 3 (h), and California Revenue and Taxation Code Section 202 (a) (1).

Description

This program exempts from the property tax any agricultural crops growing on property on the lien date (March 1 of each year). The program does not apply to mature vineyards or orchards.

Rationale

This program provides tax relief to farmers by eliminating any tax liability for growing crops. In the absence of the program, such crops would be included in the value of land under Property Tax Rule 121 of the California Board of Equalization. The program is rationalized on equity grounds. In the absence of the exemption, farmers with crops that mature early in the calendar year, such as asparagus, would have a higher tax liability than farmers with later-maturing crops, such as wheat or corn. This is because the crops which are more mature on the lien date (March 1 of each year) would be of higher value than crops which were less mature on that date.

Comments

Harvested crops are not subject to the property tax because they are exempt as business inventory under California Revenue and Taxation Code Section 219.❖

Fruit Trees, Nut Trees, and Grapevines

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution Article XIII, Section 3 (i), and California Revenue and Taxation Code Sections 211 and 223.

Description

This program exempts from the property tax fruit trees and nut trees for the first four years after they have been planted, and grapevines for the first three years after they have been planted. It also exempts nursery stock held by the grower from taxation as personal property, provided that the nursery stock is planted within the following year.

Rationale

This program provides a tax incentive for growers to plant orchards or vineyards by not levying the property tax on trees and vines until the approximate time when the trees and vines begin to bear produce.

This program has been rationalized on the grounds that no income is available from orchards and vineyards to pay taxes and other carrying costs in the initial years after their planting. Under these circumstances, the planting of fruit trees, nut trees, and grapevines cannot provide the same level of cash-flow and return on investment in the near term as can various alternative land uses. This program's rationale reflects the view that those near-term financial problems faced by owners of nursery stocks, new orchards, and vineyards should not be aggravated by imposing property taxes, when there is no income yet being generated from which to pay them. It further reflects the view that encouraging these farming-related activities benefits California.◆

Seed Potatoes

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California Revenue and Taxation Code Section 234.

Description

This program exempts from taxation as personal property seed potatoes which are held on the lien date (March 1 of each year) and are to be planted during the assessment year. The program does not apply to those potatoes owned by plant nurseries.

Rationale

This program provides tax relief to potato farmers. The program is rationalized on the grounds that seed potatoes essentially reflect business inventory that is incorporated into the potato crop and, therefore, should be exempt from taxation. This is similar to the treatment for property tax purposes of seeds, which are exempt as business inventory under Property Tax Rule 133 of the California Board of Equalization (BOE). According to the BOE, this program applies to a small number of farmers in northeastern California.❖

Timberlands

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII, Section 3 (j), and California Revenue and Taxation Code Sections 434.5 and 436.

Description

This program provides a partial property tax exemption for restricted timberlands. Restricted timberlands are assessed in a special way to reflect only the value of the land for timber production, exclusive of its development potential or aesthetic value. The Legislature has established per-acre values for various classes of timberlands. Each year, the California Board of Equalization (BOE) adjusts these values in proportion to the annual change in the unit prices of the different types of timber. In order to qualify for this program, land must be designated by the county as a timber production zone, which prohibits any use of the land that is not compatible with timber production. This restriction runs for 10 years, and is automatically renewed each year (resulting in a continuously rolling 10-year commitment). If either the property owner or the county wants to terminate this commitment, then the contract is not renewed in the following year, and the 10-year time period is allowed to "run down."

Rationale

This program provides tax relief to owners of timberlands. The program's rationale is that the reduced tax burden on lands maintained as forests reduces economic pressure for incompatible development and facilitates long-term forest management by limiting the annual ownership costs of timberlands. As a result, it is argued that these lands continue to serve public purposes by providing recreation, open space, and wildlife habitat, which merits public financial support.

Comments

This program for timberlands is similar in principle to the program that limits the assessed value of lands which are under open-space contracts. As with the open-space program, the benefit of this program has diminished since the adoption of Proposition 13 in 1978, which eliminated reassessments due to property appreciation in the absence of new construction or of a sale or other transfer of the property.

Standing commercial timber (as opposed to the underlying land) is not taxed under the property tax. Instead, standing timber is subject to a separate state tax -- the timber yield tax -- when it is cut (California Revenue and Taxation Code Section 38115). The state allocates the revenue from the timber yield tax back to the counties in which the timber was produced.❖

Transfers of Interests in Corporate or Partnership Property

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 64.

Description

This program exempts from reappraisal property owned by a legal entity such as a corporation or partnership and transferred pursuant to a corporate reorganization, or when 50 percent or less of the ownership interest in the entity is transferred (providing that control over the entity is not transferred). This exemption from reappraisal generally allows the transferred property to retain the assessed value ascribed to it prior to the transfer. In the absence of this exemption, the property's assessed value would be increased to reflect its current market value pursuant to the change-of-ownership provisions of Proposition 13.

Rationale

This program provides tax relief to the owners of corporations, partnerships, and other legal entities owning real property in California. The rationale for exempting from reappraisal the transfer of property pursuant to a corporate reorganization is that no real transfer of property has taken place. In the case of exempting transfers of 50 percent or less of an entity, program proponents argue that majority interest determines control, and that a transfer of a noncontrolling interest is not a substantive change of ownership.

Comments

This program results from the necessity of defining the term "change in ownership" for properties owned by corporations, partnerships and other legal entities with multiple ownership. It seems reasonable that Proposition 13 did not intend to trigger change-in-ownership reassessments whenever a few shares of a large corporation are traded. The same corporation continues to own the property and there is no change in the control or use of the property due to a minor stock transfer. On the other hand, the outright sale of an entire legal entity to a new owner clearly is a real change in ownership even though the name of the corporation holding title to the property may remain the same. The Legislature determined that the appropriate definition of a change in ownership for these properties is a change in the controlling ownership of the legal entity holding title.

Property transfers among farm credit institutions due to reorganizations under federal law were included in this program by Ch 560/88 (SB 569, Garamendi).❖

Real Property Transferred to an Employee Benefit Plan

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 66.

Description

This program exempts from reappraisal property transferred to an employee benefit plan. Transfers of property that are exempt under this program include: (1) the vesting of a participant's or beneficiary's interest in an employee benefit plan, (2) any contribution of real property to an employee benefit plan, and (3) any acquisition by an employee benefit plan of the stock of the employer's corporation pursuant to which the employee benefit plan obtains direct or indirect control in the employer's corporation. An employee benefit plan is defined for the purposes of this program as either an employee pension plan, or as a plan or fund which provides employee welfare benefits (such as medical or hospital care, disability or unemployment benefits, daycare, job-related training, or legal services).

This exemption from reappraisal permits the property to retain the assessed value ascribed to it prior to the transfer. Because the assessed value would otherwise be increased following the transfer to reflect the market value of the property, this exemption reduces the property's tax assessment and, therefore, its property tax liability.

Rationale

This program provides a tax incentive for firms to improve the funding of, and the benefits provided by, their employee benefit plans. To the extent that the lower property tax liability promotes use of a greater variety of financing mechanisms for plans, the program may lead employers to contribute more to the plans and, hence, provide improved benefits to their employees.

In addition, the program provides tax relief to employees having a vested interest in employee benefit plans. It also provides relief to participants when an employee benefit plan acquires controlling interest in a company in order to prevent a corporate takeover.

One rationale underlying this program is to encourage employee participation in, and ownership of, businesses in the State of California.

Comments

The exemption for stock acquisition was adopted in 1986, after an employee benefit plan acquired controlling interest in a Monterey business in order to prevent a corporate takeover by out-of-state interests. According to the California Board of Equalization, the forestalled buyout would have lead to relocation of the company outside of California and, consequently, would have resulted in the loss to California of thousands of jobs.❖

Business Inventory

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$1,000
1990-91	1,000
1991-92	1,000

Authorization

California Revenue and Taxation Code Section 219.

Description

This program exempts personal property held as inventory by businesses from the property tax.

Rationale

This program provides tax relief to businesses that maintain inventories of products for sale in the course of doing business. The program has been rationalized on the grounds that the application of the property tax to inventories causes extensive administrative problems for retailers and distributors, and may result in the loss of economic activity as businesses take actions to avoid the tax. To the extent that imposing the property tax on inventories would lead businesses to decrease their inventories or locate warehouses outside the state, the program may also be rationalized as removing a "disincentive" to efficient inventory management, as well as encouraging inventory-related economic activity in California.

Comments

Inventories were fully taxable prior to 1968, 15 percent exempt from 1968 to 1973, 50 percent exempt from 1974 to 1978, and fully exempt beginning in 1979. ❖

Business Records

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 997.

Description

This program exempts from the property tax business and professional records. The exemption applies to written documents and photographic reproductions, recorded data, research notes, calculations, and indices. However, the value of the media on which the records are stored is not exempt. In addition, the program does not apply to books, old newspapers on microfilm, computer programs, and records which are sold in the ordinary course of business.

Rationale

This program provides tax relief to persons engaged in a business or profession. The underlying rationale for the program is to simplify tax administration. The assessment of business records is a difficult and often subjective task. In most cases, moreover, these records have no value apart from that to the business itself. There are exceptions, however, such as the records of property transfers found in a title insurance business, or credit records of a credit bureau. Copies of these records might be sold to other parties who want to go into these businesses. In general, however, the value of business records is so low that the annual property tax revenues attributable to them would not offset the costs of assessing and collecting these taxes. ❖

Financial Assets

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 212.

Description

This program exempts from the property tax intangible personal property such as notes, debentures, capital stock, solvent credits, and mortgages. In addition, the program exempts money kept at hand, which is used in the regular course of business. In the absence of this exemption, such assets would be construed as business personal property and be taxed as such.

Rationale

This program provides tax relief to businesses that own various intangible financial assets and money kept on hand. According to the California Board of Equalization, the program is rationalized on the grounds that difficulties in administering the tax on such assets lead to unequal treatment of taxpayers. This is because financial assets can be very difficult to identify, and they easily can be moved outside of the state to avoid taxation. The assets covered under this program have been exempted in order to avoid such administrative difficulties and the inequities to which they give rise. ❖

Works of Art Available for Display

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 217.

Description

This program exempts from the property tax privately owned works of art made available for display in (1) a publicly owned art gallery, (2) a publicly owned museum, or (3) a museum which is both regularly open to the public and operated by a nonprofit organization. To qualify, the art must have been made available for display within a certain period of time prior to the property tax lien date, and must meet certain artistic criteria. The exemption does not apply to art loaned by any person who holds works of art primarily for purposes of sale.

Rationale

This program provides a tax incentive for individuals to loan art works to qualified museums, by exempting such works from the property tax. The underlying rationale for the program is to promote the public display of artwork in California. ❖

Works of Art Owned by the Artist

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 986.

Description

This program provides a special property tax valuation for qualified works of art owned by the artist who produced them. Art that is held by a person engaged in the business of selling or producing art is considered personal property and, as such, may be subject to the property tax (see below). This program provides that the taxable value of art which is held by its creator shall equal the value of the materials used to create the artwork. Artwork may qualify for this program only if it has never been sold or exhibited.

Rationale

This program provides tax relief to artists by reducing the cost to them of maintaining a collection of their own artwork. The program is rationalized on the grounds that, absent an actual sale of a piece of artwork, its taxable value can be difficult to determine. By valuing such artwork solely in terms of its materials, this program is intended to ease tax administration by reducing the number of appealed assessments.

Comments

In the absence of this program, some artwork owned by artists potentially would be exempt either as business inventory or as personal property used as household furnishings. In addition, certain materials used to create the artwork could be exempt from taxation as business inventory. ❖

Personal Property Used in Exhibits (Exhibition Exemption)

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 213.

Description

This program exempts from the property tax qualified personal property brought into the state temporarily for use in a public exhibit. To qualify, the property must be subject to property tax in another state or country, and any taxes due must have been paid prior to claiming the exemption in California.

Rationale

This program provides a tax incentive for nonresidents to exhibit property in California, such as automobiles, artwork, crafts, and other such items. In the absence of the program, such property owners would be required, in effect, to pay "double taxes" on any property being exhibited on the property tax lien date (March 1 of each year). This tax treatment might discourage nonresidents from exhibiting property of public interest within California. ❖

Personal Property for Display in an Aerospace Museum

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 217.1.

Description

This program exempts from the property tax aircraft loaned or donated for display in either (1) a publicly owned aerospace museum or (2) an aerospace museum which is both regularly open to the public and operated by a nonprofit organization. The property must either have been made available for display for a period of 90 days during the 12-month period immediately prior to the property tax lien date, or the person claiming the exemption must certify in writing that the property will be made available for display for at least 90 days following the first day the property was on public display. The exemption does not apply to aircraft loaned by any person who holds aircraft primarily for purposes of sale.

Rationale

This program provides an incentive for aircraft owners to lend or donate specified aircraft to qualifying aerospace museums. The program is rationalized on the grounds that aircraft used for display purposes are functionally similar to works of art and, therefore, deserve comparable treatment under the property tax.

Comments

This program was sponsored by the San Diego Aerospace Museum. The museum also qualifies for a sales and use tax program which exempts from taxation the transfer of certain tangible personal property to aerospace museums. According to the California Board of Equalization, the San Diego Aerospace Museum is the only museum in California that currently qualifies for these programs. ❖

Homeowners' Exemption

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$353
1990-91	356
1991-92	361

Authorization

California State Constitution Article XIII, Section 3 (k), and California Revenue and Taxation Code Section 218.

Description

This program provides homeowners a partial exemption from the property tax. The exemption, equivalent to $7,000 of the property's assessed value, is applicable only to a taxpayer's principal place of residence.

Rationale

This program provides property tax relief to owner-occupants of residential dwellings by reducing the assessed value of their property, and thereby lowering their property tax bills. The program is rationalized on the grounds that it encourages homeownership, and that increased homeownership results in higher levels of economic activity and promotes stability in individual neighborhoods and society generally.

Comments

Renters are eligible for the renters' tax credit under the personal income tax. The value of that credit is almost the same as the value of the homeowners' exemption for a single person, and it is greater than the value of the homeowners' exemption for a married couple or a head-of-household. (The homeowners' exemption is worth about $70 to the average taxpayer, whereas the renters' credit is currently worth $60 for individuals filing separately and $120 for married couples.) ❖

Personal Property Used as Household Furnishings

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$787
1990-91	858
1991-92	935

Authorization

California State Constitution Article XIII, Section 3 (m), and California Revenue and Taxation Code Section 224.

Description

This program exempts from the property tax all personal property owned by individuals, including household furnishings and pets. This exemption does not apply to aircraft, vehicles, or boats, or personal property held and used in connection with a trade, profession, or business.

Rationale

This program provides tax relief to individuals by eliminating the tax on their qualifying personal property. The underlying rationale for the program is to simplify administration of the property tax. The identification and valuation of household items are difficult and often subjective tasks. Moreover, the value of many household property items is so low that the annual tax revenues attributable to them would not offset the costs of collecting these taxes. ❖

Real Property Transferred Between Parents and Children

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII A, Section 2, and California Revenue and Taxation Code Section 63.1.

Description

This program exempts from reappraisal a property holder's principal residence, and up to $1 million in other real property, when the property is transferred between parents and children. This exemption from reappraisal provides that the transferred property retains the taxable value that it held prior to the transfer. Since the property would otherwise be reappraised at its current market value (which is generally higher than its taxable value) following the transfer, this program reduces the tax assessment on the specified property.

Rationale

This program provides tax relief to property owners by allowing parents to transfer the family house and other property to their children without property tax consequences. Proponents of the program argue that transfers within the family deserve special treatment in order to preserve family homes, businesses, and farms, and to generally preserve the family unit in California.

Comments

This program provides a substantial reduction in property taxes for children who inherit (or otherwise receive) homes, farms, and other real property from their parents if the parents held the property for several years or more. In these cases, the property's assessed value may be significantly less than its current market value. There is no income limitation or other "needs test" for participants in this program. In many cases, the increased property taxes from a reappraisal would not force the sale of inherited property in this program's absence. ❖

Interspousal Transfers of Real Property

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII A, Section 2 (g), and California Revenue and Taxation Code Section 63.

Description

This program exempts from reappraisal any property transferred between spouses. This exemption includes property transferred between spouses after (1) a property settlement, (2) a decree of dissolution of a marriage or legal separation, or (3) upon death of a spouse. It also exempts from reappraisal the creation, transfer, or termination between spouses of a co-owned interest in property.

This exemption from reappraisal ensures that the property retains the taxable value ascribed to it prior to the transfer. Because the assessed value of the transferred property would otherwise be increased to reflect its current market value, this exemption reduces the tax assessed on qualifying property.

Rationale

This program provides tax relief to property holders who transfer property to, or receive property from, their spouse. Proponents of the program argue that it is inequitable to reassess property transferred between spouses upon death of a spouse or dissolution of a marriage. ❖

Real Property Transferred in a Joint-Tenancy Agreement

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 65.

Description

This program exempts from reassessment any transfer of property between members of a specified joint-tenancy agreement. In order for the program to apply, the original transferor(s) of the property, or their spouses, must remain members of the joint tenancy after the transfer. When an original transferor leaves the joint tenancy, the property must be reassessed unless it vests to a remaining original transferor. If a joint tenant *other than* the original transferor leaves the joint tenancy, there is no reassessment if that tenant's share of the property is either transferred to an original transferor, or is distributed among all remaining joint tenants.

Rationale

This program provides tax relief to individuals by reducing the tax liability on property which has been transferred within a joint-tenancy agreement. The underlying rationale for the program is that joint-tenancy agreements essentially represent a single-ownership covenant, and that redistributions of property within the agreement, therefore, should not result in an increased tax liability. ❖

Mobilehome Park Property Transferred to a Tenant Cooperative

***Sunset Date:** January 1, 1994*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Sections 62.1 and 62.2.

Description

This program exempts from reappraisal any mobilehome park property which is transferred to a qualified corporation formed by the tenants of the mobilehome park for the purpose of purchasing the park. To qualify for the exemption, within 270 days of the initial transfer, at least 51 percent of the corporation's stock must be owned by tenants previously renting at least 51 percent of the spaces prior to the transfer. The exemption from reappraisal under this program permits the transferred property to retain the assessed value ascribed to it prior to the transfer.

Rationale

This program provides tax relief to mobilehome residents who organize to purchase the mobilehome parks in which they reside. Such purchases may be motivated by the potential loss of long-term, mobilehome-space leases, higher rents for spaces, and other factors. The program's underlying rationale is to promote homeownership among mobilehome residents, many of whom are lower-income or elderly individuals. ❖

Replacement Property for Disaster-Damaged Property

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII A, Section 2 (a), (e), (f), and California Revenue and Taxation Code Section Sections 69 and 5825 (c).

Description

This program provides that property which is either rebuilt or acquired as a replacement for disaster-damaged property shall be assessed at the same value as the original property prior to the disaster.

In the case of real property, qualifying property must have been damaged on or after July 1, 1985 and (1) the Governor must have declared that a disaster occurred, (2) the disaster must have reduced the market value of the property by more than one-half, and (3) the replacement property must be comparable to, and located in the same county as, the property damaged by the disaster. In cases where the market value of the replacement property exceeds 120 percent of the market value of the original property, the original assessment is adjusted upward by the amount of the excess.

For mobilehomes that are taxed as personal property, there is no increase in assessed value for any mobilehome that has been reconstructed or replaced by a comparable mobilehome due to damage or destruction by any misfortune or calamity.

Rationale

This program provides tax relief to disaster victims by reducing their tax liability on rebuilt or replacement property. The program is rationalized on the grounds that persons who are forced to replace their residences on account of a natural disaster should not have to face an increased tax liability as an additional consequence of the disaster. ◆

Replacement Property for Property Condemned Pursuant to Eminent Domain Proceedings

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII A, Section 2 (d), and California Revenue and Taxation Code Sections 68 and 5825 (d).

Description

This program allows the owner of real property or a mobilehome acquired by a government entity through eminent domain proceedings or inverse condemnation, to carry-over his or her original assessed value to a comparable replacement property. In cases where the market value of the replacement property exceeds 120 percent of the market value of the original property, the original assessment is adjusted upward by the amount of this excess.

This program, thus, seeks to ensure that taxes on a similar new property are equivalent to those that were levied on the old property prior to its condemnation. To the extent that the market value of the replacement property exceeds the assessed value of the original property, this program effectively reduces the tax assessment on the replacement property. Moreover, this program excludes from the assessed value a portion of the market value of a more expensive replacement property.

Example

A property owner's $120,000 home is condemned, and he or she purchases a similar residence for $140,000. Under this program, the base-year value of the home for property tax purposes would remain unchanged, since 120 percent of $120,000 is greater than $140,000.

Rationale

This program provides tax relief to property owners who are displaced from their property as a result of eminent domain proceedings. The program is rationalized on the basis that property owners who must move because the government has taken their property should not also be required to pay higher taxes simply because they acquire replacement property. ❖

Earthquake Safety Improvements

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Up to $10
1990-91	Up to $10
1991-92	Up to $10

Authorization

California State Constitution, Article XIII A, Section 2 (a), (c), and California Revenue and Taxation Code Sections 70 (d) and 74.5.

Description

This program exempts from reassessment as new construction any qualifying reconstruction or improvements made to existing buildings after November 5, 1990 that have been identified by local governments as being hazardous to life in the event of an earthquake. In order to qualify, the reconstruction or improvements must be required by a local earthquake safety ordinance or employ earthquake hazard mitigation technologies approved by the State Architect. In the case of required improvements to buildings with unreinforced masonry bearing walls, the exemption is limited to 15 years, but it includes improvements made after June 4, 1984. This program does not affect the taxation of buildings that are sold or transferred after the installation of earthquake safety improvements, which are reassessed at their current full market value.

Rationale

This program provides tax relief to property owners who add qualifying earthquake safety improvements to their buildings. It does this by eliminating any increase in assessed value that otherwise would take place because of the value added to such buildings by these improvements. The primary rationale for the program is to protect life and property by promoting the rehabilitation of buildings that would be unsafe in an earthquake. Program proponents also argue that providing an incentive for earthquake safety improvements will protect the tax base and reduce future disaster mitigation costs.

Comments

The 15-year exemption for improvements to buildings with unreinforced masonry bearing walls was authorized by Proposition 127, adopted at the June 5, 1984 statewide primary election. The authority for the unlimited exemption for earthquake safety improvements to other types of buildings was added by Proposition 127, approved at the November 1990 statewide general election. Most of the revenue loss from this program (which totals millions of dollars annually) probably will be associated with buildings that are renovated or converted to new uses. This is because these types of projects generally add substantial value to property, and part of that value is not taxable as a result of this program. ❖

Homes and Improvements for Severely Disabled Persons

Sunset Date: *Authority for intercounty transfers of assessed value sunsets January 1, 1999.*

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	None
1990-91	$1
1991-92	2

Authorization

California State Constitution, Article XIII A, Section 2 (a) and (c), and California Revenue and Taxation Code Sections 69.5 and 74.3.

Description

This program allows severely and permanently disabled persons, regardless of their age, to transfer the assessed value of their existing home to a replacement home in the same manner as provided for homeowners over the age of 55. In order to qualify, the disability must necessitate the move for either physical or financial reasons. The replacement residence generally must be in the same county as the original residence, and it must be bought or built within two years of the sale of the original dwelling. Further, the value of the replacement home cannot exceed the value of the original residence. In addition, this program allows the transfer of assessed valuation to a replacement dwelling located in a *different* county, provided that the county in which the replacement dwelling is located has adopted an ordinance allowing intercounty transfers of assessed value. A disabled person may benefit from this program only once.

This program also excludes from reappraisal any building improvements that make an owner-occupied home more accessible to and usable by a permanently and severely disabled person who is a permanent resident of the dwelling.

Rationale

This program provides tax relief to disabled persons who must move because of their disability. It does so by preventing the reassessment of the replacement home at its current market value. This results in a property tax savings to the disabled person to the extent that the market value of the replacement home is greater than the assessed value of the original home. The program also prevents any increase in property taxes that otherwise would result from improvements made to a home to accommodate a disabled person. Program proponents argue that disabilities reduce or eliminate income, so that disabled persons who must move or modify their dwellings often cannot afford higher property taxes and could be forced into institutions or homelessness in the absence of this program.

Comments

We have estimated that the ongoing annual revenue loss (1991-92 and beyond) from this program will be in the range of $1 million to $2 million, primarily due to the provision allowing transfers of assessed value for replacement homes.

Although the program's rationale is based on the general need to provide tax relief to disabled persons, specific evidence of need is not required to qualify, except when a move to a replacement home is being justified on the basis of financial (rather than physical) necessity.

This program was authorized by Proposition 110, which was approved at the June 1990 statewide primary election, and was implemented by Ch 1494/90 (AB 3843, Cannella). It applies to replacement homes acquired and improvements completed after June 5, 1990. ❖

Proportionate Assessment Reduction for Property Damaged by Misfortune or Calamity

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII A, Section 2(b), and California Revenue and Taxation Code Section 170.

Description

This program reduces the assessed value of qualified damaged property in proportion to the reduction in the market value of the property caused by the damage. Because the assessed value of most properties is significantly less than their current market value, this program can provide a tax reduction for properties whose market value after the damage still exceeds their pre-damage assessed value. In the absence of this program, the assessed value of damaged property is reduced only if its market value after the damage is less than its assessed value. In order to qualify under the program, the damage must have been caused by a disaster, or by misfortune or calamity, and the damage must be at least $5,000. The program is available only if adopted by a county ordinance.

Example

A supermarket with a market value of $1 million and an assessed value of $700,000 sustains $200,000 of damage in an earthquake. The damage reduces the market value of the property by 20 percent and, therefore, the assessed value also is reduced by 20 percent -- to $560,000. In the absence of this program, there would not be any reduction in assessed value, because the damage has not reduced the property's market value below its existing assessed value.

Rationale

The program provides tax relief to owners of property damaged in a disaster or in calamities, such as fires. The program is rationalized on the basis that property owners who suffer disasters or calamities should receive tax relief in order to mitigate their losses.

Comments

Not all counties have ordinances implementing this program. Some counties adopt an implementing ordinance only for a limited period of time following major disasters. ❖

Property Assessments of $2,000 or Less

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution Article XIII, Section 7, and California Revenue and Taxation Code Section 155.20.

Description

This program allows county boards of supervisors to exempt from the property tax those properties on which the total net tax liability is lower than the cost of assessing and collecting the tax. Under this authority, county boards may not exempt property with value in excess of $2,000.

Rationale

This program provides tax relief to the owners of low-valued property. The rationale for the program is to simplify administration of the property tax. The value of certain properties is so low that the annual tax revenues attributable to them would not offset the costs of collecting the tax. This program allows counties to forego incurring these net administrative losses.

Comments

According to the California Board of Equalization, fewer than half of California's counties have adopted this program. ❖

Vessels With a Market Value of $400 or Less

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 228.

Description

This program exempts from the property tax vessels with a market value of $400 or less. The program applies only to vessels used or held for noncommercial purposes, and does not apply to lifeboats. In addition, each property owner may have only one such vessel exempted in any given year.

Rationale

This program provides tax relief to owners of low-value vessels. Its underlying rationale is to simplify tax administration. The value of the qualified boats is so low that the annual tax revenues attributable to them would not offset the cost of collecting the taxes.

Comments

California Revenue and Taxation Code Section 155.20 allows counties to also provide, by ordinance, a general exemption for low-valued property (defined as property not valued at more than $2,000). In those counties having passed such an ordinance, the general exemption for low-valued property supersedes this program. ❖

Interests in Real Property that Represent Less than 5 Percent of the Property's Total Value

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 65.1.

Description

This program exempts from reappraisals transfers of ownership interests in any property which represent less than 5 percent of the entire property's full market value. The qualifying transfers must have a market value of less than $10,000. When several interests are transferred in any given assessment year, they are accumulated. If the total transfer exceeds 5 percent or $10,000, then all of the transferred interests are reappraised.

Property exempted from reappraisal under this program retains the value ascribed to it prior to the transfer. To the extent that the market value of the property has increased and would otherwise be reflected in the reassessment of the property, this program reduces the tax liability on such property.

Rationale

This program provides property tax relief to the owners of the qualifying property. The underlying rationale for the program is to simplify administration of the property tax. The tax revenues from reassessing incremental transfers of property valued under $10,000 may not offset the county costs for assessing, billing and collecting the taxes due. ❖

Supplemental Roll Assessments of $20 or Less

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 75.41 (d).

Description

This program permits county auditors to cancel supplemental property taxes due on a property if the amount of these taxes is $20 or less.

Rationale

This program provides tax relief to taxpayers who transfer or construct low-valued property. The rationale for the program is to simplify administration of the supplemental property tax. The revenues generated by collecting supplemental roll assessments of $20 or less may not offset the costs of collection.

Comments

Several county assessors have pointed out that most of the costs associated with supplemental property tax involve the *assessment* rather than the *collection* of the tax. These assessors claim that, once the assessment is made, it *is* cost-effective to collect the tax. To the extent that this is the case, the above program rationale may not be valid for certain properties. ❖

Blood and Human Parts

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	None
1990-91	None
1991-92	None

Authorization

California Revenue and Taxation Code Section 33.

Description

This program exempts from the property tax any human body part held in a bank for medical purposes. It also exempts blood and blood products.

Rationale

This program exempts from property tax blood and human body parts held in banks. Patients or medical researchers who receive the blood or parts benefit to the extent that the tax exemption is reflected in lower prices for these items. Consequently, the program is justified on humanitarian grounds.

Comments

This exemption predates the business inventory exemption (California Revenue and Taxation Code Section 219) which, according to the California Board of Equalization, would apply in the absence of this exemption. Therefore, this exemption does not result in any additional revenue loss. ❖

Restricted Historical Property

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	Minor
1990-91	Minor
1991-92	Minor

Authorization

California State Constitution, Article XIII, Section 8, and California Revenue and Taxation Code Sections 439 through 439.4.

Description

This program provides a partial exemption for restricted historical property. Eligible properties must be included on an official list of historical properties, and the property owner must enter into a contract with the city or county in which it is located that prohibits any alteration or use of the property that is not consistent with its historic designation. These contracts run for 10 years and are automatically extended each year so that 10 years always remains on the contract, unless the property owner or the local government objects. In return for this restriction, the property is assessed in a special manner that generally reduces the amount of tax levied on it. Specifically, the assessment is based only on the income that the property can generate in its restricted use, and the assessed value is derived from this anticipated income stream using a special "historical risk component" that further reduces the computed amount of assessed value.

Rationale

This program provides an incentive to preserve and restore historical property in California by reducing the tax liability on such property.

Comments

This program is similar to the partial exemption for open-space lands. Prior to the adoption of Article XIII A of the California Constitution (Proposition 13), properties could be reassessed annually based on their "highest and best" use. For example, the assessed value of an historic house in an intensively developed downtown area could be based on the development potential of the property for an office building. The resulting property tax burden could have increased the cost of maintaining the historic property to the point that development of the property, incompatible with its historical nature, became an economic necessity. An original argument for this program was that it removed this disincentive for historic preservation. Under Proposition 13, however, reassessments occur only when a change in ownership or new construction takes place. In the absence of either of these events, a property's assessed value remains constant, except for an annual inflation adjustment of up to 2 percent. Consequently, for existing property owners, an increase in the development potential of their property no longer increases their taxes. Furthermore, Proposition 13 generally limits the property tax rate to 1 percent of assessed value so that, in most cases, property taxes have a small financial impact and only marginally affect decisions to buy or develop real estate. For these reasons, a property tax reduction, such as this program provides, is unlikely to change current or future decisions regarding the development or preservation of historical property, and the program now functions essentially as a subsidy to owners of restricted historic property.

The California Board of Equalization indicates that it is aware of only seven properties in the entire state that currently benefit from this program, although it anticipates that participation will increase somewhat in the future. ❖

Fire Safety Improvements

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII A, Section 2 (c) (2), and California Revenue and Taxation Code Section 74.

Description

This program exempts from reappraisal as new construction the construction or installation in an existing building of fire sprinkler systems, other fire extinguishing systems, fire detection systems, or fire-related egress improvements. The exemption applies to systems completed on or after November 7, 1984.

Rationale

This program provides tax relief to building owners who add fire safety improvements to their buildings. It does so by exempting such systems from reappraisal as new construction, thus reducing the cost to the property owner of providing for the fire equipment. Upon a change in ownership, however, the value of the fire equipment would be reflected in the new assessed value of the property to the extent that it increases the property's market value.

Comments

Fire safety improvements often are required by local building codes when older buildings are renovated. ❖

Active Solar Energy Systems

Sunset Date: January 1, 1991

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$9
1990-91	10
1991-92	11

Authorization

California State Constitution, Article XIII A, Section 2 (c) (1), and California Revenue and Taxation Code Section 73.

Description

This program exempts from assessment as new construction certain active solar energy systems. To qualify, a system must produce heat, electricity, or mechanical energy, and its collection and storage devices must be thermally isolated from the space where the energy is used. Wind energy systems do not qualify. The exemption applies to systems constructed or added after March 1, 1981. The law also specifies that the exemption does not apply to that portion of the construction or addition associated with solar swimming pool heaters which is in excess of the cost of a comparable conventional fossil fuel heating system. Because they are not assessed when they are built, qualifying solar energy systems remain exempt from property taxation until a change of ownership occurs and triggers an assessment.

Rationale

This program provides a tax incentive for the expanded use of solar energy technology. It accomplishes this by reducing the relative cost of such installations compared to conventional systems. This reduction in the relative cost of active solar energy systems may, in combination with the net energy cost savings provided by such systems, result in lower total installation, operating, and maintenance costs over the system's life than the total costs for comparable conventional systems. The program's underlying rationale is the view that promoting solar energy technologies is socially, environmentally, and economically desirable and, therefore, worthy of public financial support.

Comments

Roughly 90 percent of the revenue loss under this program is due to the exemption of major solar electric generating facilities constructed by LUZ International Ltd. in San Bernardino County.

Although the program sunset on January 1, 1991, existing facilities that qualify for the program will continue to be untaxed until a change of ownership triggers an assessment. ❖

Returnable Containers for Soft Drink Beverages

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 996.

Description

This program exempts from the property tax returnable beverage containers held on the property tax lien date by persons who are under a legally enforceable duty to return the containers for reuse. The program also exempts from taxation the containers that are not in the physical possession of the bottler on the lien date.

Rationale

This program provides tax relief to retailers who collect containers for return to a bottling company. In addition, it provides tax relief to bottling companies by exempting them from taxes on beverage containers held by retailers and consumers on the lien date. The program does not apply to bottles physically in possession of bottling companies on the lien date.

Proponents of this program defend its provisions on equity grounds. They argue that retailers should not be responsible for taxes on containers to which they do not hold title. They likewise argue that the bottling company should not bear the tax liability for bottles not in their possession, because many of these bottles will be broken or otherwise not returned to their bottling facilities.

Prior to 1973, county assessors generally assessed bottling companies for all of the containers they owned, including those held by retailers and consumers. Industry members complained, however, that certain assessors assessed both the bottling company and the retailers for the same containers. In 1973, the courts decided that bottlers were not liable for bottles outside their control on the lien date. This program codifies the relief granted to bottlers by the courts, and extends the relief to the retailers handling the bottles.

Comments

Nonbusiness consumers of soft drinks generally are exempt from taxation of beverage containers under the constitutional exemption for household furnishings and personal effects.

Nonreturnable containers are business inventory and are exempt from property taxation under California Revenue and Taxation Code Section 219. ❖

Computer Programs

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 995.

Description

This program exempts from the property tax *all* computer programs, except basic operational (including control) programs. The storage media for the programs are, however, taxable. Such storage media are defined under this program to include punch cards, tapes, discs, or drums.

Rationale

This program provides tax relief to the owners of computer programs. The underlying rationale for the program is to stimulate technological innovation in California by promoting the development and use of computers. The program's proponents also argue that the taxation of computer programs would be detrimental to the computer science industry because it would discourage the use of computer programs by other California industries. In addition, proponents argue that the valuation of custom software is a highly subjective and potentially arbitrary process.

Comments

Custom computer programs also are exempt from the sales and use tax under California Revenue and Taxation Code Section 6010.9.

While valuing custom software may be difficult, standard software has well-established prices. Software purchases often comprise a significant portion of the total cost of a mainframe or personal computer installation, so that this exemption probably results in a revenue loss of tens of millions of dollars annually. The rationale for this program is questionable in light of the fact that computer sales and use have grown rapidly in California even though computer hardware is subject to property taxation. ❖

Racehorses

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$2-5
1990-91	2-5
1991-92	2-5

Authorization

California Revenue and Taxation Code Sections 5721 and 5741.

Description

This program exempts qualifying racehorses, which are personal property, from the property tax. Instead, these racehorses are subject to the in-lieu tax on racehorses, which in most cases results in a smaller tax liability than would be imposed by the ad valorem property tax. The in-lieu tax varies (from a minimum of $12 for a nonproducing brood mare to a maximum of $1,000 for a stallion with a stud fee of $11,000 or more), depending on the horse's activities and earnings from those activities. In order to qualify for this program, a horse must be eligible, or produce foals which will be eligible, to participate in racing meets with parimutuel betting in California. Furthermore, if the horse is over three years old (four years old for Arabians), it must have either raced or been used for breeding racehorses within the previous two years. Foals born to a racehorse mare in any given year are exempt from both the property tax and the in-lieu tax on racehorses in that year.

Rationale

This program provides tax relief to owners of qualifying horses. It has two rationales. First, it is argued that the program improves tax equity because the in-lieu tax is based on objective factors, such as race winnings, rather than appraisals of value, which may vary among counties for comparable horses. Second, the program's proponents claim that, in its absence, there would be an incentive for owners and breeders to move their horses to other major racing states because of the favorable tax treatment provided for racehorses in those states. Thus, these proponents argue that, by helping to maintain the California horseracing industry, the program increases economic activity in the state, including wagering, which in turn increases state and local tax revenues, including taxes on parimutuel wagering.

Comments

We published a detailed review of this program in our *Report on the 1988-89 Tax Expenditure Budget -- Overview and Selected Reviews* (December 1988, pp.55-62, Publication 88-20). That review estimated that the annual net revenue loss from this program (that is, the revenue loss from the property tax exemption minus the revenue gain from the in-lieu tax) is in the millions of dollars. Our review also recommended tightening eligibility requirements for the program and reevaluating the in-lieu tax schedule to determine if upward revisions are warranted. ◆

Motion Pictures

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California Revenue and Taxation Code Section 988.

Description

This program provides that the value of motion pictures for property tax purposes is the full value of the *tangible materials* upon which the motion picture is recorded. As such, this program exempts intangible rights, such as the copyright, or right to reproduce, copy, and exhibit the motion picture, as well as the value added to the motion picture in the production process.

Rationale

This program provides an incentive for the motion picture industry to locate in California by reducing the operating costs associated with doing business in the state. According to program proponents, in recent years, motion picture companies have migrated in increasing numbers to other states, most notably New York. This program is rationalized on the grounds that a healthy motion picture industry is vital to the economic health of California.

Comments

Intangible property, such as a copyright, never is taxable in itself because the property tax is levied only on real property or *tangible* personal property. However, the courts have ruled that, in valuing tangible property, assessors may take into consideration earnings from intangible rights that are associated with that property (*Michael Todd Co. v. Los Angeles County*, 57 Cal. 2nd 684, and *ITT World Communications v. Santa Clara County*, 101 Cal. App. 3d 246). ✦

Replacement Housing Purchased by Senior Citizens

Sunset Date: Authority for intercounty transfers of assessed value sunsets January 1, 1999

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	NA
1990-91	NA
1991-92	NA

Authorization

California State Constitution, Article XIII A, Section 2 (a), and California Revenue and Taxation Code Section 69.5.

Description

This program allows persons 55 years of age or older who sell their principal residence and buy or build another residence of equal or lesser value within two years, to transfer the old residence's assessed value to the new residence, provided that the replacement residence is within the same county as the original residence. In addition, this program allows the transfer of assessed valuation to a replacement dwelling located in a *different* county, provided that the county in which the replacement dwelling is located has adopted an ordinance allowing intercounty transfers of assessed value for elderly homeowners. A homeowner may benefit from this program only once.

Rationale

This program provides tax relief to taxpayers 55 years of age or older who sell their principal dwelling and then buy or build a replacement home. It does so by preventing the reassessment of the replacement home at its current market value. This results in a property tax savings to the extent that the market value of the replacement home is greater than the assessed value of the original home. This program has been rationalized on the grounds that it removes a disincentive for senior citizens who no longer need family-sized dwellings or dwellings located near schools or places of employment to move to more suitable homes, thereby increasing the availability of suitable housing for younger families.

Comments

This program was originally established when voters approved Proposition 60 at the November 1986 statewide general election, but applied only to moves *within* a county. The approval of Proposition 90 at the November 1988 statewide general election authorized the Legislature to expand the program to allow counties to make this program available to seniors moving in from *another* county. The implementing legislation, Ch 1487/90 (AB 2035, Quackenbush), allowing for the program to apply to intercounty moves will sunset on January 1, 1999.

According to the County Supervisors Association of California, as of September 1990, 12 counties had adopted ordinances to participate in the intercounty transfer portion of this program. ◆

Fixtures Excluded From the Supplemental Roll

Estimated Revenue Loss
(dollars in millions)

Fiscal Year	*Amount*
1989-90	$16
1990-91	17
1991-92	18

Authorization

California Revenue and Taxation Code Section 75.5.

Description

This program exempts qualifying fixtures from supplemental property tax assessment. In order to qualify, the fixtures must be valued as a separate appraisal unit from the structure on the property. Fixtures are real property that originally had the character of personal property, such as equipment, but have been affixed to and incorporated into real (primarily business) property.

Increases in the assessed value of property due to a change of ownership or new construction are placed on the supplemental tax roll in the year in which the change of ownership occurs or the new construction is completed. Prior to the exemption, the assessed value of qualifying fixtures was also placed on the supplemental tax roll for the year in which it was installed. The property owner then received a supplemental tax bill for the tax on the additional assessed value prorated to reflect the remaining portion of the tax year. For the subsequent tax year, the supplemental assessment was added to the assessed value of the property on the regular tax roll, and a tax on this entire assessed value appeared on the regular annual property tax bill.

Under this program, qualifying new fixtures added to a property are exempt from supplemental assessment, so that they are not taxed until the fiscal year following the one in which they are installed. Fixtures that qualify for this program include manufacturing machinery or store fixtures, which are appraised separately from any building. The program does not include fixtures such as elevators or air conditioners which are appraised as part of a building.

Rationale

This program provides tax relief to businesses that add qualifying fixtures. It does so by eliminating any property tax on these fixtures during the remainder of the tax year in which they are installed. The program's rationale relates to considerations of administrative efficiency and cost-effectiveness. Counties argue that compiling information on fixture changes and determining the proper supplemental tax amounts on fixture additions and removals made throughout the year is administratively burdensome, and that the additional revenue does not justify the expense of assessing and collecting these taxes.

Comments

This program was added by Ch 261/87 (AB 297, Klehs). Previously, since 1984, for fixtures appraised separately from buildings, businesses were required to include in their annual property report to the county assessor the date on which each new fixture was added and the date on which any existing fixture was removed. The counties then were required to compute a supplemental tax bill based on the cost of fixtures added and removed, the date of each addition or removal, and the applicable tax rate. ❖

San Diego Supercomputer Center

Estimated Revenue Loss (dollars in millions)	
Fiscal Year	*Amount*
1989-90	$0.1
1990-91	0.1
1991-92	0.1

Authorization

California Revenue and Taxation Code Section 226.

Description

This program exempts from taxation all of the computer equipment of the San Diego Supercomputer Center, located on the campus of the University of California, San Diego. Although the computer center is owned by the university and is exempt from direct taxation under the general exemption for university property, it is leased to a private operator. This lease creates a possessory interest in the computer center, which would be taxable in the absence of this program.

Rationale

The program reduces the operating costs of the San Diego Supercomputer Center by eliminating annual property tax payments. The rationale for the program is that most of the funding for operating the center comes from the federal government and the university, and the center serves public policy objectives established by the National Science Foundation. Consequently, it is argued that the center serves a worthy public purpose, and exempting it from taxation reduces the level of federal and university funds that must be raised each year to support its operating costs.

Comment

This program was established by Chapter 1559, Statutes of 1988 (SB 2584, Ellis). ❖

Appendix

Appendix

Listing of Previous Tax Expenditure Program Recommendations Made by the Legislative Analyst

I. Individually Published Tax Expenditure Studies

An Analysis of California's Tax Credit for Solar-Powered Irrigation Pumping Systems (Report 85-15).
Recommendation: *Do not reinstate tax credit.*

Sales Tax Exemption for Operators of Waterborne Vessels (letter to Senator Walter W. Stiern, April 19, 1985).
Recommendation: *Allow exemption to expire.*

Personal Income/Bank and Corporation Tax Credits for Agricultural Irrigation Tax Credits (letter to Senator Walter W. Stiern, April 7, 1986).
Recommendation: *Utilize resources now devoted to tax credit for other programs more likely to be effective in promoting water conservation.*

"Personal Income Tax Credit for State Child Care Services" *(The 1989-90 Budget: Perspectives and Issues).*
Recommendation: *Consider options to improve targeting of credit, including (1) phase-out of credit above specified income levels, (2) making credit refundable, and (3) repeal of the credit.*

Review of the Bank and Corporation Tax Exemption for International Banking Facilities (white paper issued in response to Ch 1333/88 (SB 2289, Garamendi).
Recommendation: *Make exemption permanent.*

California's Low-Income Housing Tax Credit (policy brief in response to Ch 1347/89 (SB 726, L. Greene).
Recommendation: *Reorient program to improve effectiveness.*

Continued next page

Appendix—contd

Listing of Previous Tax Expenditure Program Recommendations Made by the Legislative Analyst

II. Program Recommendations Included in *Analysis of the 1987-88 Tax Expenditure Budget* (Report No. 87-1)

- Eliminate sales tax exemption for organic materials and waste by-products used as fuel (pages 22-28).
- Discontinue bank and corporation tax deductions and credits for contributions of computers, software and scientific equipment (pages 29-36).
- Do not re-enact personal income tax deduction for charitable contributions made by nonitemizing taxpayers (pages 37-43).
- Eliminate personal income tax deduction for nonmortgage interest (pages 44-49).

III. Program Recommendations Included in *Analysis of the 1988-89 Tax Expenditure Budget* (Report No. 88-20)

- Consider options to limit personal income tax deductions for mortgage interest, including (1) limiting total amount of deductions, (2) eliminating deductions for second homes, and (3) converting the deduction to a tax credit (pages 26-38).
- Do not re-enact 18-year depreciation period for residential rental property provided for corporate taxpayers (pages 39-48).
- Eliminate sales and use tax exemption for packing ice and dry ice used to pack and ship food for human consumption (pages 49-54).
- Regarding the in-lieu tax on racehorses, (1) "tighten up" eligibility requirements and (2) review the tax rate schedule itself (pages 55-62).
- Eliminate the partial property tax exemption for land under a wildlife habitat contract, and rely fully on an existing direct-expenditure program for preserving wetlands habitat in California (pages 63-70).
- Modify sales and use tax exemption for coins and gold or silver bullion (pages 71-76).

IV. Program Recommendations Included in *Analysis of the 1991-92 Budget Bill* (February 1991)

- Terminate special valuation provisions under the property tax for open-space lands (Williamson Act) (pages 1181-1183).

Major Subject Index

Major Subject Index

Partial Index of Tax Expenditures by Selected Major Subject Areas[a]

[a] *This index provides a partial listing of tax expenditure programs by selected major subject areas. It is intended to assist readers who are interested in finding a particular tax expenditure program or who are interested in tax expenditure programs associated with particular subject areas which may involve more than one type of tax. It is not, however, a comprehensive listing of all subject areas or tax expenditure programs within them.*