February 22, 2005

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the constitutional and statutory initiative relating to corporation taxes (CTs) and voting requirements regarding certain aspects of the CT law (File No. SA2005RF0029).

Background Information

Current Tax Law. California levies taxes on the income of both individuals and businesses through the personal income tax and CT. State law includes special tax provisions for certain business-related activities that result in lower tax liabilities than would otherwise occur. These special tax provisions include special tax rates, various deductions from income, and certain credits taken against taxes owed.

Current Voting Requirements. The State Constitution requires a vote of at least two-thirds of the members of each house of the Legislature for approval of measures—including those related to special tax provisions—that result in increased revenues through the levying of new, or changes to, existing taxes. In contrast, legislative actions that result in *reductions* in revenues from such taxes require a simple majority vote of the Legislature.

Provisions of the Initiative

The initiative defines CT preferences (which we hereafter refer to as "special corporation tax provisions") as certain tax laws adopted after January 1, 1985, including: (1) credits; (2) deductions that are not consistent with generally accepted accounting principles; (3) measures that result in special tax rates not available to corporation taxpayers generally; and (4) actions that extend special exemptions, exclusions, and elections to corporation taxpayers.

The initiative amends the Constitution and state statutes in the following manner with respect to such special CT provisions:

Voting Requirements. The measure amends the Constitution to provide that the Legislature could repeal or amend special CT provisions in a manner that resulted in increased revenue by the same vote as necessary for their approval. In other words, these tax provisions generally could be repealed with a majority vote rather than a two-thirds vote.

Reserve Requirement. The initiative directs that revenues resulting from the repeal or amendment of special CT provisions adopted after January 1, 1985, be deposited into the state's prudent reserve fund. These funds could only be appropriated during a state of emergency or in years in which current service levels of state expenditure programs exceeded revenues. (Current service levels would be based on program commitments as of June 30 of the previous fiscal year.)

Legislative Review Requirement. The measure establishes an annual legislative review requirement for all special CT provisions as part of the budget process. This review would: (1) assess the cost of the provision; (2) determine its public purpose; and (3) evaluate the provision's costs, benefits, and distributional impacts.

Sunset Provision. The measure establishes that any special CT provision adopted (or expanded) after January 1 of the year that the measure goes into effect would be repealed after five years unless reenacted for one or more subsequent five-year periods.

Fiscal Effects of the Initiative

The impact of the initiative would depend in part on definitions of special CT provisions. To the extent that this term is broadly interpreted, the fiscal impacts would be larger.

The measure would have the following fiscal effects on state government:

Voting Requirements and Reserve Fund. This measure, by decreasing the voting requirement for the elimination or limitation of special CT provisions, would make it easier in some situations to raise state revenues from these sources. Thus, the measure could result in higher revenues from CTs than would otherwise have occurred. The extent of any impact, however, would depend on a number of factors—such as the state's financial circumstances and the actions of future Legislatures. The CT generates about $9 billion annually, and has numerous components that could be considered special CT provisions under the terms of the initiative. The repeal or limitation of even a few selected provisions could result in significant revenue impacts.

The additional revenues received by the state from the elimination or limitation of special CT provisions would be deposited in the state's reserve fund. These additional revenues could then be used to: (1) fund current service levels (such as in low-revenue-growth years), (2) increase the reserve level, and/or (3) provide funds for a state of emergency declared by the Governor.

Legislative Review. The annual review of each special CT provision would result in some additional state administrative costs.

Summary

This measure would have the following major fiscal effects:

- Potentially significant state revenue increases resulting from reducing the legislative vote requirement necessary to eliminate or limit certain special corporation tax provisions. Any increases would go into a state reserve fund, where they could only be used to fund current service levels or in response to a state of emergency. Fiscal impacts would depend on the actions of future Legislatures.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance