

February 24, 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 9003, we have reviewed the constitutional and statutory initiative relating to (1) various changes in the state's existing corporation tax (CT), personal income tax (PIT), insurance gross premiums tax, and local property tax, and (2) the imposition of a oil severance tax (File No. SA2005RF0033).

Background Information

Corporation Tax. The state levies a corporation tax (CT) on net earnings of businesses operating within California. For California corporations, net income is taxed at the rate of 8.84 percent. For corporations operating both inside and outside of California, tax liability is determined by apportioning corporation income based on its *California* activities as a percentage of *all* of its activities and taxing this result at the 8.84 percent rate.

Corporation income is apportioned according to the following: (1) the corporation's property, payroll and sales factors in California are each computed as a percentage of property, payroll and sales everywhere, (2) the average of these factors is computed, with the sales factor used twice (except for farming, financial, and extractive industries), and (3) this average is multiplied by total corporation income to reach California income.

In addition, the CT has the following pertinent features:

- Corporations are generally allowed to elect whether their earnings are based on total income ("worldwide") or income received only in the United States and certain other territories ("water's edge").
- Corporations with a limited number of shareholders may qualify as a Subchapter S corporation, and be taxed at lower CT rate of 1.5 percent.

Generally, Subchapter S corporation earnings are passed through to shareholders and subject to the personal income tax (PIT)

- For all corporations, certain deductions from income and credits against the tax are allowable. Some industries receive preferential treatment through such tax programs. Corporations that benefit from a substantial amount of preferential treatment may be subject to an alternative minimum tax (AMT) which is current levied at the flat rate of 6.65 percent.

Property Tax. The California Constitution limits the property tax levy on real property to 1 percent of assessed value as determined by the acquisition cost of the property. Except for an up-to-2 percent increase each year, the assessed value of real property changes only when it is sold or transferred. As a result of this acquisition-based system, properties and property types that change hands less frequently will generally have lower assessed value and have lower taxes than properties that change ownership more frequently.

The California Constitution specifies that property taxes shall be collected by counties and allocated to local agencies (cities, counties, special districts and K-14 school and community college districts) within the counties. Local property tax revenues are distributed to these agencies pursuant to formulas specified in state law. Currently, about 40 percent of property taxes are allocated to K-14 school and community college districts and the remainder is allocated cities, counties, and special districts.

Property taxes allocated to K-14 districts offset state education General Fund spending obligations on a dollar for dollar basis. Local property tax revenues allocated to school districts and community colleges count toward the Proposition 98 minimum funding guarantee. Increases in local property tax revenues reduce the General Fund obligations to meet the Proposition 98 minimum guarantee.

Oil Severance Tax. In most states, businesses in extractive industries—such as mining and oil drilling—are taxed on the basis the quantity or value of raw material extracted from the ground. California does not currently levy a severance tax.

Insurance Gross Premiums Tax. In lieu of paying the CT, insurance companies operating in California pay a tax equal to 2.35 percent of gross premiums collected.

Sales and Use Tax. The sales and use tax (SUT) is levied on the final purchase of most tangible personal property purchased or used within the state. The state General Fund rate is 5 percent.

Provisions of the Initiative

Corporation Tax

The initiative would result in the following fundamental changes to the CT:

Tax Rates. The measure would increase the rate on earnings apportioned to California from the existing 8.84 percent to 9.3 percent beginning with the 2006 tax year. The AMT rate would also be increased from 6.65 percent to 7 percent.

Apportionment Formula. The measure would eliminate the “double-weighting” of the sales factor beginning with the 2006 tax year. Thus, the apportionment factor applied to worldwide or water’s edge income would be the average of the three ratios—property, payroll, and sales—only.

Subchapter S Corporation. The measure would change the tax rate applied to subchapter S corporations from a single rate to multiple rates based on income. Income of \$100,000 and below would be taxed at the rate of 1.5 percent; income between \$100,000 and \$1 million would be taxed at the rate of 2 percent; income in excess of \$1 million would be taxed at 2.5 percent.

Inverted Corporations. Inverted corporations are formerly U.S. based multinational companies with foreign income, which have reincorporated and relocated their domiciles abroad. The “inversion” is accomplished by having shareholders exchange their shares of the U.S. company for the shares of a foreign corporation. The foreign corporation then owns the shares of the U.S. company. This inversion allows certain income earned by water’s edge corporations that would otherwise be taxed, to escape taxation. The measure would require that income from an inverted domestic corporation be included in corporations with water’s edge reporting.

Intangible Drilling Costs. California conforms to federal law in allowing intangible costs associated with oil, gas, and geothermal drilling to be “expensed” or deducted immediately, for tax purposes. Ordinarily, such costs would be amortized over several years. This treatment results in a lower tax liability than would otherwise occur. The measure would eliminate the expensing allowance under the CT as well as the PIT for this industry beginning in tax year 2006.

Credit Limitation. The use of carry forward credits (in combination with credits available from the current year) would be restricted to an amount not to exceed 50 percent of the before credit tax liability.

Property Tax.

The measure would result in annually reassessing all property used for commercial activities (except commercial agricultural property and residential commercial property) at fair market value. The assessed value of residential property—including single family dwelling and apartments—would not be affected by the measure.

Oil Severance Tax

The measure would impose a tax of 3 percent of the gross value of oil that is mined, produced, or withdrawn in the state. Only producers which have production in excess of 30,000 barrels per month would be affected by the measure.

Insurance Gross Premiums Tax

The measure would increase the premiums tax rate from 2.35 percent to 2.46 percent beginning in 2006.

Economic Recovery Tax Relief Fund

The measure would result in increased *state* revenues from changes to the existing insurance tax, CT and PIT, and by imposing a new severance tax (partially offset by increased deductions from corporate income). The measure would also increase *local* revenues by requiring that commercial property be assessed at full market value. The measure would require that any revenue increases resulting from tax law changes imposed by the measure be offset by commensurate decreases in the SUT, as described below

The measure specifies that the Department of Finance annually shall calculate the amount of additional tax revenues raised by this measure and that revenues equal to this amount are to be deposited into a new state Economic Recovery Tax Relief Fund (ERTRF). Because the measure does not change the underlying constitutional requirement that property taxes be allocated by counties to local agencies within the counties, it is not evident whether any of the new property tax revenues associated with this measure would be available for meeting the ERTRF funding obligation.

At the conclusion of each fiscal year, the Department of Finance would estimate the amount of revenue generated by a 0.25 percent SUT over the succeeding year. To the extent that revenues in the ERTRF equal or exceed the amount that would be generated by the 0.25 percent SUT, the SUT would be reduced by 0.25 percent. To the extent that revenues in the ERTRF warrant multiple reductions in the SUT, these reductions would occur in 0.25 percent increments.

Fiscal Effects of the Initiative

This measure would increase revenues from various state taxes by about \$1.7 billion and increase local property tax revenues by \$2.1 billion. These increases would be fully offset by commensurate reductions in the state sales tax rate. Thus the measure would not result in a net increase in combined state and local revenues. However, the revenue effect of these tax changes on state and local governments could vary substantially, depending on whether local property taxes could be deposited into the ERTRF.

Revenue Impacts

The measure would result in additional state and local revenues of approximately \$3.8 billion. Revenues equal to this would be deposited into the ERTRF and used to compensate the General Fund for the reduction in SUT revenues. A portion of this ERTRF funding requirement would be met by the \$1.7 billion increase in state revenues. However, because the measure does not change the underlying constitutional requirement that property taxes be allocated by counties to local agencies, it is not clear whether any property tax revenues would be available for use by the state for this purpose.

Assuming any increased revenues from the property tax remain local, local district revenues would increase by \$2.1 billion. The state would absorb increased spending of \$2.1 billion to fund this portion of the ERTRF. These increased state costs would be offset somewhat by decreased state education funding obligations (of about \$800 million) under Proposition 98, resulting in a net fiscal impact on the state of approximately \$1.3 billion.

Tax Incidence

There would be significant differences in the type of taxpayer experiencing increased taxes and those benefiting from reduced taxes. Taxes would increase on businesses paying the property tax, insurance tax, the CT and the PIT. Tax decreases would be experienced by businesses and households paying the SUT (about two-thirds of the SUT is paid by households).

K-14 Education Funding

Depending on how the measure's provisions regarding property taxes are interpreted, this measure could result in the state depositing more funds into the ERTRF than it receives in increased revenues. To the extent this occurs, the amount of state revenues used to calculate the state's K-14 spending obligations (under one of its three "tests") could be reduced. This, in turn, could result in a reduction in the minimum funding level of K-14 education.

Administrative Costs

State Costs. The state would incur minor costs in adapting the existing CT to the changes required by the measure. Additional start-up costs would be required for imposing a new severance tax on oil producers. Initial costs are likely to be less than \$1 million, with ongoing administrative costs a fraction of that.

Local Governments. Reassessing commercial property at full market value on an annual basis would impose additional costs on counties. The cost of additional staff required to make such assessments is likely to be in the low tens of millions.

Summary of Fiscal Effects

This measure would have the following fiscal effects:

- Potential increase in local government revenues of about \$1.3 billion coupled with increased state spending obligations of the same amount.
- Increased property tax and income tax payments by businesses and sales tax reductions for individuals and businesses

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance