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60 YEARS OF SERVICE

February 25, 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 statutory initiative relating to state taxation (File No. SA2005RF0042).

BACKGROUND ON STATE TAXES

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, or "double-weighted" (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 a 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).
- Corporations are allowed certain deductions from income as well as credits against tax liabilities. 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 currently levied at the flat rate of 6.65 percent.

Other Taxes

Oil Severance Tax. Most states that tax businesses in extractive industries—such as mining and oil drilling—do so on the basis of 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.

PROVISIONS OF THE INITIATIVE

Corporation Tax

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

- ***Tax Rates.*** The measure increases 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 is also increased from 6.65 percent to 7 percent.
- ***Apportionment Formula.*** The measure eliminates 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 changes 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 still 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 that have reincorporated and relocated their domiciles abroad. The so-called "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 requires that income from an inverted domestic corporation be included for 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"—that is, immediately deducted—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 eliminates 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 a company's before credit tax liability.

Other Taxes

Oil Severance Tax. The measure imposes 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 increases the premiums tax rate from 2.35 percent to 2.46 percent beginning in 2006.

Deposit of Funds

Revenues raised by the initiative would flow into the state's General Fund. At the conclusion of each fiscal year, beginning 2005-06, the Department of Finance would estimate the amount of revenues generated from adoption of the measure. These revenues would be deposited in the existing Transportation Investment Fund, which funds maintenance and expansion of transportation systems in the state. The measure includes intent language to neither increase nor decrease funding for schools governed by Proposition 98.

Fiscal Effects of the Initiative

Revenue Impacts

The measure would increase revenues as a result of changes to the insurance tax, CT, and PIT, and by imposing a new oil severance tax. Changes to the CT would result in additional revenues of about $1.3 billion, with the largest annual increases stemming from raising the CT rate ($360 million), raising the tax rate on Subchapter S corporations

($350 million), and restricting the ability to claim tax credits ($400 million). Revenue increases from raising the tax rate on insurers would result in additional annual revenues of about $100 million. The oil severance tax would result in new revenues of about $275 million. In total, the measure would generate about $1.7 billion in additional revenues in 2006-07 and increasing amounts thereafter.

Administrative 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 in the range of $1 million, with ongoing administrative costs a fraction of that amount.

Summary of Fiscal Effects

The measure would have the following major fiscal effect:

- Increased state revenues from higher business taxes of approximately $1.7 billion annually, with the proceeds used for transportation purposes.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance