December 28, 2011

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Dawn McFarland
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed a proposed statutory initiative related to state corporate taxes and energy efficiency (A.G. File No. 11-0080).

Background

Corporate Tax Structure. For tax purposes, firms in the United States report their profits at the national level and not on a state level. Thus, states have devised a process known as "apportionment" to determine what fraction of a multistate firm's profits they can tax. This term implies that the states in which a firm operates divide the firm's profits up such that the sum of the taxable profits claimed by each state is equal to the firm's total profits. However, the reality is that each state in which the firm operates performs its own calculation using its own method. Taxable profits at the state level have historically been based on the firm's property, payroll, and/or sales that occurred in that state. States set their own relative weights on these three factors. A firm that operates in states that use different formulas may find that the sum of its taxable profits for those states in which it operates is higher or lower than its overall national profits. In response to differing state formulas, firms have an incentive to use tax planning to minimize their overall state tax bills.

Currently, California uses an apportionment formula that includes a "double-weighted" sales factor. That is, the weights on both property and payroll are 0.25, but the weight on sales is 0.5. The initial rationale for setting the weight on sales higher than the weights on property and payroll was to induce mobile firms that can produce in one state but sell into others (typically manufacturers) to locate facilities and employees in the state. However, as of 2011 firms have the option to choose between the double-weighted sales formula and a new formula that uses only the sales factor (the "single sales factor"), ignoring the property and payroll factors. (Banks and agricultural or resource extraction firms [such as oil and gas] do not have this option and are required to use a three-factor formula that is equally weighted.) Firms have an option each year as to which of the two formulas they want to use. (Accordingly, this policy is known as the "optional single sales factor.")

Proposition 98 Minimum Guarantee. In 1988, voters approved Proposition 98. Including later amendments, Proposition 98 establishes a guaranteed minimum annual amount of state and local funding for K-14 schools. Generally, Proposition 98 provides K-14 schools with revenues (including those collected from state corporate taxes) that grow each year with the economy and the number of students. Funding is provided through a combination of state General Fund appropriations and local property tax revenues. Proposition 98 expenditures are the largest category of spending in the state's budget—totaling roughly 40 percent of state General Fund expenditures. With a two-thirds vote, the Legislature can suspend the Proposition 98 guarantee for one year and provide any level of funding it chooses.

Energy Efficiency Programs. Since the 1970s, California has sought to reduce statewide energy consumption in order to curtail the need to build new energy infrastructure (such as power plants and transmission lines) and to meet environmental quality standards. Current state law prioritizes the implementation of cost-effective energy efficiency before all other resources for meeting the state's energy needs. For example, the state implements energy efficiency standards and programs that focus on reducing energy use while maintaining a comparable level of service. The California Public Utilities Commission (CPUC) on a triennial basis conducts a cost-benefit analysis to determine the level of funding that the state's investor-owned utilities should invest in energy efficiency programs.

California energy ratepayers, taxpayers, and consumers spend a significant amount each year on state-directed energy efficiency efforts. For example, energy ratepayers alone spend over $1 billion annually on such efforts. Some of the funded efforts include building design and appliance standards, as well as state-mandated utility energy efficiency upgrade programs (such as lighting; heating, ventilation, and air-conditioning [HVAC]; insulation programs; and appliance rebate programs). These energy efficiency efforts are administered through multiple entities, such as the CPUC and the California Energy Commission (CEC), local governments, and utility companies.

Proposal

Establishes Mandatory Single Sales Factor. This measure eliminates the current optional single sales factor in January 2013 and replaces it with a mandatory single sales factor tax policy for multistate firms. This change, however, would not apply to agricultural, extraction, and financial firms, which would remain on the equally weighted three-factor formula.

Requires Market Share Formula for Sales of Intangible Goods. Current state law allows firms that choose to use the three-factor apportionment formula to attribute all sales of intangible goods (such as trademarks, customer lists, and digital files) to the state with the largest share of these sales. For example, a firm with 20 percent of its intangible sales in California would have zero in-state sales for tax purposes as long it has more than 20 percent of its sales in at least one other single state. This measure eliminates this provision and requires all firms to attribute their actual intangible sales to California for tax purposes, as firms that use the single sales factor already do.

Establishes Clean Energy Job Creation Fund. This measure establishes a new special fund, the Clean Energy Job Creation Fund, to support projects intended to improve energy efficiency and expand the use of alternative energy. Specifically, the measure states that the fund could be used to support (1) energy efficiency retrofits and alternative energy installations in public schools, colleges, universities, and other public facilities; (2) local governments in establishing and financing energy retrofit financial assistance programs; and (3) job training and workforce development programs such as the California Conservation Corps and Certified Community Conservation Corps. The measure also specifies that all funded projects must be coordinated with CEC and CPUC and that up to 4 percent of the fund could be used for administrative costs.

Under the terms of the measure, up to $550 million would be transferred each year from 2013-14 through 2017-18 from the state General Fund, the main state fund used to support state programs, to the Clean Energy Job Creation Fund. The actual amount of the annual transfer would be dependent on the estimated increase in revenues resulting from the mandatory single sales factor authorized in this measure—as determined by the Department of Finance (DOF) and the Legislative Analyst's Office (LAO). Specifically, the measure states that if it is estimated that the increase in revenues is less than $1.1 billion in a given year, then the amount transferred from the General Fund to the Clean Energy Job Creation Fund is one-half of the estimated increase in revenues for that year. Otherwise, the transfer for the specified years shall be $550 million. Monies in the fund would be subject to legislative appropriation.

Provides for Program Oversight. According to the measure, existing government agencies (such as CEC) would select and oversee the specific projects funded by the Clean Energy Job Creation Fund. In addition, the measure creates a new Citizens Oversight Board to annually review all expenditures from the fund and submit an annual evaluation of the program to the Legislature. This board would consist of nine members appointed by the State Treasurer, the State Controller, and the Attorney General.

Fiscal Effects

Increase in State General Fund Revenues. The Franchise Tax Board has estimated that a change from the current optional single sales factor formula to a mandatory single sales factor formula and other provisions of the bill would increase revenues to the state General Fund by approximately $1 billion annually. As corporate tax revenues tend to be volatile, the amounts generated by this change could vary significantly from year to year. In addition, since the proposed tax change would take effect January 1, 2013 as specified in the measure, General Fund revenues would likely increase by roughly $500 million in 2012-13 (roughly half a year's worth of revenue from April and June 2013 estimated payments) and by approximately $1 billion annually thereafter under existing budgetary accrual policies.

Increase of Proposition 98 Minimum Guarantee. The measure would increase the amount of General Fund revenues used for calculating the Proposition 98 minimum guarantee by roughly $500 million each year from 2012-13 through 2017-18. For 2012-13, there would be no transfer from the General Fund to the Clean Energy Fund so all the revenues would count toward the guarantee. For 2013-14 through 2017-18, revenues deposited directly in the Clean Energy Job Creation Fund would be excluded from the Proposition 98 calculation. As a result, the measure would increase the Proposition 98 minimum guarantee by roughly $225 million annually through 2017-18. Beginning in 2018-19, all of the additional state revenues resulting from this measure would be deposited into the General Fund and included in the Proposition 98 calculation. This would result in a minimum guarantee that is roughly $500 million higher than it otherwise would be.

General Fund Transfers to the Clean Energy Job Creation Fund. As previously discussed, the measure requires DOF and LAO to determine the amount of revenue to be transferred from the General Fund to the Clean Energy Job Creation Fund. For example, under the measure, the General Fund transfer in 2013-14 would be based on tax year 2013 collections. However, final liability for tax year 2013 is not likely to be publicly available until 2016. The measure does not contain an after-the-fact settle-up mechanism that would allow the fund to be "trued up" once all revenue data has been received. However, the measure appears to allow DOF and LAO to wait to determine the transfer amount for a given fiscal year until May or June of that year, by which time revenue collections from final (but not extended) returns will be known. While revenues for a given tax year could still be subject to change, the magnitude of this change is likely to be small.

Summary of Fiscal Effects. We estimate that this measure would have the following major fiscal effects:

- Approximately $500 million in additional state General Fund revenues in 2012-13 and $1 billion each year thereafter from requiring a single sales factor formula for corporate taxes, with about half of the additional annual revenues from 2013-14 through 2017-18 supporting energy efficiency and alternative energy projects.
- Increased Proposition 98 minimum funding guarantee for K-14 schools of roughly $225 million annually from 2012-13 through 2017-18 and by roughly $500 million each year thereafter, as a result of additional state General Fund revenues.

Sincerely,

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Mac Taylor
Legislative Analyst

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Ana J. Matosantos
Director of Finance