LAO
65 YEARS OF SERVICE

September 29, 2010

Overview of Proposition 24

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Joint Hearing of Senate and Assembly Committees
On Revenue and Taxation

Overview

☑ Three provisions of California's laws for taxing businesses changed recently as part of 2008 and 2009 state budget agreements between the Legislature and the Governor. The three provisions are those dealing with:

- The use of operating losses.
- The taxation of the income of multistate businesses.
- Tax credit sharing.

☑ Under *current law*, all of these recent changes will be in effect by the 2011 tax year.

☑ Proposition 24 would repeal business tax law changes passed in 2008 and 2009 in the three areas listed above. In general, this would return business taxes to what they were under *prior law*.

LAO
65 YEARS OF SERVICE

Changes to the Use of Operating Losses

Prior Law	Current Law	Law if Proposition 24 Passes
Carrybacks. Business losses cannot be used to get refunds of taxes previously paid.	*Carrybacks.* Business losses can be used to get refunds of taxes paid in the prior two years.	Same as prior law.
Carryforwards. Businesses can use losses to offset income in the ten years following the loss.	*Carryforwards.* Businesses can use losses to offset income in the 20 years following the loss.	Same as prior law.

- ☑ Under federal and state tax laws, in a year when a business has more deductible expenses than income, the business has a net operating loss (NOL).
- ☑ Under current state law, a business with an NOL in one year generally can *"carry forward"* the losses to reduce its taxes when it makes a profit in the 20 years following the loss.
- ☑ Under current state law, a business with an NOL in one year generally will be able to *"carry back"* the losses to reduce its taxes for the two *previous* years, if those years were profitable.
- ☑ These mechanisms have been put in place in part to recognize that business income or expenses can vary significantly from year to year.
- ☑ Example: a business that had profits and paid taxes in 2009 but has a loss in 2011 may deduct its 2011 NOL against its 2009 taxable income under current law. The business would file an amended tax return for 2009 and receive a tax refund.
- ☑ If Proposition 24 passes, carryback and carryforward provisions would return to what they were under prior law.

LAO
65 YEARS OF SERVICE

Changes to Taxation of the Income of Multistate Businesses

Prior Law	Current Law	Law if Proposition 24 Passes
A single formula determines the level of a multistate business' income that California taxes based on the business' sales, property, and payroll in California.	Most multistate businesses will choose every year between two options to determine the level of income that California can tax: (1) the formula under prior law, or (2) a formula that considers only the business' sales in California relative to its national sales.	Same as prior law.

- ☑ Businesses often operate in many states. To determine how much of the income of a multistate business is taxed by the state, California law has used a "three-factor" formula that considers how concentrated a business' property, payroll, and sales are in California compared to the rest of the nation.

- ☑ Starting in 2011 under current law, most multistate businesses will be able to choose *each year* between two formulas to set the level of income California can tax. A business' two options will be:
  - The three-factor formula.
  - The new "single sales factor" formula, which is based only on the portion of the business' overall national sales that are in California.

- ☑ If Proposition 24 passes, taxation of the income of multistate businesses would continue to be based on the three-factor formula.

LAO
65 YEARS OF SERVICE

Changes to Rules for Tax Credit Sharing

Prior Law	Current Law	Law if Proposition 24 Passes
Tax credits given to a business entity can only reduce that entity's taxes. That entity cannot share its tax credits with entities in the same group of businesses.	Tax credits given to a business entity can be used to reduce the taxes of other entities in the same group of related businesses.	Same as prior law.

- ☑ Tax credits can reduce a business' taxes. If a business has credits which exceed the amount of taxes it owes in a given year, it will have unused credits that typically can be carried forward to be used in future years.

- ☑ Many business organizations consist of a group of business entities. This is called a "unitary group" if it meets certain conditions, such as operating jointly or operating under the same management.

- ☑ Tax credits are given to individual business entities—not unitary groups.

- ☑ A law approved by the Legislature and the Governor in 2008 allows a business with available tax credits to transfer unused tax credits to another business in the same unitary group. Shared credits can be used to reduce taxes in 2010 and later years.

- ☑ If Proposition 24 passes, tax credits would not be able to be transferred to other businesses within a unitary group.

LAO
65 YEARS OF SERVICE

Summary of Proposition 24's Effects

- If Proposition 24 passes, the three business tax provisions discussed in this handout will return to what they were before 2008 and 2009 law changes. As a result:
  - A business will be less able to deduct losses in one year against income in other years.
  - A multistate business will have its California income determined by a calculation using three factors.
  - A business will not be able to share tax credits with related businesses.
- If Proposition 24 does not pass, the three business tax provisions that were recently changed will not be affected.

LAO
65 YEARS OF SERVICE

Increased State Revenues

- This proposition would increase state General Fund revenues by increasing the taxes paid by businesses.
- By 2012-13, state revenues would increase by an estimated $1.3 billion annually. There would be smaller increases as the provisions of Proposition 24 are phased in during 2010-11 and 2011-12.
- More than one-half of these estimated increased taxes would be paid by multistate businesses as a result of the elimination of the single sales factor option.
- Under the formulas of Proposition 98, a significant part of Proposition 24's revenue increases would be allocated to schools and community colleges.