LAO
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March 12, 2014

Hon. Mark Leno, Chair
Senate Budget and Fiscal Review Committee
Room 5100, State Capitol
Sacramento, California 95814

Dear Senator Leno:

At the Committee on Budget and Fiscal Review's January 23 hearing, you asked our office to provide the committee with information concerning long-term trends for California's corporation tax (CT). This letter responds to that request.

CT Is a Small Part of California Businesses' Tax Payments. The discussion at the January 23 hearing concerned the CT specifically, as does most of the rest of this letter. To put the CT in context, we note that these tax payments represent a small portion of the overall tax burden borne by California businesses. According to a study of 2011-12 business taxes by the Council on State Taxation—a trade association of multistate corporations—corporate income taxes made up only about 10 percent of the entire amount of state and local taxes paid by California businesses. The two largest taxes paid by businesses—property taxes and sales taxes—were each much larger than the total amount of state corporate income taxes.

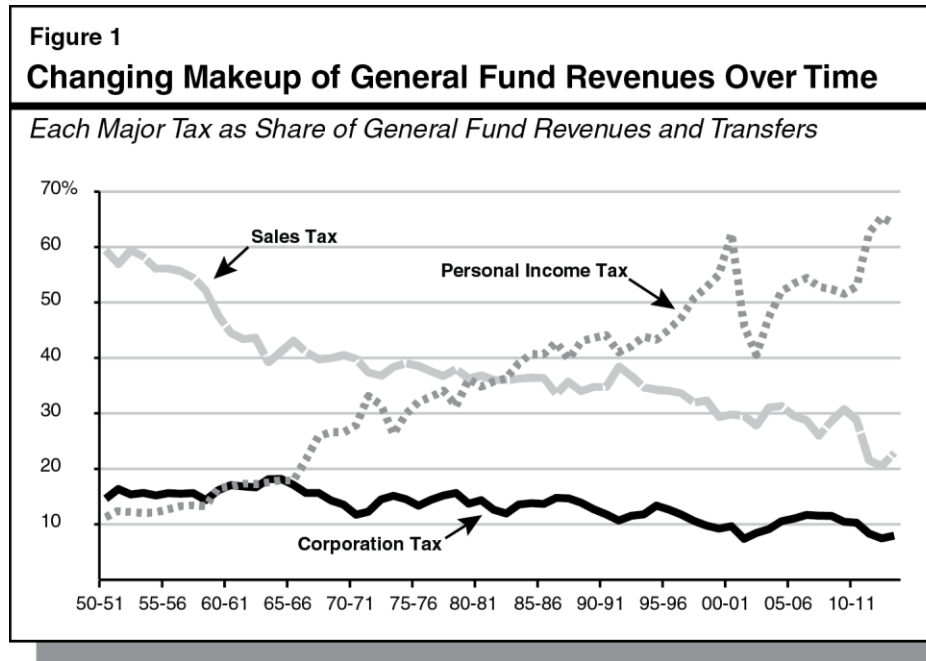
Corporation Tax as Percent of State Revenues

The discussion at the hearing focused largely on the trend, over time, in the share of state revenues that come from the CT.

Compared to Other States, Above Average Share of California's Revenues. Census data shows that in 2012, 7.1 percent of California's overall state tax revenues came from corporate income taxes. (This Census dataset considers both General Fund and some other state funds' revenues.) This is an above-average share of state tax revenues derived from corporate income taxes. Specifically, the average share among the 50 states was 5.1 percent of tax revenues. Among the 47 states with corporate income tax revenues, the average share was 5.6 percent. The Census data indicates that six states received a greater share of their tax revenues from corporate income taxes: New Hampshire (23.6 percent), Tennessee (10.2 percent), Illinois (9.6 percent), Alaska (9.4 percent), Massachusetts (8.8 percent), and Delaware (7.8 percent).

CT as Share of General Fund Revenues Has Declined Over Time. Figure 1 shows the percentage of General Fund revenues from CT, the personal income tax (PIT), and the sales and use tax (SUT)—now sometimes called the state's "Big Three" taxes—since 1950-51. The CT has declined as a percentage of General Fund revenues over the last six decades. Specifically, the CT's average share of annual General Fund revenues in each decade was 16 percent in the

1950s, 16 percent in the 1960s, 14 percent in the 1970s, 14 percent in the 1980s, 11 percent in the 1990s, 10 percent in the 2000s, and an estimated 9 percent for the period of 2010-11 through 2013-14.

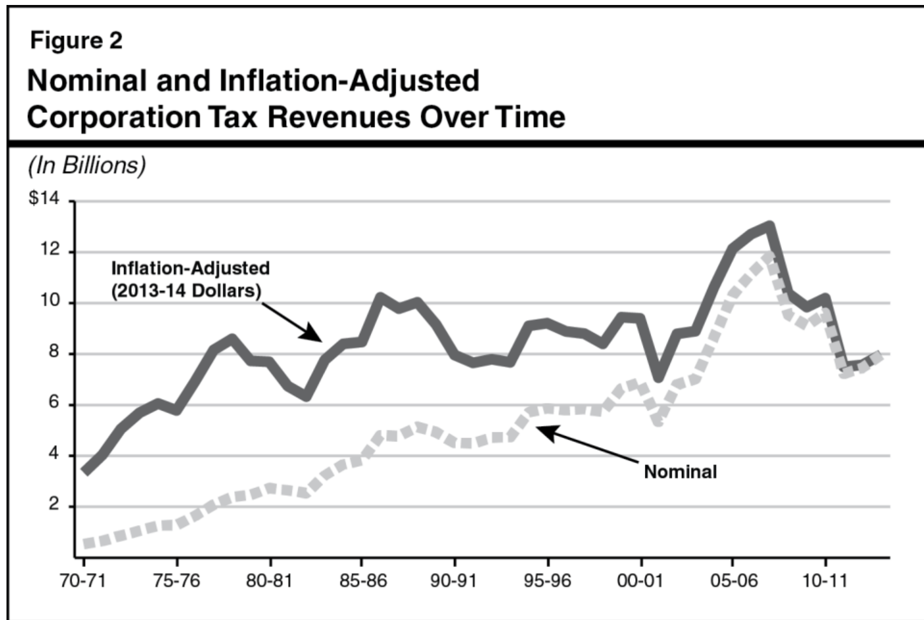


PIT's Share of the General Fund Has Expanded Dramatically. The most telling feature of Figure 1, however, is the dramatic increase over time in the proportion of General Fund revenues provided by PIT. Over that period, PIT has replaced SUT as the General Fund's primary revenue source, with PIT climbing from 11 percent of General Fund revenues in 1950-51 to about two-thirds today. The growth of PIT's share of the General Fund has contributed substantially to the decline of the CT's share of the General Fund. For this reason, the CT's share of General Fund revenues alone is not a good indicator of the robustness of California's corporate tax as a state revenue source over time. Accordingly, we provide additional measures of the CT's robustness below.

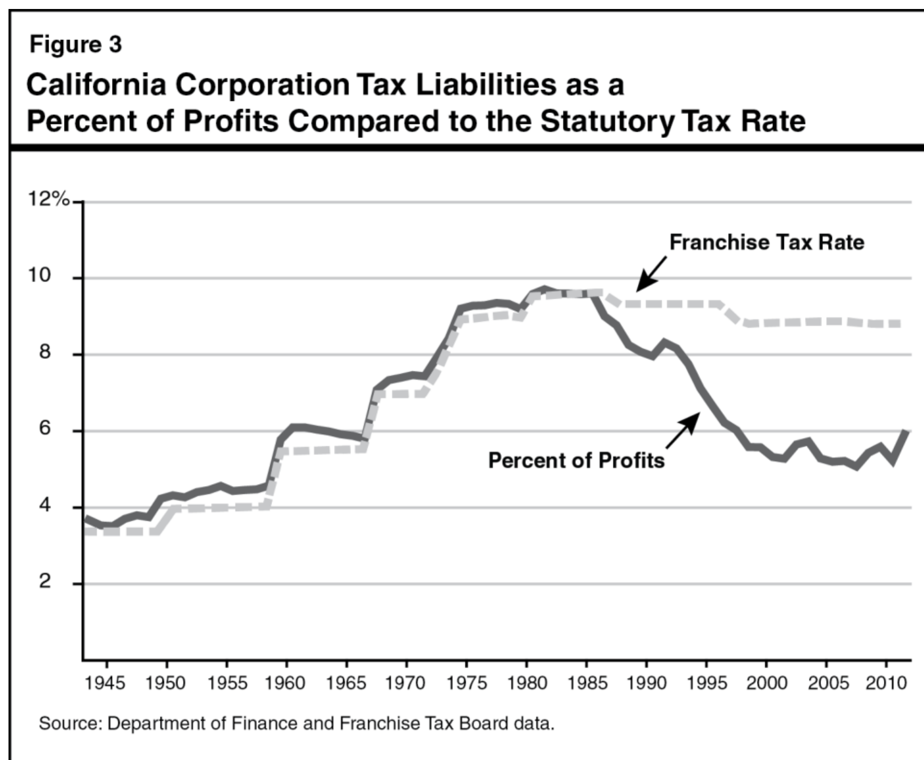
Changes in CT Collection Trends Over Time

CT Revenues Estimated at $8 Billion for 2013-14. The *2014-15 Governor's Budget* projects that nominal CT revenues will total $8 billion in 2013-14 (8 percent of General Fund revenues), rising thereafter. (For example, in 2017-18, the administration projects $9.8 billion of nominal CT revenues, which would still be 8 percent of General Fund revenues under the projections.)

Figure 2 displays the trend of CT collections from 1970-71 through 2013-14—both in inflation-adjusted and non-inflation-adjusted (nominal) terms. In nominal terms, the CT—while volatile—has tended over the long term to grow in most years, but revenues spiked during the mid-2000s (during the "housing bubble") and fell during the most recent recession and in some years thereafter for a variety of reasons, some of which are discussed later in this letter. In inflation-adjusted terms, the state's CT revenues have tended to be between $8 billion and $10 billion per year (in 2013-14 inflation-adjusted dollars) since the mid-1980s. As such, in 2013-14, the projected level of CT is at the low end of this long-term range.



Prior to 1985, More Reliable CT Collections. On page 174 of the *2014-15 Governor's Budget Summary*, the administration observed that from 1943 through 1985, CT revenues as a percentage of reported California corporate profits closely tracked increases in statutory CT (franchise tax) rates. Figure 3 illustrates this trend.



After 1985, Changes in the Long-Term Trend. Figure 3 shows, however, that this reliable pattern ended soon after 1985. Thereafter, California's CT liabilities, as a percent of corporate profits, began to lag the statutory rates by notable margins.

A similar story is shown in Figure 4, which compares California's CT collections over time to the state's personal income. Personal income in the state grows in line with the state's economy (including wage and price growth) and increases in population. Therefore, comparing a tax's collection trend to personal income provides a good metric to check whether the tax is keeping pace with the growth of the state's economy. (For example, a CT that grew exactly with the economy would be reflected by a flat line in Figure 4.) By this measure, CT revenues grew faster than the economy from the 1950s through the mid-1980s, although the rate increases displayed in Figure 2 were a contributor to this trend. Specifically, CT grew from 0.4 percent of personal income in 1952-53 to about 1 percent of personal income—its all-time peak—in the late 1970s. After dropping during the early 1980s recession, CT climbed again to 1 percent of personal income in 1986-87. Since then, the trend for CT collections by this measure, while volatile from year to year, generally has been one of decline. The most notable exception to this declining trend was a period of robust growth in the mid-2000s during the housing boom. Recently, CT collections have fallen to about 0.4 percent of personal income—about the level recorded in the 1950s.

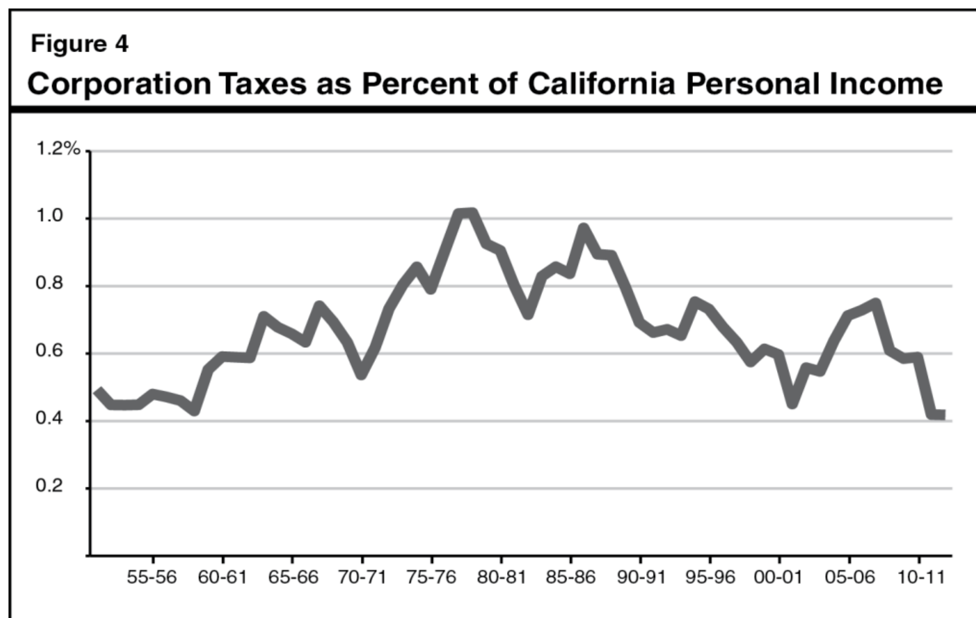


Figure 4
Corporation Taxes as Percent of California Personal Income

What Has Happened Since the 1980s?

A Variety of CT Changes in the 1980s and 1990s. Some of the major changes in California's CT in the mid-to-late 1980s and 1990s included:

- ***"Water's-Edge" Elections.*** Prior to the late 1980s, California's CT considered total worldwide net income for all corporations. Chapter 660, Statutes of 1985 (SB 85, Alquist), allowed corporations to elect between reporting income on the worldwide combined reporting basis or, alternatively, the new water's-edge basis.

The water's-edge method generally considers income only from the corporation's U.S. operations, apportioning this income to California based on statutory formulas. Given that water's-edge is elective (generally for a seven-year period in current law), many corporations choose this method when it reduces their tax liability. Of the top 100 CT payers, 40 percent elected to use the water's-edge method in 2012. The tax revenue reduction due to water's-edge elections is now estimated to be about $1 billion per year.

- ***Net Operating Loss (NOL) Deductions.*** In a year when a business has more deductible expenses than income, the business has a NOL. Starting in 1987, California allowed corporations to subtract a portion of NOLs generated in the previous five years from their state-reported profits before calculating their taxes. The portion of NOLs that could be deducted and the time periods over which they may be claimed have been changed subsequently in state law. Federal and state NOL deductions—and the ability to use them to offset taxable income in other years—have been put in place to recognize that business income and/or expenses can vary significantly from year to year. (In recent years, the state has made a number of changes in its NOL policies, which are summarized later in this letter.)
- ***Recognition of Subchapter S Corporations.*** Starting in 1987, California recognized "subchapter S corporations" (S-corporations). Now, over 400,000 S-corporations file California tax returns. Several changes in the federal Tax Reform Act of 1986 helped spur rapid growth in the number of S-corporations. Shifts of businesses from "general corporations" to S-corporation status after 1987 appear to have been one of the factors reducing the ratio of CT liability to corporate profits (shown in Figure 3). This is because non-financial S-corporations, for example, are taxed through the state CT at a rate of 1.5 percent, rather than the 8.84 percent for non-financial general corporations. Since S-corporation income is passed through to shareholders—who owe PIT on the income—the resulting reduction in CT revenue is mostly offset by an increase in PIT revenue. Accordingly, a small part of the PIT growth that has reduced the CT's share of the General Fund over time is attributable to the growth of S-corporations. The most recent rough estimate by state tax officials is that California's S-corporation tax treatment reduces CT revenues by $485 million in 2013-14, which is largely offset by a related PIT net revenue gain of $260 million.
- ***Much More Usage of State Tax Credits.*** In 1988, California corporations claimed $64 million of tax credits. This grew to over $900 million by 2001 and around $2.5 billion in 2011. In 2012, tax credit use declined to $1.6 billion, based on preliminary tax agency data. (One likely reason for this decline was that large companies once again were able to use NOL deductions in 2012 after that ability had been suspended for several years by the state.) Despite the decline in 2012, the use of tax credits still grew by nearly eight-times the rate of growth of personal income between 1988 and 2012. This growth is the result of legislative actions to create and, in some cases, expand various tax credits over time. Two 1987 laws established the state's research and development (R&D) tax credit, and two 1984 laws established the state's first enterprise zone (EZ) programs. (Both of these and various other tax credits affect both CT and PIT collections.) Later laws changed these credits,

generally broadening their use. As of 2012, between 80 percent and 90 percent of CT credit usage resulted from these two tax credits: the R&D credit (about $1 billion) and EZ credits (around $350 million). During the last two decades, the state has curtailed some credits or suspended their use for certain periods. For example, the Legislature passed laws in 2013 to phase out the existing EZ credits and replaced them with other tax benefits for various types of businesses. Over time, the legislative package that eliminated the EZ program should reduce or moderate the growth of CT credit usage and simultaneously increase sales tax exemptions used by manufacturers, as well as other tax benefits.

- ***Tax Rate Reductions.*** As shown in Figure 2, the state has reduced its main statutory CT rates since the mid-1980s. For general corporations, for example, the tax rate was lowered from 9.6 percent to 9.3 percent in 1987. Beginning in 1997, the rate was lowered further to 8.84 percent. For S-corporations, the statutory CT tax rate was lowered from 2.5 percent to 1.5 percent in 1995.

Some Changes to Boost CT During Recession Are Now Reducing Revenues. The state faced difficult choices for how to balance its budget during the most recent economic recession. Among many actions to help balance the state's budget, the Legislature and the prior Governor made choices to temporarily boost CT revenues during the downturn, which resulted in reducing CT revenues somewhat in future years. California's General Fund is now experiencing the effect of those CT revenue reductions. Other measures of recent years simply increased or reduced CT revenues in future fiscal years. Some of the recent CT changes included:

- ***Limits on Credit Usage and NOL Deductions During Recession.*** The state took actions to limit many businesses' use of tax credits in 2008 and 2009 and the use of NOL deductions in 2008 through 2011. A 2008 measure also expanded the period for which NOL deductions can be "carried forward" from 10 to 20 years. The state also allowed NOL deductions to be "carried back" for the first time in California, to offset taxable income in the prior two years. The limitations on credit usage are estimated to have increased CT revenues by around $200 million to $300 million per year in 2008-09 and 2009-10, but these limitations result in taxpayers using more carried-over credits later than otherwise would have been the case. As a result of the higher credit usage, CT collections are lower by around $60 million in 2013-14, an amount expected to decrease in future years. With regard to the NOL limitations, these increased CT revenues by an estimated $320 million in 2008-09, $580 million in 2009-10, and $620 million in 2010-11, but reduced CT revenues beginning in 2012-13. In 2013-14, the NOL changes are estimated to lower CT revenues by $220 million, an amount expected to decrease in future years.

- ***Credit Sharing Allowed Within Unitary Corporate Groups.*** Many business organizations consist of a group of business entities. Under law, these are called "unitary groups" when they meet certain conditions, such as operating jointly or under the same management. (For example, one business in a group may develop a product, and another business in the group may sell that product.) A 2008 state law allows a business with available tax credits to transfer unused credits to another business in the same group in 2010 and later years. "Credit sharing," as this policy is

called, allows a unitary group to use credits that otherwise might never be used by individual businesses within the group, thereby decreasing CT revenues. Data received from the state's tax agencies in November 2013 indicate that credit sharing reduced CT revenues by about $400 million in 2010-11, $300 million in 2011-12, and over $200 million per year (generally growing) thereafter. (A statutorily required report by the Franchise Tax Board (FTB) in late 2013 showed that the usage of transferred credits has been highly concentrated among the top 25 CT taxpayers.)

- ***On Net, Apportionment Changes Have Reduced CT Revenues.*** The multinational and multistate companies paying the largest share of California's CT revenues operate across the country and around the world. To determine how much of the income of a multistate business is taxed by California, state law previously used a formula that involved three factors: (1) property, (2) payroll, and (3) sales. A 2009 law gave multistate businesses a new way to determine how much of their income that California taxes. Beginning in 2011, this law allowed most multistate businesses to choose each year the method by which their profits would be taxed—either (1) the existing three-factor tax methodology described above or (2) a new formula based only on the portion of their overall national sales in California. This new policy was known as the "elective single sales factor" apportionment method. Because businesses would choose the formula that minimizes their California taxes, elective single sales reduced CT revenues by an estimated $900 million in 2011-12, an amount that was to climb in the future. In 2012, voters repealed the *elective* single sales factor policy in Proposition 39, which made the single sales factor apportionment methodology *mandatory* for most multistate businesses. Based on recent tax agency estimates, Proposition 39 is offsetting most, but not all, of the revenue losses due to the elective single sales factor change. In addition, changes to apportionment rules in bills passed in 2009 and 2010 increased revenues. In 2013-14, the net effect of all of these changes is a reduction of CT revenues of around $70 million.
- ***Large Corporate Understatement Penalty (LCUP) Increases CT Compliance.*** A 2008 law imposed a new penalty, the LCUP, on certain understatements of tax in CT returns by certain corporations. Specifically, the penalty was set at 20 percent of understatements of tax in excess of $1 million in 2003 or thereafter, in addition to all other penalties. The LCUP is believed to improve tax compliance and accelerate payments of corporate taxes that are owed but would have been initially underpaid otherwise. The LCUP is estimated to have increased 2007-08 CT revenues by a few billion dollars, followed by increases of $500 million in 2008-09, and $400 million in 2009-10. A 2010 state law modified the LCUP to apply only to understatements of tax that exceed the greater of: (1) $1 million or (2) 20 percent of the tax shown on certain returns. As a result of the change, net increased revenues attributed to LCUP fell to around $15 million in 2013-14.

Credits and Recent Changes Reduce CT Revenues by About $3 Billion Per Year. Figure 5 displays a very rough estimate by our office—based generally on FTB data—of how much water's-edge elections, the state's S-corporation tax policies, the key tax credits described above, and the recent CT policy changes are reducing state CT collections in 2013-14. Our rough

estimate is that these policies are reducing CT revenues by $3.2 billion in the current fiscal year. If—hypothetically—CT revenues were higher in 2013-14 by this amount, total CT revenues would rise from 8 percent to as much as 11 percent of General Fund revenues and from 0.4 percent to as much as 0.6 percent of California personal income. Compared to personal income, this would return CT collections to levels similar to those of 2000-01 or 2004-05.

Figure 5

Major Reductions in Corporation Tax Collections Due to Major Tax Expenditures and Recent Policy Actions

2013-14 (In Billions)

	Rough Estimate
Water's-edge election	$1.0[a]
Research and development credit	1.0[b]
Subchapter-S corporation tax treatment	0.5[c]
Enterprise zone credit	0.3[b]
Net operating loss changes	0.2
Various recent apportionment policy changes (net)[d]	0.1
Film and television production credit	0.1
Effects of credit use limitations during recession	0.1
Other recent changes (net)	—[e]
Total	**$3.2**

[a] Based on Franchise Tax Board (FTB) tax expenditure report.
[b] Based on November 2013 data from FTB concerning use of the credit in 2012. For enterprise zone tax credits, reflects $57 million reduction below 2012 levels due to the legislation that phases out the enterprise zone program over several years. Included in these tax credit lines are estimates of increased credit usage due to the 2008 law allowing credit sharing within unitary corporate groups.
[c] Based on FTB estimates. $0.5 billion reflects the estimated corporation tax revenue reduction due to the subchapter-S tax policy. In addition, this policy increases personal income tax revenues by about $0.3 billion, resulting in an estimated net state revenue loss of about $0.2 billion.
[d] Includes elective single sales factor apportionment legislation, the reversal of that policy in Proposition 39 (2012), and other apportionment rule changes adopted in 2009 and 2010.
[e] Small net tax collection gain of less than $0.05 billion.

Offsetting Revenue Increases in Other Taxes. To the extent that some of the tax actions described above—such as the R&D credit—have encouraged businesses to remain, locate, or expand in California, they may have generated increases in economic activity and some additional state and local revenues not accounted for in Figure 5. The additional revenues from the R&D credit and other CT changes, for instance, may have played a small role in the increases in recent years of PIT revenues. As we have noted on many occasions, it is very difficult to ascertain whether particular tax expenditures and other tax policies create additional economic activity in this manner. In some cases, however, these tax policies likely partially offset declines in CT revenues.

Other Tax Collection Issues May Affect CT Revenues. The items discussed above relate generally to policies adopted by state leaders and how they have reduced CT revenue collections. In addition, as discussed at the January 23 hearing, some allege that corporations have increased their use of a variety of tax management strategies—some legal (tax minimization) and some potentially illegal (evasion)—such as sheltering income in various international arrangements. A 2013 Congressional Research Service report noted that the "dividing line" between tax minimization and evasion "is not entirely clear" in many cases. As a 2003 report by an FTB

economist describes, in practice tax shelter activity normally will lower the measured level of corporate profits "because all of the data series on corporate profits are constructed from tax return data." Accordingly, we lack solid data to shed light on the scale of other tax avoidance and evasion efforts that may be reducing state (and federal) corporate tax revenues. It is possible, but not certain, that these types of activities may be reducing California CT revenues by hundreds of millions of dollars or more per year. (In some cases, the tax policy changes described above—such as water's-edge elections—may overlap with estimates of revenue losses due to tax minimization or evasion.)

LAO Perspective

CT Is a Very Difficult Tax to Administer. For California and other states, CT is a very difficult tax to administer. For a variety of practical reasons, a state's CT is tied to federal tax policy to some extent, such that federal tax actions outside of the state's control could affect state collections. Moreover, because the large corporations paying the vast majority of the CT operate throughout the nation and the world, their financial operations can be so complex as to make it difficult for tax agencies to monitor, audit, and prevent tax evasion. Finally, ultimate "incidence" of the tax—the entities upon which the ultimate burden of paying CT falls—is difficult to decipher, as businesses pass on taxes to consumers, investors, workers, and/or their business counterparties.

Broad Tax Base With Lowest Possible Rates Advisable. Concerning broad-based state taxes like the CT, our traditional guidance to the Legislature has been to aim for the broadest possible tax base. A broad tax base, in turn, allows a given level of revenues to be generated with the lowest possible tax rate. By allowing, for example, tax credit usage to expand significantly, the Legislature has decreased the amount of CT revenues that can be generated at a given tax rate. By contrast, if the state were to move in the opposite direction and limit or eliminate tax credits (as it did recently by eliminating the EZ program over the next few years), the same amount of revenue raised now through the CT could be raised at a lower tax rate. As was the case with elimination of the EZ program, such changes could be implemented gradually over a multiyear period in order to disrupt near-term planning by businesses as little as possible.

Limiting or eliminating certain tax credit programs will negatively affect certain businesses in the industries that now benefit from the tax credits. At the same time, other businesses could benefit, and the "playing field" would be leveled so that effective tax rates across industries would be more uniform. A broad CT tax base with the lowest possible rates would reduce the phenomenon whereby businesses' choices are affected, or "distorted," due to the structure of the tax code.

For more information, contact Jason Sisney (jason.sisney@lao.ca.gov, 916-319-8361) or our office's corporate tax analyst, Brian Weatherford (brian.weatherford@lao.ca.gov, 916-319-8337).

Sincerely,

Mac Taylor
Legislative Analyst

cc: Members of the Senate Budget and Fiscal Review Committee