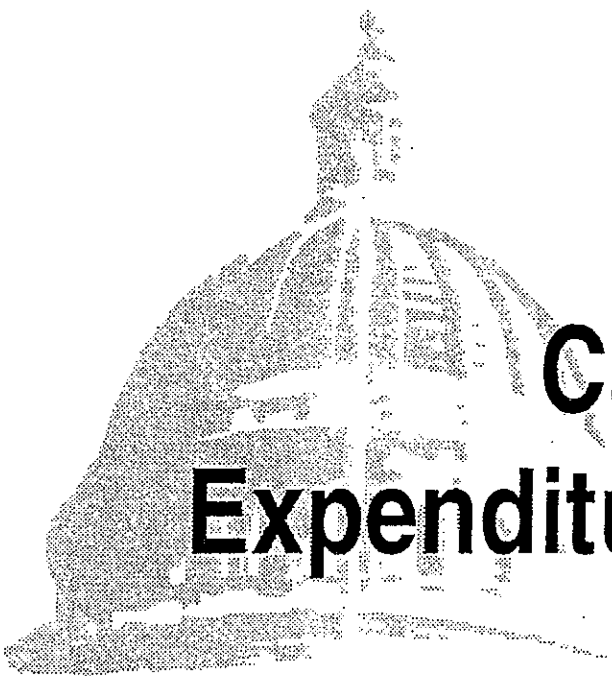

California's Tax Expenditure Programs

Part Two—Compendium of Individual Programs

Legislative Analyst's Office
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✦ Introduction

This is Part Two of a two-part report on California's tax expenditure programs (TEPs). It is the fourth in a series of such reports produced by the Legislative Analyst's Office.

CONTENTS OF THE REPORT

Part One of the report, published as a separate document and entitled *California's Tax Expenditure Programs: Overview,* provides (1) a discussion regarding alternative definitions of the tax base, (2) a review of issues associated with the revenue estimation process for TEPs, (3) a brief discussion of tax incidence and distributional issues associated with TEPs, (4) the identification of TEPs with significant fiscal impacts, (5) the identification of TEPs recently enacted or eliminated, and (6) a discussion of the policy role for TEPs and the effectiveness of tax expenditure reporting.

This part of the report, entitled *California's Tax Expenditure Programs: Compendium of Individual Programs,* presents an overview of each type of tax and detailed descriptions and commentary regarding individual TEPs, by program type. For each program, the following information is provided:

- *Legal Authorization.* In most cases, the legal citation provided references the California Revenue and Taxation Code. There are some cases however, where program authorization is given by the California Constitution or other state code sections. For those income tax programs that conform partially or fully to federal law, the appropriate Internal Revenue Code Section is noted.
- *Revenue Effect.* Estimates of the fiscal effect of each program, measured by the foregone tax revenues associated with it, are provided for 1996-97 through 1998-99. These estimates were developed by the state's two major tax agencies—the California Franchise Tax Board (FTB), for income taxes, and the State Board of Equalization (BOE), for all other taxes.

  There are a significant number of programs for which no dollar revenue effect is available, due to data limitations or methodological considerations. These are designated by an "NA" (not available). In addition, for programs with no revenue effect for a particular year, or with revenue effects incorporated into another program, a dash has been used (—). The term "Minor," used in other cases, indicates a revenue reduction of less than $1 million. The term "Major" indicates estimated revenue reductions of an indeterminate amount in excess of $1 million.
- *Description.* A description of each TEP's basic provisions, and conditions under which they are applicable, is provided. A sunset date is provided if the program's authorization contains such a provision.

- *Rationale.* In most cases, the rationale for a TEP can be categorized as a tax incentive to encourage certain behavior and/or as tax relief to certain groups or individuals. Also, in certain cases, TEPs may facilitate effective and efficient tax administration. For each TEP, the rationale provided represents our attempt to identify the apparent logic or motivation behind the program's establishment and/or continuation. This rationale should not be viewed, however, as necessarily providing evidence as to a program's cost-effectiveness or value to the public.
- *Distributional Impacts.* For a limited number of TEPs relating to PIT and BCT, we present information regarding the distribution of program benefits by income class (for PIT), or size of firm and type of industry (for BCT). For purposes of these data, the amount or percent of TEP claims indicated is the amount or percent claimed *and* actually applied for tax purposes. In some cases, amounts claimed may be in excess of amounts actually applied. This may occur, for example, if a taxpayer has insufficient income to use certain tax credits.

  In addition, depending on the type of program, the distributional data for PIT programs may not reflect the true *value* of the particular tax provision. This is because the value of the tax provision may vary depending on the taxpayer's marginal tax rate. For example, for income deductions, adjustments, and exclusions, the value of the tax provision will increase along with the marginal tax rate. In such cases, the distributional data is for the amount of the deduction, adjustment, or exclusion claimed and applied.
- *Comments.* For many TEPs, we provide comments that may assist the Legislature or other readers in understanding a program's application or impact. These comments may relate, for example, to the TEP's legal history, its relationship to comparable federal programs, or empirical findings regarding the effectiveness of the TEP.

At the end of Part Two, we provide an index that cross-references by general subject area the TEPs contained in the report, in order to assist readers in locating those programs that might be of particular interest or concern to them.

ACKNOWLEDGMENTS

The principal author of this report was Mark A. Ibele. Michael Cohen was responsible for the section dealing with property taxes. The report's preparation was overseen by David Vasché. We gratefully acknowledge the assistance of the FTB, the BOE, and the California Department of Finance in providing various background information and fiscal data used in the report.

✦ Personal Income Tax

✦ Bank and Corporation Tax

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Credits

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✦ Income Taxes—Overview

This section provides information on tax expenditure programs (TEPs) associated with the income tax liabilities of individuals and businesses. These programs affect the amount of General Fund revenues raised by the state's first and third largest taxes—the Personal Income Tax (PIT) and the Bank and Corporation Tax (BCT), respectively. Both of these taxes are administered by the California Franchise Tax Board (FTB). The following provides a brief summary of the PIT and BCT.

Personal Income Tax

The PIT is paid by all California residents and nonresidents who receive income from sources in the state. Estates and trusts are also required to pay personal income taxes. The largest sources of taxable income under PIT include wages and salaries, interest, dividends, rents and royalties, net capital gains, and net business income. Business income includes the distribution of profits from partnerships, sole proprietorships, and Subchapter S corporations to shareholders or partners. Subchapter S corporations are also subject to an entity-level corporate tax on their net taxable income.

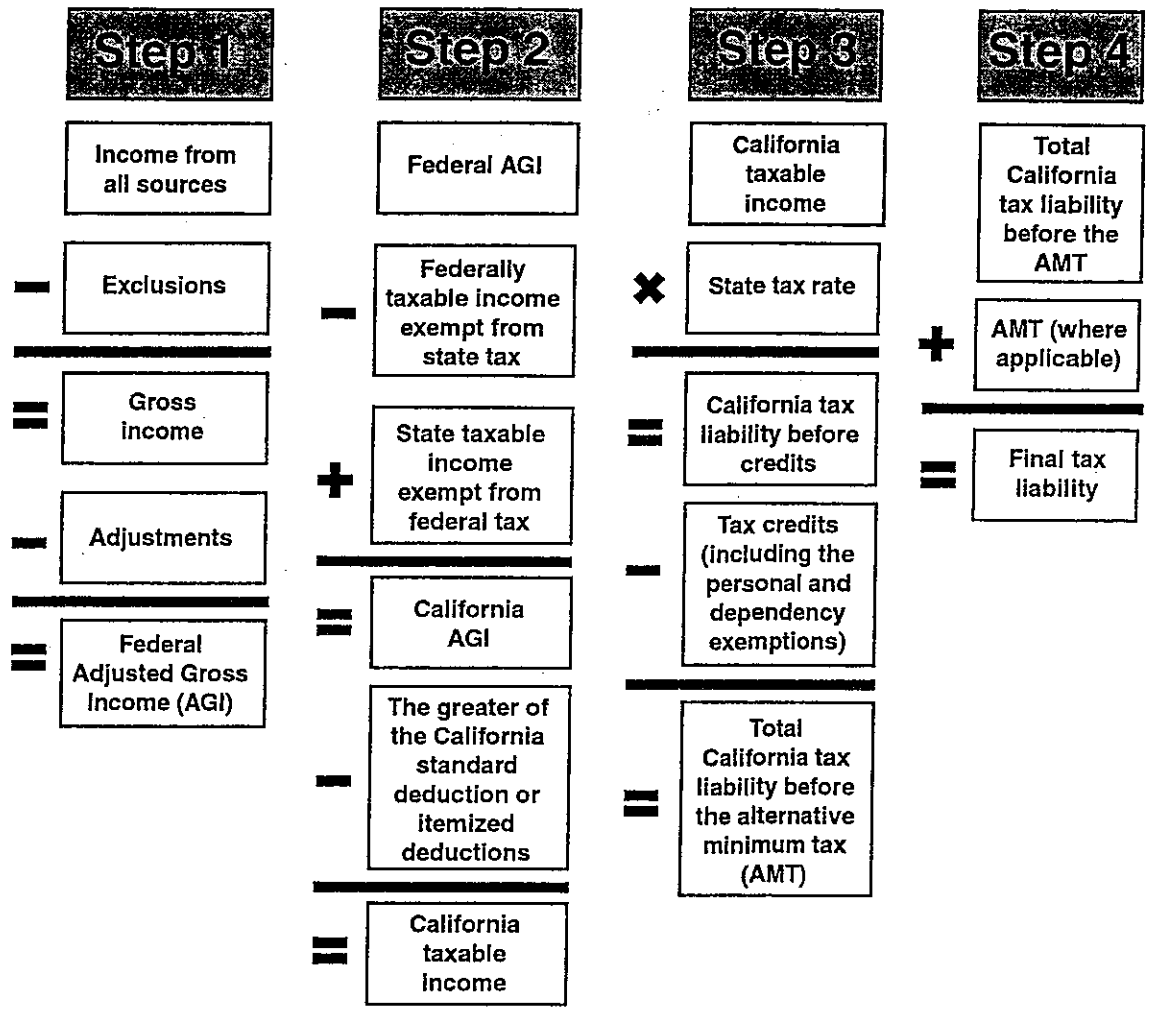
California's PIT law conforms to federal PIT law in many areas, which helps simplify both the calculations of tax liabilities for taxpayers, as well as the administration and enforcement activities of the FTB. Filing under California's PIT system, for example, builds upon preliminary steps carried out for the calculation of federal PIT liabilities.

Basic Calculation of State Income Tax Liabilities. Figure 1 provides a flowchart of how California's PIT liabilities are calculated. For the purposes of calculating PIT, there are four basic steps involved:

- **Step 1—Federal Adjusted Gross Income.** Calculation of a taxpayer's state PIT liability first requires the calculation of the taxpayer's federal *adjusted gross income* (AGI). To do this, income from all sources is first measured and then modified by subtracting income that is exempt (or excludable) from *federal* taxation. Some of the more notable examples of exempt income include certain social security benefits, scholarships and fellowships, and gifts under a certain dollar amount. Once completed, this calculation provides a measure of *gross* income (defined as income from all sources except that which is exempt or excluded) which is the starting point for the taxpayer's federal income tax calculation. Following this, certain *adjustments* are made to gross income, such as subtracting alimony paid or payments to IRAs or Keogh plans, to finally arrive at the measure of *federal* AGI.
- **Step 2—California Taxable Income.** Federal AGI marks the starting point for the state income tax calculation. The next step is to make specified *adjustments* to federal AGI, subtracting income that is *not* taxable under state tax law and adding back income that *is* taxable, to arrive at *California* AGI.

Figure 1

Determination of California Personal Income Tax Liabilities



Taxpayers are then allowed to deduct from their California AGI the larger of either a fixed dollar amount (called the "standard deduction") or the total amount of their allowable itemized expenditures of specified types (called "itemized deductions"), to arrive at California *taxable income* (TI).

- **Step 3—California Tax Liability.** Tax rates are then applied to California TI to arrive at state PIT liability before credits. Taxpayers are allowed tax credits of certain types which are directly subtracted from their pre-credit tax liability. For most taxpayers, the resulting amount reflects their *income tax liability*.

- **Step 4—Alternative Minimum Tax.** Some taxpayers may be subject to the state's add-on *Alternative Minimum Tax* (AMT), or to having their tax credits limited under the AMT. The latter can occur if they reduce their tax liabilities below a specified threshold amount through the use of certain TEPs or other special tax provisions. California's AMT-related provisions are intended to ensure that all taxpayers pay a minimum state tax amount, and in essence, serve to "recapture" some of the tax revenues that otherwise would be lost due to the use of tax exemptions, exclusions, deductions, and credits. California's AMT law is similar in principle to the federal AMT law, although there are some notable differences (including the AMT tax rate and tax credit restriction).

Marginal Tax Rates and Income Tax Brackets. The tax rates used to calculate state PIT liabilities depend on both the *filing status* and *taxable income* of the taxpayer. California has five filing statuses: single, married filing jointly, married filing separately, head of household, and surviving spouse with dependents. A different tax rate schedule is used for each filing status. In general, taxpayers must use the same filing status on both their federal and state tax returns. Over 84 percent of all California tax returns filed are from taxpayers selecting the married filing jointly or the single filing statuses.

As noted above, each filing status has a corresponding tax rate schedule. Figure 2 provides tax rate schedules by filing status for the 1998 tax year. As Figure 2 shows, under California's progressive income tax rate structure, taxpayers at higher income levels pay a larger share of their income in taxes than do taxpayers at lower income levels. In 1998, marginal tax rates ranged from 1 percent to 9.3 percent, with an AMT rate of 7 percent. To calculate their state tax liability before credits, taxpayers use the tax rate schedule that corresponds to their appropriate filing status. For example, a single taxpayer with taxable income of $28,500 would have a state tax liability of $920.25 + (8 percent x $1,856.00), or $1,068.73. California indexes its PIT brackets annually for inflation using the June- (of the prior year) to-June (of the current year) increase in the California Consumer Price Index. California's standard deduction and personal and dependent credits also are indexed for inflation.

Because the tax brackets for single persons are divided at levels that are exactly half

Figure 2

Personal Income Tax Rate Schedules for 1998

If the taxable income is: Over	But Not Over	Computed Tax Is			Of The Amount Over
Married Filing Jointly and Surviving Spouses with Dependents					
$0	$10,262	$0.00	+	1.0%	$0
10,262	24,322	102.62	+	2.0	10,262
24,322	38,386	383.82	+	4.0	24,322
38,386	53,288	946.38	+	6.0	38,386
53,288	67,346	1,840.50	+	8.0	53,288
67,346	and over	2,965.14	+	9.3	67,346
Single and Married Filing Separate					
$0	$5,131	$0.00	+	1.0%	$0
5,131	12,161	51.31	+	2.0	5,131
12,161	19,193	191.91	+	4.0	12,161
19,193	26,644	473.19	+	6.0	19,193
26,644	33,673	920.25	+	8.0	26,644
33,673	and over	1,482.57	+	9.3	33,673
Head of Household					
$0	$10,264	$0.00	+	1.0%	$0
10,264	24,323	102.64	+	2.0	10,264
24,323	31,353	383.82	+	4.0	24,323
31,353	38,803	665.02	+	6.0	31,353
38,803	45,833	1,112.02	+	8.0	38,803
45,833	and over	1,674.42	+	9.3	45,833

Source: Franchise Tax Board.

of their married-filing-joint counterparts, California's income tax bracket structure generally does *not* result in a "marriage penalty." (At the federal level, this penalty can occur when two single taxpayers with equal incomes are subject to lower tax liabilities than are two similar taxpayers who are married.) California's tax system results in either marriage neutrality or, for many taxpayers, actual marriage *bonuses*.

Effect of Different Marginal Tax Rates. In many of the reviews of TEPs relating to PIT, we indicate that the program results in disproportionate benefits to higher-income taxpayers due to their higher marginal tax rates. It is important to note why this happens, since its occurrence is so frequent in TEPs which result in either deductions or exclusions from income.

An example of this is a married couple filing jointly with California taxable income (TI) of $75,000. Their marginal tax rate is 9.3 percent and tax liability before credits is $3,676.96. Now assume the couple has a deduction for mortgage interest payments of $5,000. This would result in TI of $70,000 and a tax liability of $3,211.96, or $465 less than their liability without the deduction.

Alternatively, a married couple filing jointly with a California TI of $50,000 has a marginal tax rate of 6 percent, and a pre-credit tax liability of $1,643.22. With a mortgage interest deduction of $5,000, their tax liability would drop to $1,343.22, or $300 less than their tax liability without the deduction.

Based on this example, in terms of taxes saved, the deduction is worth $165 more to the higher-income couple. A similar result occurs when income *exclusions* are involved.

BANK AND CORPORATION TAX

Most corporations that earn income derived or attributable to California sources are subject to California's BCT. Some corporations, however, are either *exempt* or *partially exempt* from the tax. These include insurance companies (which are subject to a gross premiums tax in lieu of a tax on net income) and nonprofit organizations (which are only subject to the BCT for earned income that is unrelated to their tax-exempt status).

Types of Bank and Corporation Taxes. There are four basic categories of taxes levied under the BCT:

- *Franchise Tax.* Most California corporations are subject to the franchise tax, which is levied for the privilege of conducting business in California. For most corporations, a flat 8.84 percent tax rate is applied to the corporation's *net* income attributable to California to arrive at pre-credit state tax liabilities. Subchapter S corporations are subject to an entity-level tax at the reduced rate of 1.5 percent. A variety of tax credits are available to BCT taxpayers, as discussed in the TEP reviews which follow.

  The franchise tax accounts for the majority of revenues raised under the BCT, and generally is the tax being referred to when the term "corporate income tax" is used (even though there is a separate smaller corporate income tax, as discussed below). As under PIT, corporate taxpayers who take advantage of certain tax preferences or special tax provisions must complete an AMT calculation and pay any resulting amount by which it exceeds the amount of the regular tax due. For 1998, the AMT tax rate is 6.65 percent.

- *Corporate Income Tax.* Corporations that derive income from California sources but do *not* have a substantial enough presence to be classified as "conducting business" in the state are subject to the corporate *income* tax. (Business trusts are also taxable under this tax.) Very few corporations actually file under the corporate income tax. This tax is levied in a manner similar to the corporate franchise tax; however, there are a number of provisions unique to it. (For example, businesses that file under the corporate income tax are not subject to the state's minimum tax [see below] and also may exclude income from tax-exempt securities.)

- *Minimum Franchise Tax.* Corporations that have less than an $800 annual computed franchise tax liability, or no computed tax liability at all, must pay a minimum franchise tax of $800. *New* corporations with gross income under $1 million pay a reduced minimum tax of $300 the first year and $500 the second year. In recent years, the minimum tax has applied to the majority of California corporations because their computed tax liabilities are below the minimum tax threshold. For example, in 1996, 325,000 of the 430,800 total corporate tax returns that were filed (or 75 percent) were subject to the minimum tax.
- *Bank Tax.* Banks and other financial institutions are subject to an "add-on" tax that is levied in addition to the franchise tax. This tax is paid in lieu of personal property taxes and local business taxes. Under current law, the add-on portion of the bank tax rate is 2 percent. (Prior to 1996, the rate was set annually by the FTB to be equivalent to the average amount of personal property and local business taxes paid by corporations.) Thus, banks and other financial institutions are subject to a total corporate tax rate of 10.84 percent.

Figure 3 provides a history of California BCT rates levied since the tax was created in 1929. As it shows, the current general franchise tax rate is at its lowest level since 1973. Other state corporate-related tax rates—such as for Subchapter S corporations, the corporate AMT, and banks and financial corporations—have generally declined in recent years as well. However, the corporate minimum tax has remained at $800 for most corporations since 1990.

Figure 3

Bank and Corporation Tax Rates

	General Corporation Rate	Minimum Tax[a]
1929-34	2.00%	$25
1935-42	4.00	25
1943-49	3.40	25
1950-58	4.00	25
1959-66	5.50	100
1967-71	7.00	100
1972	7.60	200
1973	8.30	200
1974-79	9.00	200
1980-81	9.60	200
1982-86	9.60	200
1987-88	9.30	300
1989	9.30	600
1990-96	9.30	800
1997 to present	8.84	800

[a] Beginning in 1998, new small corporations pay a minimum tax below this amount.

Source: Franchise Tax Board.

Calculation of Income for Multistate and Multinational Corporations. If a corporation derives *all* of its income from California sources, the entire nonexempt portion of income is used in the state BCT liability calculation described above. However, if the corporation has multistate or multinational operations and has business income attributable to non-California sources, then it must *apportion* the amount of its *business* income attributable to its California operations. *Nonbusiness* income, such as interest and royalties, is allocated to (1) the corporation's official state of residence, in the case of taxable income derived from intangibles, or (2) where relevant property is located, in the case of taxable income derived from real or personal property.

Before apportioning income, the corporate taxpayer must first identify the extent of its operations that are attributable to a corporation or group of corporations operating as one integrated business. This taxpayer may elect to combine either: (1) its *worldwide* income or, (2) its income *within* the U.S. and certain specified "tax havens." The former method is known as the "worldwide" basis and the latter as the "water's-edge" basis. Once this election is made, formula apportionment (see below) is used to determine the portion of income attributable to California for tax purposes.

Formula Apportionment. California's apportionment formula is based on looking at a firm's average ratio of its corporate activity in California to its total corporate activity (either on a worldwide basis or water's-edge basis, depending on the taxpayer's preference) for three factors: property, payroll, and sales. In California, the sales factor is double-weighted (except for mining and other extractive industries, agriculture, and banking and financial business activity). The average computed ratio is then multiplied by the total net corporate income (whether on a worldwide basis or water's-edge basis) to arrive at the amount of income attributable to California. This amount is then used in the calculation described above to arrive at corporate state tax liabilities.

Because the sales factor is weighted twice in computing the apportionment factor (versus the alternative approach of equally weighting all three factors), certain corporations are advantaged. Specifically, the formula provides relative benefits to those corporations that are based in California but conduct most of their sales outside of the state. This procedure serves to encourage and stimulate California-based development and production activities.

Calculation of Income Tax Liabilities. Corporations may choose to file their taxes based upon either a calendar-year or fiscal-year basis (which in the latter case, commences in any month other than January). Corporations calculate tax liabilities based upon a process similar to that described above for PIT filers. First, all income attributable or sourced to California must be added up, and then tax-exempt or excluded income is subtracted from this amount to arrive at *gross* income. Next, deductions are subtracted to arrive at a measure of corporate *net* income. For most corporations, the flat 8.84 percent tax rate is levied on this net income, yielding state BCT liabilities before tax credits. Certain tax credits may reduce corporate tax liabilities. However, as noted above, corporations are subject to the state's AMT, which serves to recapture some of those tax revenues that would otherwise be lost due to tax exemptions, exclusions, deductions, and credits.

Exclusion/Exemption:

CAPITAL GAINS ON INHERITED PROPERTY

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 18031 and 18036, which partially conform to Internal Revenue Code Section 1014.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$575
1997-98	610
1998-99	650

DESCRIPTION

This program exempts from capital gains taxation the appreciation in the value of property which has occurred prior to the transfer of the property from a decedent to an heir. Thus, the heir's "basis" in the property, from which capital gains eventually will be measured, is adjusted upward to equal the property's fair market value at the time of the decedent's death. Accordingly, taxes on the capital gains that materialize prior to the transfer of property to heirs are permanently forgiven.

RATIONALE

This program provides tax relief to heirs who inherit property that has appreciated in value while held by the deceased. The original rationale for this program was that inherited property was itself subject to taxation; thus, some argued that subjecting inherited capital gains to taxation would amount to a form of "double taxation."

It also is frequently argued that, without this program, heirs might need to sell their inherited property to pay the tax on previously accumulated capital gains.

COMMENTS

California eliminated its inheritance tax in 1982 pursuant to Proposition 6. The state's current taxes on inherited property—the estate tax and the generation-skipping transfer tax—do not impose any real tax burden on California taxpayers, since both represent so-called "pick-up" taxes. This type of tax simply collects a state tax that would otherwise go to the federal government by taking maximum advantage of the federal estate tax credits that are granted to Californians for their state death-related taxes paid. Thus, the tax imposes no additional cost to these California taxpayers. The double taxation rationale, therefore, no longer applies.

The concern that heirs might need to sell their inherited property in order to pay capital gains taxes could be dealt with directly by a tax-deferral program. A tax-forgiveness program is not necessary to address this particular concern.

Exclusion/Exemption:

CAPITAL GAINS ON THE SALE OF A PRINCIPAL RESIDENCE

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17131 and 17152, which generally conform to Internal Revenue Code Section 121.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**PIT**
1996-97	—
1997-98	$485
1998-99	750

DESCRIPTION

For sales and exchanges of residences occurring after May 6, 1997, California law allows the taxpayer to exclude from gross income the gain realized on the sale or exchange up to a maximum amount. The exclusion is allowed if the taxpayer used the residence as a principal residence for two of the previous five years. The subsequent purchase of another residence is not required. The exclusion for a given sale is limited to $250,000 for single income tax filers and $500,000 for married taxpayers filing jointly. Exclusions can be claimed for additional sales or exchanges providing the above conditions are met. California law waives a portion of the two-year occupancy rule for Peace Corp volunteers. Additionally, it does not conform to federal transitional provisions which allow certain taxpayers to elect prior tax treatment for certain sales.

RATIONALE

This program provides tax relief to homeowners who sell their residences. There are two apparent rationales for the program. First, in the case where the sale of a residence is entirely or largely involuntary, due to such factors as changing employment or family circumstances, the program avoids putting an additional financial burden on certain households faced with acquiring replacement housing.

Second, the program provides an incentive for households to invest more of their resources in owner-occupied housing than they otherwise would. This is because the program reduces the overall costs of home ownership, and thus raises its overall rate of return as an investment. This is especially true when housing is compared to those other investments whose capital gains are subject to taxation.

DISTRIBUTION OF BENEFITS

This program primarily benefits higher income taxpayers. As shown in the accompanying table, about 85 percent of the total benefits go to those earning in excess of $100,000 annually, and almost two-thirds goes to those earning $150,000 or more. The average amount claimed also generally increases for those with higher incomes. The reduction in the average amount claimed for those in the highest income category is a result of limitations on the amount of the capital gain that can be excluded for tax purposes.

Capital Gains on the Sale of a Principal Residence Exclusion

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	—	—	—
20-40	1.2%	0.3%	$338
40-60	4.9	1.5	487
60-80	18.3	6.8	621
80-100	15.6	6.8	727
100-150	27.4	21.5	1,302
150-200	14.6	21.6	2,463
200-250	7.3	,13.5	3,078
250-500	8.2	24.1	4,925
Over 500	2.6	4.1	2,674

COMMENTS

This program is a liberalized extension of the previous capital gains exclusion which both state and federal law allowed for capital gains on sales of residences. Specifically, for sales and exchanges occurring on or prior to May 6, 1997, there was a one-time exclusion granted to taxpayers over age 55 of up to $125,000 for married couples filing jointly and single taxpayers, and up to $62,500 for married taxpayers filing separately. This program also replaces the deferral of capital gains available to taxpayers who sold a principal residence. To qualify for the deferral, another principle residence of equal or greater value had to be acquired within two years of the date of sale.

The change from the more-limited exclusion and deferral programs to the more-generous provisions incorporated in the current program may result in a one-time "unlocking" effect, stimulating a shift toward nonhousing investments on the part of certain homeowners.

Overall, however, this provision makes housing a relatively more attractive investment than it otherwise would be when compared to alternative types of investments. This is because the exclusion essentially raises the economic "rate of return" on housing by reducing the taxes which eventually have to be paid on a residence. Although the previous capital gains exclusion program noted above also raised the rate of return on housing investments, the more-generous provisions of this current program have a stronger effect in this regard.

Exclusion/Exemption:

CAPITAL GAINS FROM HOUSING SALES TO LOW-INCOME RESIDENTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 18041.5 and 24955.*

Estimated Revenue Reduction		
(In Millions)		
Fiscal Year	**PIT**	**BCT**
1996-97	—	*NA*
1997-98	—	*NA*
1998-99	—	*NA*

DESCRIPTION

This program allows taxpayers to exclude from taxable income their capital gains from the sale of government-assisted low-income housing units to low-income tenants. In order to qualify for the exclusion, a majority of the housing units sold must remain in use by low-income tenants for either 30 years from the date of sale or for the remaining term of existing federal government financial assistance, whichever is longer. In addition, the taxpayer must reinvest all of the proceeds from the sale in residential property other than a personal residence. The taxpayer's "basis" in the new residential property is reduced by the amount of the gain from the sale. Thus, the program provides for a tax *deferral* rather than permanent tax forgiveness.

RATIONALE

This program provides an incentive for owners of low-income housing that has been subsidized by the federal government to sell the property to low-income tenants for continued use as low-income housing, rather than sell it for, or convert it to, other purposes upon termination of the federal subsidy. It does this by providing for a tax deferral on the gain from that sale. This deferral of the tax liability amounts to an interest-free loan from the government, which increases the economic gain from the property sale.

COMMENTS

The estimated PIT revenue effects for this program are not directly available. Rather, the estimates are included within the estimates for "Capital Gains on The Sale of a Principal Residence." The BCT estimates are not available due to the lack of comparable federal data upon which to base these estimates.

In the 1960s, the federal government provided low-interest loans and rent subsidies through various programs administered by the federal Housing and Urban Development Department (HUD) and Farmers' Home Administration (FHA). In return, private developers and property owners agreed to build or operate rental projects which were protected by low-income use restrictions. In order to stimulate private sector participation, the owners were given the option to terminate their contracts prior to their loan maturity dates. As owners exercise their options to sell and/or as federal subsidy periods expire, the housing units may be sold or converted to market-rate units, thereby displacing low-income tenants and reducing the state's supply of affordable low-income housing. This program aims to lessen the extent to which this occurs.

The original state program was created by Chapter 1436, Statutes of 1990 (SB 1286, Seymour).

Exclusion/Exemption:
EMPLOYER-SPONSORED EDUCATIONAL ASSISTANCE PROGRAMS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17151, which partially conforms to Internal Revenue Code Section 127.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT
1996-97	$6
1997-98	4
1998-99	4

DESCRIPTION

This program allows taxpayers to exclude from their gross income contributions made to qualified educational assistance programs by their employers on their behalf. The amount which may be excluded under this program is limited to $5,250 annually. In order to qualify for this exclusion, the educational program must be provided for the exclusive benefit of employees and their dependents, and comply with various federal rules to ensure nondiscrimination in favor of highly compensated employees. The exclusion is inapplicable to graduate level courses commencing after June 30, 1996.

RATIONALE

This program provides an incentive for employers to provide, and employees to accept, contributions to educational assistance programs in lieu of taxable monetary compensation. This is because a given level of contributions is worth more to employees on an after-tax basis than an equivalent amount of taxable income. The program represents a policy designed to encourage additional consumption of education and stimulate an increase in human capital formation.

COMMENTS

This program conforms to an identical federal program, except that the federal program provides an exclusion only through June 1, 2000. In contrast, California law has no sunset provision.

Exclusion/Exemption:

UNEMPLOYMENT INSURANCE BENEFITS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17083.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$63
1997-98	58
1998-99	53

DESCRIPTION

This program exempts unemployment insurance benefits from the recipient's gross income for tax purposes.

RATIONALE

Various reasons are mentioned for the tax relief provided by this program. One is that legislatively provided social welfare benefits should not be taxed, since they often are structured by policymakers with the intent of providing specific amounts of purchasing power to recipients. Another is that paying taxes on such benefits could be an especially onerous burden on jobless individuals, who often have trouble paying for such basic necessities as housing, food, and clothing.

COMMENTS

State law does not conform to federal provisions, as contained in the 1986 Federal Tax Reform Act, which require certain taxpayers to *include* their unemployment compensation as gross income. The intent of the federal requirement is to treat government-paid unemployment benefits more like privately provided unemployment compensation benefits. The latter are fully taxable to recipients in California to the extent that they exceed prior contributions.

The subsidy provided by the program is worth disproportionately more to higher-income taxpayers than lower-income taxpayers, due to the former's higher marginal income tax rates. Economists argue that a side-effect of this program is that it may provide a disincentive for certain unemployed persons to seek jobs, since it reduces the after-tax cost of being unemployed. This could be particularly relevant in such cases as unemployed spouses of moderate-to-high-income taxpayers, whose economic need for employment may be less than that of lower-income individuals.

Exclusion/Exemption:

EMPLOYER CONTRIBUTIONS TO ACCIDENT AND HEALTH PLANS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 106.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$1,690
1997-98	1,800
1998-99	1,910

DESCRIPTION

This program excludes employer contributions to accident and health plans from the gross income of employees for tax purposes.

RATIONALE

This program provides tax relief to all individuals whose employers contribute to the costs of accident and health plans that provide compensation for sickness and injury.

It is argued that the program provides both employers and employees with an incentive to make accident and health insurance a standard part of the employees' compensation packages. Program supporters argue that this is a desirable social goal, because it provides security to workers, increases productivity, and reduces the need for the government itself to provide accident and health care programs.

An additional rationale for continuing this program is that paying taxes on these noncash benefits would impose a financial hardship on many taxpayers.

DISTRIBUTION OF BENEFITS

Tax benefits under this program are concentrated in the middle income groups. As shown in the accompanying table, over 50 percent of exclusions accrue to taxpayers with annual income of $60,000 or less, and over 70 percent go to taxpayers earning $80,000 or less. Very little of the benefits go to taxpayers earning $20,000 or less, due in part,

Employer Contributions to Accident And Health Plans Exclusion

1998 Tax Year (Dollars In Millions)

Adjusted Gross Income ($000)	Total Amount Claimed	Percent of Total
$0-20	$16	0.8%
20-40	442	23.2
40-60	507	26.6
60-80	372	19.5
80-100	238	12.5
100-150	200	10.5
150-200	59	3.1
200-250	39	2.0
250-500	21	1.1
Over 500	15	0.8

to the fact that individuals in this income class are more likely than those in higher-income categories to have jobs which do not include paid benefits. Over 80 percent of the exclusions from this program go to married joint filers and heads of household.

COMMENTS

According to a February 1997 U.S. General Accounting Office (GAO) study, approximately two-thirds of Americans under the age of 65 have employment-based health insurance. The GAO estimates that in 1993, three-quarters of the workforce participated in employer-subsidized plans such as those that qualify under this program. The GAO also found that as the costs of providing health insurance have increased, the number of individuals with employer-based coverage has declined over the last few years.

The consensus view of economists is that state and federal programs like this one have contributed significantly to shifting the mix of employee compensation away from wages and salary income in favor of nonmonetary fringe benefits. In fact, some economists believe that the subsidy provided by these programs has reduced the after-tax cost of health care to such a degree that there is excessive use of health care services by those with employer-subsidized health plans. To the extent that this is true, these programs can result in a misallocation of economic resources and the escalation of health care costs.

In recent years, however, structural changes made to many employer-based health insurance programs have resulted in increased health-related costs being borne by the consumer, either through higher deductibles, greater premium payment contributions, per visit charges, or some combination of these factors. To the extent that resource misallocations involving health-care benefits have occurred in the past, the effect of the above-noted increases in health-care usage costs to the consumer should help mitigate the inefficiencies and misallocations associated with the favorable tax treatment of employer-based health insurance programs.

Generally speaking, the health-care benefits under this program provide proportionately greater benefits to higher-income taxpayers than to lower-income taxpayers. This is because higher-income taxpayers typically face higher marginal income tax rates, which in turn makes a given dollar exclusion under this program worth more to them than for a lower-income taxpayer. In addition, higher-income taxpayers have been shown to participate in employer-subsidized health care plans to a greater extent than do lower-income taxpayers.

Exclusion/Exemption:

EMPLOYER CONTRIBUTIONS TO PENSION PLANS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17501, which conforms to Internal Revenue Code Sections 401 through 404a.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	*PIT*
1996-97	*$2,400*
1997-98	*2,500*
1998-99	*2,610*

DESCRIPTION

This program excludes employer contributions to qualified retirement plans and simplified employee pension plans (SEPs) from the gross income of employees, subject to certain conditions. (Employees do, however, eventually have to pay tax on that portion of the retirement benefits they receive which was funded through employer contributions.) In general, for defined contribution plans, the allowable annual addition to a participant's account that can be excluded from gross income is limited to the lesser of 25 percent of the taxpayer's compensation, or $30,000.

RATIONALE

This program provides tax relief to persons who receive income in the form of employer contributions to their pension plans. This tax relief is in the form of a tax *deferral*, since these persons eventually are subject to paying taxes on the retirement benefits they receive. The underlying rationale for the program is the view that employees should not have to pay taxes on income until this income actually is received by the employee.

DISTRIBUTION OF BENEFITS

Generally, the tax benefits associated with this program are distributed over a wide range of income classes, excluding the very lowest. As shown in the accompanying table, almost one-third of the claims are by taxpayers with annual earnings of $80,000 or less, with over half going to those earning $150,000 or less. Those taxpayers earning more than $500,000 annually receive almost one-quarter of the exclusions, however, even though they constitute fewer than one percent of returns.

Employer Contributions to Pension Plans Exclusion

1998 Tax Year
(Dollars In Millions)

Adjusted Gross Income ($000)	Total Amount Claimed	Percent of Total
$0-20	$29	1.1%
20-40	196	7.5
40-60	306	11.7
60-80	287	11.0
80-100	243	9.3
100-150	345	13.2
150-200	185	7.1
200-250	201	7.7
250-500	194	7.4
Over 500	623	23.9

COMMENTS

In the long run, the tax deferral provided by this program has a net cost to the state. This is because most persons are in lower marginal income tax brackets after retirement, compared to their marginal income tax brackets during their working years when their employers were contributing to their retirement plans. In addition, the "present value" of the deferred taxes paid in later years is less than the value of the taxes that the state would have received if they had been paid at the time the employer contributions were made, due to such factors as inflation. Generally, the structure of retirement programs, especially arrangements in which employers "match" the contributions made by employees, encourage a greater rate of participation and contributions than would have otherwise occurred.

Exclusion/Exemption:

SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17087.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$800
1997-98	825
1998-99	850

DESCRIPTION

This program exempts social security benefits and federal railroad retirement benefits from the recipient's gross income for tax purposes.

RATIONALE

This program provides tax relief to social security and railroad retirement recipients. The apparent rationale is a desire to protect the retirement income of elderly or disabled individuals who may have high living expenses due to illness or infirmity.

COMMENTS

Federal law under Internal Revenue Code Sections 72(r), 86, and 105(h), provides for the *partial* taxation of social security and railroad retirement benefits. For most taxpayers, the amount of these benefits that must be reported as income for federal tax purposes equals the lesser of one-half of the benefits received, or one-half of the excess of the taxpayer's combined income (as defined) over a specified base amount. For 1998, the base amount is $32,000 for married taxpayers filing jointly. However, for high income taxpayers, up to 85 percent of social security and railroad retirement benefits may be included as income.

The partial taxation of these benefits at the federal level was adopted to put social security benefits more on a par with other types of pension benefits, which are taxable only to the extent that the annuity or pension received exceeds a taxpayer's own direct pension-related contributions.

Because a given dollar exclusion of social security benefits from state income for tax purposes is worth more to taxpayers as their marginal income tax rates rise, social security recipients with higher amounts of taxable income from other sources realize disproportionate benefits from this state program.

Exclusion/Exemption:

EMPLOYER CONTRIBUTIONS FOR LIFE INSURANCE

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17081, which conforms to Internal Revenue Code Section 79.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$65
1997-98	65
1998-99	65

DESCRIPTION

This program exempts from an employee's gross income that portion of the employer's contributions to his/her group term life insurance policy associated with the first $50,000 in individual coverage. Also exempt are contributions to life insurance policies which specify that the beneficiary is no longer employed by the employer providing coverage and is disabled, or the beneficiary is the employer or a charitable organization. In addition, insurance contributions under a qualified pension or profit-sharing plan are tax exempt.

RATIONALE

This program, by subsidizing the cost of life insurance, provides tax relief to policyholders and an incentive for employees and employers to incorporate life insurance coverage into their compensation packages. According to federal reports, the original rationale for the federal program (to which California conforms) was two-fold. First, it was believed that there were difficulties in properly apportioning group life insurance premium costs among individual employees, since premium costs depend on such factors as age, health, and related mortality factors. Second, it was believed that life insurance benefits would help keep family units intact upon death of the primary wage earner.

COMMENTS

Higher-income taxpayers benefit disproportionately under this program, both because of their higher marginal income tax rates and because employer-paid life insurance is most commonly provided for more highly compensated management-level employees.

Life insurance proceeds themselves are not taxed (see "Proceeds from Life Insurance and Annuity Contracts"). Thus, the provision of life insurance as a fringe benefit is completely tax exempt for many individuals. However, life insurance purchased by self-employed individuals, or by individuals whose employers do not make premium contributions, receive no tax break comparable to this program.

Exclusion/Exemption:

Proceeds from Life Insurance and Annuity Contracts

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17081, 17131, 17132.5, 24302, and 24305, which generally conform to Internal Revenue Code Sections 72 and 101.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	$690	$36
1997-98	710	36
1998-99	730	36

Description

This program generally allows an exclusion from gross income for proceeds received by a beneficiary from the life insurance policy of a deceased person. (Any *interest* component of such proceeds received as installments *is* taxable, however, and must be included in the recipient's gross income.) If the proceeds are received under circumstances other than death, then only the actual investment in the contract (for example, the aggregate premium and any other consideration paid) is excludable from gross income.

Beginning in 1991, Chapter 1387, Statutes of 1990 (AB 2663, Peace), makes amounts received under a "living benefits" contract excludable from gross income. These types of contract arrangements involve situations in which the insured, under a life insurance policy, has a catastrophic or life-threatening illness or condition. In such an event, the policy owner can give up or transfer the right to receive death benefits under the policy in exchange for compensation amounting to less than the death benefits.

Rationale

This program provides tax relief to persons who have been designated as beneficiaries of deceased persons' life insurance policies. To the extent that these beneficiaries were financially dependent on the deceased, the program helps to stabilize their economic situations. The program also provides financial relief to individuals receiving accelerated benefits due to catastrophic or life threatening illness, thereby helping them cope with the financial hardships that often are associated with such illnesses.

Comments

Higher-income individuals are likely to benefit disproportionately from this program, since insurance coverage tends to be positively correlated with income, and high-income taxpayers are in the highest marginal income tax brackets.

Due to a developing market involving the "sale" of insurance policies to investors, the rationale related to financial dependence of beneficiaries has been weakened. The sale of insurance policies generally requires that the investor pay the remaining premiums in exchange for being named the beneficiary of the policy. Proceeds received pursuant to the sale of an insurance policy would be subject to taxation.

With few exceptions, California has been in conformity with federal law since 1987.

Exclusion/Exemption:

INTEREST ON GOVERNMENT DEBT OBLIGATIONS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California State Constitution, Article XIII, Section 26(b), and California Revenue and Taxation Code Sections 17088, 17133, 17143, 17145, and 24272, which partially conform to Internal Revenue Code Sections 103 and 852.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	$320	Minor
1997-98	350	Minor
1998-99	380	Minor

DESCRIPTION

This program exempts from gross income the interest income earned on certain debt obligations issued by the U.S. government, territories of the United States, Puerto Rico, certain federal agencies, and California state and local government entities. The interest received from a mutual fund also is tax exempt if government obligations (those of California state and local governments and the federal government) comprise 50 percent or more of the fund's portfolio or of a series of assets within the portfolio. While the interest on qualifying debt obligations is tax exempt, any capital gains on the sale of such tax-exempt obligations must be reported as income.

The program applies to both PIT and the corporate *income* tax, but *not* to the corporate *franchise* tax.

RATIONALE

This program subsidizes the costs of governmental borrowing, by providing tax relief to investors who purchase qualifying debt obligations issued by California governments or by the federal government. This tax relief encourages investors to accept lower interest returns on these obligations which, in turn, reduces the debt-servicing costs of these debt-issuing governmental entities. In addition, the program provides an incentive for certain investors to purchase more government-issued debt than they otherwise would. As a result of these factors, governments are able to finance public outlays at lower costs than would otherwise prevail.

DISTRIBUTION OF BENEFITS

As shown in the accompanying table (see next page), the benefits from the program accrue disproportionately to high-income taxpayers. Over one-third of the claimed amount goes to the small fraction of the taxpayers earning in excess of $500,000 annually, and over one-half go to those earning more than $200,000. The average amount claimed for those in the highest income category is in excess of ten times that claimed by taxpayers in any of the lowest three income categories.

COMMENTS

The revenue figures shown above only include reductions due to outstanding California state and local obligations, and mutual fund pass-through interest dividends. No revenue-reduction amounts are included for federal debt obligations since, pursuant to the principle of "reciprocal immunity," states are prevented from taxing the interest on U.S. government debt obligations.

Interest on Government Debt Obligations Exclusion

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	9.6%	4.5%	$463
20-40	16.3	7.1	435
40-60	16.0	8.7	525
60-80	13.4	7.1	527
80-100	9.6	5.8	601
100-150	13.4	10.0	724
150-200	5.2	6.3	1,198
200-250	3.4	3.7	1,053
250-500	6.7	10.0	1,448
Over 500	6.5	36.8	5,614

The benefits of the tax exemption are worth proportionately more to taxpayers in higher tax brackets than those in lower tax brackets. This distinction is based on the notion of a *taxable yield equivalent,* or the effective (after tax) yield to the investor of an investment in tax-exempt securities. The taxable equivalent yield for a California municipal bond with an interest rate of 7 percent for a taxpayer in the 9 percent tax bracket would be 7.7 percent. For a taxpayer in the 2 percent bracket, however, the taxable yield equivalent would be only 7.1 percent. The greater benefits to higher-income taxpayers are even more pronounced at the federal level because of its higher marginal tax rates.

Despite the widespread use and long history of tax-exempt financing for government-issued debt, considerable controversy amongst public finance experts surrounds the continued broad-based use of programs like this. One reason for this involves the use of subsidized debt to finance projects which are not strictly "governmental" in nature, such as industrial projects and home purchases. In addition, many analysts view tax-exempt borrowing as an inequitable means of subsidizing governmental projects, since a disproportionate share of the foregone tax revenues flows to high-income investors. Finally, in order to generate sufficient market demand for the debt obligations, the interest rate on such debt is higher than the minimum required to ensure the participation of high-income taxpayers; consequently, many economists would argue that a more efficient means of aiding local governments is through various grant and loan programs. For a discussion of these and other related issues regarding this program, see *The Use of Tax-Exempt Bonds in California: Policy Issues and Recommendations,* Legislative Analyst's Office, State of California, December 1982.

Exclusion/Exemption:

COMPENSATION FOR INJURIES OR SICKNESS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 104.

Estimated Revenue Reduction (In Millions)

Fiscal Year	PIT
1996-97	$130
1997-98	135
1998-99	140

DESCRIPTION

This program allows taxpayers to exclude from their gross income the compensation they receive from workers' compensation, accident insurance, and health insurance, due to injuries or sickness. The exemption also covers the amount of any compensatory damages awarded for injury or sickness, regardless of whether the award is made under an in-court or out-of-court settlement, or whether the taxpayer receives a lump-sum award or installment payments. Punitive damages, however, are taxable. In addition, certain amounts paid by an employer to reimburse an employee for expenses incurred for the care of the employee, the employee's spouse, or the employee's dependents are excluded from taxation.

RATIONALE

This program provides tax relief to qualified taxpayers on the grounds that injuries or sickness often impose significant economic hardship, and can limit the ability of individuals to pay for such basic necessities as housing, food, and clothing. Under these conditions, taxes on compensation for injuries or sickness are viewed as a particularly onerous burden.

COMMENTS

This program covers the disability benefits received under state statute, but does not apply to amounts received as reimbursement for medical expenses claimed as income tax deductions in prior years.

Exclusion/Exemption:
EMPLOYEE DEATH BENEFITS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17131,17132.5, and 17132.6 which generally conform to Internal Revenue Code Section 101(b).*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***PIT***
1996-97	*$2*
1997-98	*2*
1998-99	*2*

DESCRIPTION

This program allows tax-exempt treatment for the qualified employer-provided death benefits of employees deceased *prior* to August 21, 1996, by allowing beneficiaries to exclude from their income for tax purposes up to $5,000 of noninterest-related death benefits they receive. Formerly, certain noninterest-related amounts paid by an employer to an employee's beneficiaries on account of the employee's death were nontaxable up to a total amount of $5,000, regardless of the number of employers involved. This $5,000 exclusion, however, was repealed in 1997 for both California and federal tax purposes for deaths occurring after August 20, 1996. The exclusion program continues for survivor benefits paid under certain circumstances (see "Comments").

RATIONALE

This program provides tax relief to a qualified decedent's beneficiaries with the original rationale apparently being that death benefits often are used by such individuals to adjust to the economic hardships caused by the death of decedents, and/or to cover the death-related expenses they may face (such as burial costs). However, the fact that the program no longer applies to new decedents (except as noted below), suggests that this original rationale is no longer viewed as sufficient to justify the program.

COMMENTS

Federal changes embodied in the Taxpayer Relief Act of 1997 included a provision that excludes from gross income certain survivor benefits paid as an annuity to the immediate family of a public safety officer killed in the line of duty. California incorporated this provision as a federal conformity measure through Chapter 322, Statutes of 1998 (AB 2797, Cardoza), with an effective date of January 1, 1998.

Exclusion/Exemption:
MEALS AND LODGING FURNISHED BY AN EMPLOYER

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 119.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	$24
1997-98	24
1998-99	24

DESCRIPTION

This program allows the exclusion from gross income of the value of meals and lodging furnished by an employer (other than the military) to an employee, spouse, or dependent. To qualify for the exemption, the meals or lodging must be provided at the employer's place of business and for the convenience of the employer. In addition, for the value of lodging to be exempt, the taxpayer must be required to accept the employer-provided lodging as a condition of employment. This means that the taxpayer must accept the lodging in order to fulfill the requirements of the job.

RATIONALE

This program provides tax relief to taxpayers who are required to live in or eat at facilities which are owned by their employers. The primary rationale for the program is to simplify tax administration. For example, the value to an employee of employer-provided meals or lodging is often difficult to establish.

In addition, the lodging provided by an employer may simply duplicate rather than substitute for private quarters, in which case its value to the employee could be negligible.

COMMENTS

In some cases, such as a live-in housekeeper or resident apartment manager, employer-furnished meals and lodging may represent a large portion of the employee's total compensation. To the extent that the employee's regular wages are lower as a result of this program, the government ends up subsidizing occupations that are characterized by such forms of compensation.

The program also provides an incentive for employers and employees to rely more than they otherwise would on such nonwage compensation, since the after-tax value of a dollar of this form of nonwage income is greater than that of a dollar of regular taxable wage income.

Exclusion/Exemption:

MISCELLANEOUS FRINGE BENEFITS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17131, which partially conforms to Internal Revenue Code Section 132.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$185
1997-98	200
1998-99	210

DESCRIPTION

This program provides a tax exemption to employees for specified types of employer-paid fringe benefits that they may be receiving. These benefits include: (1) special services provided to employees at no direct cost to them (such as free stand-by flights provided by airlines to their employees); (2) employee discounts for products and services sold by the employer; (3) use of company equipment (such as a company car); and (4) "de minimis" fringe benefits (such as personal use of an employer's copying machine or use of on-premises eating or gymnasium facilities).

RATIONALE

The rationale for this program depends on the type of fringe benefit involved. For instance, program supporters argue that the exemption for employer-provided gymnasium facilities is intended to provide employers with an incentive to improve the well being and productivity of their employees. The rationale for the exemption of certain other benefits often appears to be based primarily on administrative considerations, such as the difficulty of determining the value to individual employees of the specific benefit involved.

Exclusion/Exemption:

SCHOLARSHIPS, FELLOWSHIPS, AND GRANTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 117.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	$24
1997-98	27
1998-99	31

DESCRIPTION

This program allows taxpayers to exclude from gross income any qualifying scholarships, fellowships, and tuition grants or reductions they receive that are used for qualified educational expenses. This includes tuition and fees for enrollment and attendance at an educational institution, as well as fees, books, supplies, and equipment required for educational courses. The exclusion does not, however, apply to the portion of the scholarships, fellowships, and grants which is used to pay for room and board.

RATIONALE

The rationale for the tax relief that this program provides to the recipients of scholarships, fellowships and grants appears to relate to the problem of uniformity in the treatment of different taxpayers. According to federal sources, the related federal tax-exclusion program (to which California's program conforms) initially required that all scholarship, fellowship and grant income be included as gross income, unless the taxpayer could show that it was a gift (this is because gifts are nontaxable, as specified). However, when the Internal Revenue Code of 1954 was enacted, the present program was adopted on the grounds that it would treat all taxpayers consistently and uniformly, and eliminate the need to determine whether a "gift" was involved. Thus, the rationale for the program is that it provides equity among different taxpayers and is administratively convenient.

Another rationale offered by the program's proponents is that recipients of scholarships, fellowships and grants often are students who have limited economic resources of their own. Thus, the program helps relieve some of the economic difficulties they face and thereby encourages increased educational attainments in our society.

COMMENTS

The program applies to amounts received for such incidental expenses as travel, research, clerical assistance, and equipment, but does not apply to amounts received for teaching, research work, or similar services. In many cases the value of scholarships, fellowships, and grants is small enough that the recipients, who frequently are students with only limited outside income, would have little or no tax liabilities in the program's absence.

Exclusion/Exemption:
STATE LOTTERY WINNINGS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Government Code Section 8880.68.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	$27
1997-98	27
1998-99	28

DESCRIPTION

This program exempts from gross income any winnings from the California State Lottery.

RATIONALE

This program presumably was intended to provide a tax incentive for individuals to participate in the state lottery. It does this by increasing the "take-home" value of winnings from lottery wagering.

COMMENTS

This program was established in November 1984 by Proposition 37, which enacted the California State Lottery Act of 1984.

State lottery winnings are subject to federal income taxation, to the extent that they exceed lottery wagering losses. Gambling winnings other than lottery winnings are subject to both state and federal income taxation, to the extent that they exceed gambling losses.

Exclusion/Exemption:

INCOME FROM INVESTMENTS IN ECONOMICALLY DEPRESSED AREAS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17231, 17233, 24384.5, and 24385.*

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

This program exempts from gross income the interest received from investments made in state-designated economically depressed areas, including Enterprise Zones and the Los Angeles Revitalization Zone (LARZ). For example, the interest income from a loan to a business that expands its operations in an Enterprise Zone area is tax-exempt. The loan must be used solely in connection with activities within an Enterprise Zone or LARZ, and the taxpayer must have no equity or ownership interest in the business(es) involved.

RATIONALE

This program provides an incentive for investments to be made in economically depressed areas of the state, by increasing the after-tax investment return that taxpayers can earn on loans to businesses which are located in such areas. Proponents argue that this increased rate of return may be necessary to induce investments in areas where such investments are perceived to face higher-than-average financial risks.

COMMENTS

In recent years, over two-thirds of all states have enacted some form of tax incentives for businesses operating in economically depressed areas. These incentives differ widely in their purpose and coverage. Some of the tax incentives currently made available by states include tax exemptions for businesses investing capital within a designated geographic area or zone, income tax credits based on the number of eligible employees hired by businesses in these locales, and property tax abatement programs for land and structures in such areas.

The problems of economically disadvantaged areas can take many forms, including a declining or stagnant base of economic activities, an inadequately trained or skilled labor force, a dilapidated public infrastructure involving poor-quality educational and transportation facilities, and a depressed private infrastructure involving run-down business and residential structures.

Arguments in Support. Supporters of this program argue that, given such factors, these geographic areas are worthy of financial subsidies, at least to "put them on track" to eliminate these adverse conditions. In addition, supporters argue that there often is evidence of some type of "market failure" that makes it especially difficult for these areas to deal with their problems—including imperfect information among investors about the positive investment opportunities that these areas may offer. Thus, supporters argue, government should "get involved" to help to correct these areas' problems. They note that the benefits to be realized from such involvement include both private-sector economic gains and public-sector improvements, such as reduced crime.

Other supporters argue that, while market failures may be important to address, the program can be justified on equity grounds alone. According to this view, government-provided incentives to businesses in depressed areas can result in greater economic opportunities for the people residing in them, thereby benefitting both individual residents and the public generally.

Arguments Against. Critics of this program argue that it is an ineffective and inefficient means of stimulating new economic activity, and that it simply encourages relocation of *existing* businesses to the designated areas as opposed to the creating of truly "new" enterprises. This view holds that a "zero-sum" game is involved, with such tax incentives benefitting certain localities at the expense of others. Some critics go even further, arguing that the tax incentives represent such a small part of the cost calculation for a business that they simply constitute a "windfall benefit" for business behavior that would have occurred anyway.

Given the above, the controversy about the program's merits seems to largely revolve around the geographic scope of the program's evaluation, for example, whether the focus is on the economic effect on the targeted impact area *alone* or the change in the level of economic activity for the state or a region as a *whole*. Supporters argue that even if the program does not increase economic activity for the state generally, it still is justified on distributional grounds if it benefits a particular disadvantaged area. They also note that there may be efficiency gains resulting from relocating investment from high-employment labor markets to low-employment labor markets, as otherwise under-utilized resources are tapped.

Empirical Evidence. Empirical evidence is mixed as to the efficiency and effectiveness of this and similar programs. For example, in *What Do We Know About Enterprise Zones?* (Tax Policy and the Economy, Volume 7, National Bureau of Economic Research, 1993), evidence is presented of increased investment and reduced unemployment claims within enterprise zones in Indiana. Also, a report prepared for the New Jersey Department of Commerce that surveyed firms receiving such tax incentives found that about one-third said they were the sole or major factor in their investment decision (see Rubin and Armstrong, *The New Jersey Enterprise Program: An Evaluation*, 1989). However, data from the U.S. Census Bureau indicates that the economic well-being of enterprise zone residents has not significantly improved since the zones were established.

The California Bureau of State Audits (BSA) conducted a review of the effectiveness of the employment and economic incentives of California enterprise zones and program areas (a former state program). Based on statistics provided by the California Employment Development Department, the BSA found that business and job growth in the enterprise zones and program areas generally exceeded the growth in the counties in which they were located. However, the BSA was unable to determine whether this growth was the result of tax incentive programs per se versus other factors (see California Trade and Commerce Agency, *The Effectiveness of the Employment and Economic Incentive and Enterprise Zone Programs Cannot Be Determined*, November 1995).

Exclusion/Exemption:
FOSTER CARE PAYMENTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which partially conforms to Internal Revenue Code Section 131.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**PIT**
1996-97	$2
1997-98	2
1998-99	2

DESCRIPTION

This program allows taxpayers to exclude from gross income the payments they receive from state, local, and nonprofit agencies as reimbursement for the costs of taking care of a foster child. To qualify, a foster child must live in the taxpayer's home.

RATIONALE

This program provides an incentive for individuals to take on the responsibilities of caring for foster children. The payments and tax exclusion are intended as compensation for and to cover expenses associated with foster care.

COMMENTS

Supplemental payments made by the state or a tax-exempt child-placement agency as "difficulty-of-care payments," are also excludable from gross income for tax purposes. These are intended as compensation for the additional expense associated with the care of a foster child with a physical, mental, or emotional handicap.

Exclusion/Exemption:
EMPLOYEE RIDESHARING BENEFITS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17090 and 17149, which partially conform to Internal Revenue Code Section 132.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows taxpayers to exclude from their gross income the compensation or any other benefits they receive from an employer for their costs of participating in a qualified ridesharing program. The exemption covers compensation or other benefits received for commuting in a third-party vanpool, private commuter bus, or subscription taxipool, and for monthly transit passes that are used by an employee or the employee's dependents. It also covers such benefits as carpooling, free or subsidized parking, bicycling, ferry use, travel to or from a telecommuting facility, and any alternative transportation method that reduces the use of motor vehicles in traveling to or from a place of employment.

RATIONALE

This program provides tax relief to employees who participate in ridesharing programs, and an incentive for employers to make ridesharing benefits a part of their employees' overall compensation. The program's underlying rationale is based on the view that state tax incentives are needed to encourage employees and employers to use ridesharing programs as a means of alleviating traffic congestion and reducing air pollution.

COMMENTS

The exemption provided by this program originally was established by Chapter 25, Statutes of 1982 (AB 548, Ryan), and was allowed for income years 1981 through 1985. Chapter 1444, Statutes of 1986 (SB 1794, Beverly), which extended the exemption through 1990, was repealed in 1987. The current program was enacted by Chapter 1437, Statutes of 1988 (SB 1904, Morgan).

Exclusion/Exemption:

EMPLOYEE CHILD AND DEPENDENT CARE BENEFITS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which partially conforms to Internal Revenue Code Section 129.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$28
1997-98	31
1998-99	34

DESCRIPTION

This program allows taxpayers to exclude from their gross income the compensation or other benefits they receive from an employer for qualified child and dependent care services. In addition to exempting these employer-provided benefits, an employee may exempt the amount of child and dependent care benefits received through a salary-reduction agreement entered into with an employer. In this case, the employee elects to receive a salary reduction in the amount of the additional employer-paid child or dependent care benefits.

RATIONALE

This program provides tax relief for employees who receive child and dependent care benefits through either of the methods above, and an incentive for employers to make such benefits a part of their employees' overall compensation package. The program's underlying rationale is that it benefits society as a whole in several ways. One of these ways, proponents argue, is through increased labor output and productivity, which occurs because the availability of child care enables more individuals to work and reduces employee absenteeism and turnover. Another cited benefit of the program is a reduction in the need for government-provided child care programs.

COMMENTS

This program covers payments or services provided by the employer for child or dependent care services, which enable or assist the taxpayer to work. To qualify for the program, the assistance must be provided under a plan that does not discriminate in favor of officers, owners, or higher-paid employees, and which meets various other requirements.

Federal tax law, to which California conforms, limits the exclusion for employee child care benefits (both those paid by the employer and those provided through employee salary reductions) to $5,000 per year ($2,500 in the case of married individuals who file tax returns separately from their spouse), beginning in 1987. Individuals are allowed to use this income exclusion in conjunction with the tax credit for child and dependent care expenses.

Exclusion/Exemption:

TAX-EXEMPT STATUS FOR QUALIFYING CORPORATIONS

Program Characteristics	
Tax Type:	Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 23701 through 23710.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	BCT
1996-97	$92
1997-98	97
1998-99	99

DESCRIPTION

This program allows an exemption from the BCT franchise and income taxes for the income of qualifying tax-exempt nonprofit and charitable organizations. (The BCT *franchise* tax is levied against all banks and corporations doing business in the state. In contrast, the BCT *income* tax is imposed on banks and corporations that do not do business in the state, but which have income from California sources, such as holding companies and firms engaged only in interstate commerce.)

This exemption extends to the minimum franchise tax imposed on corporations which otherwise would have a tax liability less than that amount. Qualifying organizations are still subject to taxes on "unrelated business income," which includes income associated with activities that are not directly related to their tax-exempt status. For example, a church would have to pay taxes on the income earned from the lease of its personal property to a business, even though its income from religious-related activities would be tax exempt.

RATIONALE

This program provides tax relief to organizations which are engaged in various charitable, or otherwise not-for-profit, activities. The tax-exempt status generally applies to nonprofit religious, charitable, educational, and scientific organizations. Certain homeownership organizations, civic and business organizations, and financial cooperatives also qualify for tax-exempt status. The commonly cited rationale for exempting such organizations from taxation is that they provide social benefits which are worthy of indirect public financial support.

Exclusion/Exemption:

Recycled or Redeemed Beverage Container Redemption Payments

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17153.5 and 24315.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

Description

This program allows taxpayers to exclude from gross income the amounts they receive for returning recyclable beverage containers to state-designated recycling centers.

Rationale

This program provides an incentive for taxpayers to return beverage containers to recycling centers. The program's underlying rationale is that resource conservation and litter reduction are worthy of public financial support.

Comments

This program was enacted by Chapter 1290, Statutes of 1986 (AB 2020, Margolin), which established a statewide recycling program for certain types of beverage containers. The program's exclusion covers the amounts that a taxpayer receives as a refund/redemption value. The term "refund value" refers to the minimum refundable value established by the California Department of Conservation (DOC) for each type of beverage container. Generally, the current refund value is 2.5 cents per container.

Exclusion/Exemption:
BENEFITS PROVIDED UNDER CAFETERIA PLANS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which generally conforms to Internal Revenue Code Section 125.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$170
1997-98	195
1998-99	220

DESCRIPTION

This program allows employees to exclude from their gross income benefits received from cafeteria plans. Such cafeteria plans are employer-sponsored benefit packages that offer employees a choice between taking monetary compensation or qualified benefits. The employee is allowed to choose among the "qualified benefits" that a particular employer's plan offers, which can include such benefits as accident and health coverage, group-term life insurance coverage, or child and dependent care benefits. Qualified benefits cannot include deferred compensation plans, except for certain plans maintained by educational institutions. If the employee chooses to take monetary compensation instead of the qualified benefits, the monetary compensation must be included in gross income subject to taxation.

RATIONALE

This program creates an incentive for employers to provide, and employees to accept, contributions made to benefit plans in lieu of monetary compensation. This is because a given contribution amount to such a program is worth more to employees on an after-tax basis than an equivalent amount of taxable income. In addition, the program provides both employers and employees with an incentive to make these types of benefits a standard part of the employees' compensation package. The rationale advanced for the program is that it furthers a desirable social goal, because it improves workers' income security and reduces the need for governments to provide these benefit programs themselves.

COMMENTS

California has been largely in conformity with federal law regarding cafeteria plan benefits since 1987.

Exclusion/Exemption:

WATER'S-EDGE ELECTION

Program Characteristics	
Tax Type:	Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 25110 through 25112.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	BCT
1996-97	$335
1997-98	340
1998-99	355

DESCRIPTION

This program gives a unitary multinational corporation the option of computing its California taxable income on a "water's-edge" basis, which means the company's tax liability is determined on the basis of its United States income only, instead of on the basis of its worldwide income. (That is, nondomestic income may be excluded for tax-computation purposes.)

A qualifying water's-edge corporation is also allowed to deduct a percentage of its foreign dividends. Corporations electing to file on a water's-edge basis must do so for a seven-year period following the year of election.

RATIONALE

This program provides tax relief to multinational corporations by allowing them to compute their taxes using an alternative method. The net effect is that they are allowed to exclude the activities of foreign operations for the purposes of calculating California tax liabilities under BCT. One rationale for the program is that it is burdensome for some multinationals to keep track of all their worldwide income sources and amounts for the sole purpose of computing California's tax liability. The water's-edge election provides these corporations with an alternative that makes it easier and less costly for them to comply with California's tax laws, because it relies on the same information now required for federal tax purposes.

It also is argued by proponents that the worldwide method could result in an unfairly high allocation of income for California tax purposes, and that the water's-edge method reduces this distortion.

DISTRIBUTION OF BENEFITS

As shown in Figure 1, the benefits of the water's-edge election are claimed by a broad

Figure 1

Water's-Edge Election Tax Benefits by Receipt

1998 Income Year

	Percent of	
Total Receipts (In Millions)	Total Taxpayers Benefitting	Total Amount Claimed
Under $1	13.3%	0.1%
1–10	26.7	0.1
10–50	25.3	0.1
50–100	6.0	0.5
100–500	16.5	4.2
500–1,000	5.1	7.8
Over 1,000	7.2	87.4

spectrum of businesses, based on total receipts. However, total benefits accrue disproportionately to larger corporations. This is due to the fact that corporations with worldwide operations who can benefit from a water's-edge election tend to be large entities. Figure 2 indicates that the total benefits associated with the program accrue largely to manufacturing and to finance, real estate, and insurance enterprises.

Figure 2

Water's-Edge Election Tax Benefits by Industry

1998 Income Year

	Percent of		
Industry Type	Gross State Product	Total Taxpayers Benefitting	Total Amount Claimed
Agriculture, Forestry & Fishery	3.0%	0.9%	0.1%
Construction	3.8	0.8	0.1
Manufacturing	15.9	20.6	50.9
Services	25.1	13.1	0.2
Trade	18.2	45.1	1.1
Finance, Real Estate & Insurance	25.9	17.0	30.7
Utilities & Transportation	8.2	2.5	17.1

COMMENTS

This program was enacted by Chapter 660, Statutes of 1986 (SB 85, Alquist), and is applicable for tax years beginning in 1988.

Exclusion/Exemption:

LIMITED PARTNERSHIP INVESTMENT SOURCE RULES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17955.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$10
1997-98	10
1998-99	10

DESCRIPTION

This program exempts from taxation dividends, interest, or gains and losses from qualifying investment securities of limited partnership members who reside outside of California, and whose only contact with this state is through a broker, dealer, or investment advisor located in the state. "Qualified investment securities" include, but are not limited to, common stock, bonds, and mortgage-based or asset-backed securities.

RATIONALE

This program provides tax relief to members of limited partnerships residing outside of California that make use of investment services within the state, on the grounds that such activity does not constitute "doing business" in the state.

COMMENTS

Prior to this program, members of limited partnerships were subject to taxation on investment income because they were deemed to be "doing business" within the state, even though they did not physically reside in California. This increased the cost of using investment services in California, placing this industry at a comparative disadvantage in California relative to other states such as New York and Massachusetts, which had rules exempting limited partnership investment source-income from taxation.

Exclusion/Exemption:

CREDIT UNION TREATMENT

Program Characteristics	
Tax Type:	Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Section 23153.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	BCT
1996-97	$13
1997-98	13
1998-99	13

DESCRIPTION

This program exempts credit unions and nonprofit cooperative associations from the state minimum franchise tax. This is the amount that a corporation must pay, regardless of income. It is currently $800 for most corporations, although new, small corporations pay a lower minimum franchise tax.

RATIONALE

This program provides tax relief to credit unions and nonprofit cooperative associations, based on the rationale that the primary goal of these organizations is to provide low-cost financial services to members who might not otherwise have access to such services.

COMMENTS

While credit unions and nonprofit cooperative associations are exempt from any minimum franchise tax, credit unions must prepay a tax of $25 when they incorporate under the laws of California, or when they qualify to transact business in California.

Exclusion/Exemption:

SMALL BUSINESS ALTERNATIVE MINIMUM TAX

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17062,17309, 23036, 23453, 23455 through 23457, and 23459, which generally conform to Internal Revenue Code Sections 55 through 59.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

For certain businesses and individuals which have large amounts of deductions, credits, exemptions, and exclusions, the Alternative Minimum Tax (AMT) may limit the amount of these "tax preference" items that may be claimed, or may impose an additional tax or limit tax credits receivable to ensure that these taxpayers are not receiving more than a "reasonable" amount of benefits from these preference items. This program exempts certain small businesses from the state AMT.

To qualify for this treatment, the taxpayer must (1) own or have ownership interest in a trade or business, and (2) have aggregate adjusted gross receipts of less than $1 million from these trades or businesses. Proportionate interest in a partnership, regulated investment company, real estate investment trust, and real estate mortgage investment conduit are includable in the gross receipt totals.

RATIONALE

This program provides tax relief to qualified small businesses, thereby increasing their economic viability. The rationale is based on the belief that encouraging the development of small business helps the vitality of state and local economies.

Exclusion/Exemption:

TUITION REDUCTION OR WAIVER

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 117(d).*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*PIT*
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

DESCRIPTION

This program allows an exclusion from gross income for tuition reductions or waivers received by an employee of a qualified educational institution for undergraduate education provided to the employee, the employee's spouse, or dependent children. It also provides tuition reductions or waivers for graduate education of the employee, who must be engaged in teaching or research activities for the qualifying educational institution.

The educational institution may provide the tax-exempt tuition reduction or waiver only if it does not discriminate in favor of highly compensated employees. A qualified educational institution must maintain a regular faculty and curriculum, and have a regularly enrolled student body in attendance at the institution.

RATIONALE

This program provides tax relief to university and college employees based on the rationale that individuals in these occupations should be provided additional public support for their activities and because of the perceived importance of education. Schools have argued for the exemption as an added benefit to attract and maintain highly sought-after employees, who otherwise might be hired at other universities or by private sector companies. (This reasoning, however, does not provide a rationale for *public* financial support of this program.)

COMMENTS

On several occasions in the late 1970s and early 1980s, the Internal Revenue Service (IRS) and some Members of Congress attempted to review or repeal this program, but met with strong resistance. As a method of curbing its use, the federal government restricted the use of the tax-exempt tuition reduction to undergraduate education only, except in the case of an employee who is concurrently attending graduate school.

Due to rising costs in recent years, some universities have limited the amount of tuition reduction to new employees as a means of cutting costs; however, many still provide a full tuition waiver.

Exclusion/Exemption:

Scholarshare Trust Income

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17140, 23735, 24306, and 24328.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	—
1997-98	Minor
1998-99	$1

Description

The Golden State Scholarshare Trust program was established by the state to encourage families to save for the post-secondary education expenses of their children. Contributions under a Scholarshare Trust Account are not included for state tax purposes in gross income. Earnings on contributions under the Scholarshare Trust Account are not taxable when earned, but rather included in the beneficiaries' gross income upon distribution for educational purposes.

Contributions to and earnings on the trust must be used for qualified higher education expenses at a public or private post-secondary institution, including the following: tuition, fees, books, supplies, and (in most cases) room and board. Maximum contributions to the Scholarshare Trust Account are limited to estimated qualified expenses that can be incurred for a designated beneficiary to obtain a baccalaureate degree at an institution of higher education in California within four years.

Rationale

This program is one of several incorporated into state law that makes it financially easier for families to afford to send their children to colleges, universities, or other post-secondary educational institutions. The underlying rationale is that higher education is worthy of public financial support.

Comments

While the major thrust of this program is to make it easier for households to pay for post-secondary education, there are broader issues associated with this program. In particular, if there exist *social* benefits to post-secondary education in addition to *private* benefits, a less-than-optimal amount of education may result in the absence of programs like this. Since the after-tax price of post-secondary education is lowered through this program, it would typically be expected to result in an increase in the amount of education undertaken.

Some argue that sufficient public support for higher education already occurs and that programs such as this may actually stimulate consumption in excess of the appropriate amount.

Exclusion/Exemption:

Capital Gains on Small Business Stock

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 18152.5, which partially conforms to Internal Revenue Code Section 1202.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	—
1997-98	—
1998-99	$15

Description

This program provides a PIT exclusion for 50 percent of the gain from the sale or exchange of qualified small business stock that is held for more than five years. The amount of the exclusion may not exceed the greater of the following (for a married couple filing a joint return) (1) $10 million, or (2) ten times the amount of the qualified small business stock under specified conditions. These amounts are halved for single taxpayers. The stock must be issued by a C corporation between January 1, 1993 and January 1, 1999 in order to qualify for the exclusion.

Qualified stock must be issued by a corporation with less than $50 million in total gross assets (before and after the stock issuance), and 80 percent of its total dollar payroll must be attributable to employment in California. "Qualified businesses" are those where at least 80 percent of the business assets are used to conduct qualified business or trade activities. Qualified business, in general, does not include professional or financial services or the hospitality industry. The measure was designed primarily to promote startup operations in manufacturing and related activities.

Rationale

The program was conceived of as a means by which small businesses in particular industries could gain access to the capital markets more easily than they otherwise would. Small, new or expanding businesses may face more substantial hurdles in raising funds for growth than large business entities. This program represents an effort to reduce the costs of access to required financial capital.

Comments

The federal government also has a PIT exclusion for 50 percent of small business stock gains held for five years or more. The design of the state's provision was largely based on the federal law but does not incorporate certain of its provisions including the rollover of capital gains.

The small business stock exclusion, which results in a reduction in capital costs, represents an attempt to address what are perceived as multiple issues relating to small businesses. These issues may stem from market failure of some type, but may also relate to the achievement of other social goals. For example, some argue that small businesses and industries face a capital shortage; that, for some reason, insufficient funds are being channeled to small businesses. This may be due to insufficient or inaccurate information, or an aversion to perceived high-risk ventures. Some feel that by increasing the return to investors, additional capital can be channeled into the small business sector.

Other proponents suggest that the cost of capital itself is the problem, and that a subsidy is necessary for small business start-ups and expansions to be viable. Finally, some supporters take the view that small businesses are worthy of special support, perhaps because they may be more labor intensive than larger businesses, or because small businesses tend to be a substantial source of product development and innovation.

Economists differ, and empirical evidence is inconclusive, regarding the validity of some of the claims regarding the positive aspects of small business activities or the existence of capital shortage for this sector. Even if the justifications given for the program are accurate, there may exist alternative ways to assist small business enterprise.

Adjustment:

CONTRIBUTIONS TO INDIVIDUAL RETIREMENT ACCOUNTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17085, 17201, 17203, 17210.6, 17501, 17504 through 17509, 17551, and 17554, which largely conform to Internal Revenue Code Sections 219 and 408.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$51
1997-98	57
1998-99	62

DESCRIPTION

This program allows a deduction when computing adjusted gross income (AGI) for contributions to a taxpayer's Individual Retirement Account (IRA). The annual maximum deduction permitted is the lesser of $2,000 or 100 percent of the individual's compensation. A nonworking spouse may make a deductible IRA contribution of up to $2,000. The maximum aggregate contribution for a married couple is the lesser of $4,000 or 100 percent of their combined compensation.

If a taxpayer is a participant in an employer-sponsored retirement plan, the above deduction limitation is gradually reduced and then eliminated at a certain point. For the 1998 tax year, taxpayers who belong to employer-established pension programs can claim the full deduction, provided their AGI is below $30,000 for single filers, and $50,000 for married joint-return filers. For incomes above these amounts, the deduction is gradually phased-out, and then eliminated altogether for taxpayers whose AGI exceeds $40,000 for single filers and $60,000 for married joint-return filers.

RATIONALE

This program provides an incentive for taxpayers to save for retirement. It does this by permitting taxpayers to defer taxes on IRA contributions until they are withdrawn (after age 59½), thereby increasing the investment earnings on such monies.

In addition, the program provides tax relief to IRA account owners, to the extent that their marginal income tax rates are lower when they retire compared to when they are working.

COMMENTS

California has generally been in conformity with federal law regarding deductions for IRA account contributions since 1987. The state incorporated changes made at the federal level for tax years beginning in 1996 regarding maximum deductible contributions.

Adjustment:

Contributions to Self-Employed Retirement Plans

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17501, 17504, 17506, and 17507, which generally conform to Internal Revenue Code Sections 219, 401 through 404, 408, and 415.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$145
1997-98	155
1998-99	170

Description

This program allows a deduction when computing adjusted gross income (AGI) for a taxpayer's contributions to a self-employed retirement plan (these plans are usually referred to as "Keogh" plans).

For defined contribution plans, the deduction is limited to the lesser of $30,000 or 25 percent of earned income. For defined benefit plans, the annual normal retirement benefit limitation is the lesser of $90,000 or 100 percent of average compensation for the highest three consecutive years of active plan participation. The $90,000 limitation is adjusted annually based on the cost of living; for 1998, this adjusted figure was $130,000. California law requires that amounts used as earned income for federal income tax purposes must also be used for state income tax calculations.

Rationale

This program provides self-employed individuals an incentive to save for retirement, by granting them the same basic type of tax deferral that is available to individuals who are covered by employer-established retirement programs.

Distribution of Benefits

The accompanying table indicates that taxpayers receiving benefits from this program are broadly distributed across the income spectrum. However, the majority of benefits accrue to those in the upper-income categories, with almost 80 percent of amounts claimed by taxpayers earning more than $100,000. Average benefits also increase as income increases throughout most of the income spectrum.

Contributions to Self-Employed Retirement Plans Adjustment

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	1.6%	0.1%	NA
20-40	6.3	1.2	$167
40-60	11.0	4.1	333
60-80	14.1	8.1	519
80-100	11.5	7.5	591
100-150	19.9	18.5	842
150-200	11.0	16.2	1,333
200-250	6.3	12.1	1,750
250-500	12.6	23.1	1,667
Over 500	5.8	9.3	1,455

COMMENTS

In general, no distinction is made between (1) pension, profit-sharing, and other retirement plans, including simplified employee pension plans established by corporations; and (2) plans established by self-employed individuals and partnerships. In addition, contributions and deductions for a self-employed participant in a qualified plan are limited in the same way as those of an employee participant. California has been largely in conformity with federal law in this area since 1987.

Adjustment:

CONTRIBUTIONS TO EDUCATION INDIVIDUAL RETIREMENT ACCOUNTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17085, 17201, 17210.6, 17501, and 17505 through 17509, which generally conform to Internal Revenue Code Sections 219 and 408.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	—
1997-98	$1
1998-99	7

DESCRIPTION

This program allows for an exclusion from gross income when computing adjusted gross income (AGI) for earnings on contributions to an Individual Retirement Account (IRA) established for the purpose of funding a child's post-secondary educational expenses. Under the program, up to $500 per child, per year may be contributed to an educational IRA, effective for tax years beginning after 1997. Earnings on contributions are distributed tax-free provided that they are used for the purposes of the child's qualified post-secondary education expenses.

Qualified expenses include tuition, fees, books, supplies, equipment, and (in most cases) room and board. The program is available for taxpayers with modified AGI of up to $150,000 (joint returns) and $95,000 (single taxpayers). The program is phased out for filers with modified AGI between $150,000 and $160,000 (joint returns) and $95,000 and $110,000 (single taxpayers).

RATIONALE

This program provides favorable tax treatment of investment earnings specifically set aside for a child's post-secondary education. Although contributions to the education IRA themselves are not deductible from income, the incentive to earmark savings for educational purposes involves recognition of the high costs of education and the necessity of post-secondary education for many careers. Proponents argue that encouraging such behavior is deserving of public support.

COMMENTS

California generally conforms to federal tax law with regard to education IRAs.

Adjustment:

MEDICAL SAVINGS ACCOUNTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17201, 17215, and 24343.3, which generally conform to Internal Revenue Code Sections 106, 138, and 220.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	$4	NA
1997-98	8	NA
1998-99	10	NA

DESCRIPTION

This program allows small business employers and self-employed individuals to create tax-favored Medical Savings Accounts. In general, employer or employee contributions are limited to 65 percent of the annual health insurance deductible for taxpayers with individual insurance coverage. The comparable limitation for taxpayers with family coverage is 75 percent.

Employer contributions are excluded, and employee contributions deductible, from the employee's income for tax purposes. Any earnings accumulated in the Medical Savings Account are tax-free. Contributions and earnings placed in this account may be withdrawn for medical purposes without penalty. Withdrawals made for other purposes may be subject to tax, as well as a penalty, under certain circumstances.

RATIONALE

This program provides an incentive for taxpayers to save for medical treatment and emergencies. It does this by permitting taxpayers to defer taxes on their Medical Savings Account contributions and for employers, to deduct contributions made to employee accounts.

COMMENTS

This program provides a "double" tax incentive. First, it lowers the adjusted gross income of taxpayers by exempting from income all of the *contributions* they make towards their Medical Savings Account. Second, it does not tax *earnings* accumulated or *withdrawals* made for medical purposes.

Adjustment:

MOVING EXPENSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17072, 17076, 17084, 17134.5, 17201, and 17218, which conform to Internal Revenue Code Sections 62, 67, 82, 132, and 217.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$20
1997-98	20
1998-99	20

DESCRIPTION

This program allows taxpayers an above-the-line deduction when computing their adjusted gross income (AGI) for the qualified moving expenses they incur, associated with beginning a new job in a new location. Only those expenses that are not paid or reimbursed by the employer are deductible. The allowable expenses taken as a deduction in calculating AGI are those direct expenses associated with relocation, but specifically excluding: (1) meals consumed while traveling and living in temporary quarters near the location of new employment; (2) preliminary house-hunting travel prior to the move; (3) temporary living expenses for up to 30 days in the general location of new employment; and (4) lease expenses associated with the new or old residence.

In order for the taxpayer to claim the deduction, the move must meet two basic tests—a distance test and a time test. The *distance* test requires that the taxpayer's new employment must be at least 50 miles further from the taxpayer's old residence than the former place of employment was from the taxpayer's old residence. The *time* test requires that the taxpayer be employed on a full-time basis at the new location for at least 39 weeks during the 12-month period following the move. Self-employed individuals must work in the new location for at least 78 weeks during the two years following the move in order to claim the deduction.

RATIONALE

This program provides tax relief to individuals whose employment requires that they relocate. The basic rationale is that such moving expenses actually are a type of employee business expense that is necessary in order to earn income, and that employees often have little control over incurring such expenses.

Adjustment:

HEALTH INSURANCE PREMIUMS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17270, and 17273, which partially conform to Internal Revenue Code Section 162.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	*PIT*
1996-97	*$34*
1997-98	*46*
1998-99	*50*

DESCRIPTION

Under this program, self-employed taxpayers are allowed to deduct a percentage of the costs they incur for health insurance premiums for themselves and their families, not to exceed the taxpayer's earned income from his/her trade or business. California law allows self-employed taxpayers to deduct 40 percent of their costs for health insurance premiums. This deduction may be taken regardless of whether the taxpayer itemizes deductions.

RATIONALE

The purpose of this program is to encourage taxpayers to provide health insurance for themselves and their families. The program's rationale reflects the view that self-employed individuals incur these business-related expenses which can be treated in the same fashion as business-related expenses incurred by larger corporations.

COMMENTS

Federal tax law increased the deductible percentage for health insurance premiums from 25 percent to 30 percent for tax years beginning after 1994. The percentage deduction for federal purposes increases to 40 percent for the 1997 tax year and then increases further at fairly regular intervals thereafter until the deductible percentage reaches 100 percent for tax years beginning after 2006.

For tax year 1997, the California deductible percentage was 40 percent, with the amount scheduled to decline to 25 percent for subsequent tax years. However, under Chapter 322, Statutes of 1998 (AB 2797, Cardoza) and Chapter 323, Statutes of 1998 (AB 2798, Machado), the 40 percent deductibility is scheduled to continue.

Adjustment:

EMPLOYEE CONTRIBUTIONS TO QUALIFIED RETIREMENT AND SALARY REDUCTION PLANS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17501, which conforms to Internal Revenue Code Sections 401 through 404a, 408, and 457.*

Estimated Revenue Reduction *(In Millions)*	
Fiscal Year	***PIT***
1996-97	—
1997-98	—
1998-99	—

DESCRIPTION

This program allows an exclusion from gross income for a taxpayer's contributions to a qualified employer-sponsored retirement plan, a simplified employee pension plan (SEP), or a cash or defined-arrangement plan (CODA) such as a 401(k), 403(b), or 457 plan. Taxpayer contributions to a CODA are limited annually and vary by type of plan.

RATIONALE

This program provides individuals with an incentive to participate in employer-sponsored retirement plans and salary reduction plans, by permitting them to defer taxes on their contributions until they are "withdrawn" as benefits after retirement. This deferral reduces the cost of funding a specified level of retirement benefits, because the present value of taxes paid upon the withdrawal of benefits is less than the present value of the taxes that would be paid when the contributions are made, due to such factors as inflation. In addition, the program provides a further tax reduction to such individuals to the extent that their marginal income tax rates are lower when they retire and receive retirement distributions compared to when they made the contributions.

COMMENTS

The revenue effects of this program are included in those for the program "Employer Contributions to Pension Plans." California has generally been in conformity with federal law since 1987. See comments under "Employer Contributions to Pension Plans."

Deduction:

STANDARD DEDUCTION

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17041, 17073, and 17073.5.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	PIT
1996-97	$840
1997-98	910
1998-99	950

DESCRIPTION

This program allows taxpayers who do not itemize their income tax deductions to claim a standard deduction. The deduction amount for the 1998 income year was $2,642 for single-return taxpayers and $5,284 for joint-return taxpayers. The standard deduction is indexed annually for inflation, as measured by the percent change in the California Consumer Price Index for June of the tax year compared to June of the preceding year.

RATIONALE

This program is intended to simplify state tax administration and the tax-computation process for taxpayers who have less than a specified level of itemized tax deductions.

DISTRIBUTION OF BENEFITS

As shown in the accompanying table, the standard deduction is a program which is used heavily by lower-to-moderate income taxpayers. Almost 75 percent of the taxpayers claiming the standard deduction have $40,000 or less in annual income, and over three-quarters of all deductions go to taxpayers earning $60,000 or less annually. For the lowest income class, the great majority of benefits (in excess of 90 percent) go to single taxpayers or married taxpayers filing separately. Average claims for this deduction decline in the higher income categories due to the increased prevalence of the use of itemized deductions.

Standard Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of: Total Taxpayers Benefitting	Percent of: Total Amount Claimed	Average Amount Claimed
$0-20	39.6%	13.8%	$57
20-40	33.9	35.8	174
40-60	15.9	28.3	294
60-80	5.5	12.2	367
80-100	2.1	4.7	364
100-150	1.6	3.3	341
150-200	0.5	0.8	280
200-250	0.2	0.4	308
250-500	0.5	0.7	240
Over 500	0.3	0.2	143

COMMENTS

Considerable disagreement exists regarding how the tax expenditure associated with the standard deduction should be defined and measured. The revenue reduction amounts shown above represent the amounts the state would gain if the standard deduction were eliminated altogether, and those taxpayers who would otherwise claim it were instead left with itemizing their deductions. Thus, for a single taxpayer with itemizable deductions of $1,000, the revenue reduction for this program would be based on an increased deduction of $1,642 (reflecting the excess of the standard deduction over the taxpayer's itemizable deductions).

However, alternative ways of defining and computing the tax expenditure amount have been suggested which can lead to significantly different revenue effects. For example:

- One view is that the standard deduction is part of the "basic tax structure" because it is available to all taxpayers. In this view, the standard deduction does *not* give rise to any tax expenditure, and only those itemized deductions in *excess* of the standard deduction are tax expenditures.

- Another view is that the standard deduction is a tax expenditure which is claimed, either directly or indirectly, by *all* taxpayers. This view is based on the notion that it is not possible to distinguish between itemized deductions, which *are* tax expenditures, and the standard deduction, which is really a "proxy" for some minimal level of itemized deductions. Under this view, the cost of this program should reflect not only the standard deductions explicitly claimed by nonitemizers, but also the standard deductions which itemizers implicitly receive from the "zero bracket amount" that is built into the state's tax rate schedules. In other words, this view holds that, to identify the full cost of this tax expenditure program, one must add together (1) the standard deductions claimed by nonitemizers, and (2) that portion of the itemized deductions claimed by itemizers which is equivalent to the standard deduction.

Deduction:

CASUALTY LOSSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17131, 17207, and 24347.5 which largely conform to Internal Revenue Code Section 165.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	$15	$1
1997-98	20	1
1998-99	20	1

DESCRIPTION

This program allows as a deduction from gross income any qualifying casualty losses that exceed 10 percent of federal adjusted gross income (AGI), to the extent that these losses are not compensated for by insurance or other means. In addition, the program allows that subgroup of casualty losses associated with certain officially designated disasters (as proclaimed by the President or the Governor) to be (1) carried back as a deduction against income for the prior year, and/or (2) carried forward as a deduction against future income for up to five years. Fifty percent of the amount of any such loss remaining after five years may be carried forward for the next ten taxable years.

The term "casualty loss" includes losses arising from fire, storm, shipwreck, floods, and other such casualties, or from theft. Each separate casualty or theft loss is deductible only to the extent that it exceeds $100, and the total of all individual losses is deductible only to the extent that it exceeds 10 percent of federal AGI.

California law incorporates federal law allowing a deduction for corporate losses sustained and not compensated by insurance proceeds or other means. The corporate provisions regarding the deduction and carryover of disaster losses are the same as the provisions under the PIT.

RATIONALE

This program provides tax relief to those individuals, businesses, and corporate entities which suffer large casualty losses, have a tax liability, and (in the case of PIT) are able to itemize deductions. The most commonly cited rationale for the program is that it helps to relieve the hardships that these losses can impose on such individuals and firms.

COMMENTS

This program has a number of important side effects and tax-equity considerations. First, because the program shifts part of the cost of a taxpayer's property losses to the general taxpayer, it serves as a form of indirect property insurance. As such, it reduces the costs of not having insurance and gives taxpayers an incentive to purchase less private insurance than they otherwise might. Insurance can result in a phenomenon known as "moral hazard," whereby an insured individual behaves in a manner which results in increased risk since the full costs of such behavior are not directly borne by the taxpayer. Private insurers attempt to control these tendencies by instituting experience-adjusted insurance premiums and deductibles. This tax program can be perceived as a supplemental insurance policy, but without such protective devices.

Second, depending on the size of a casualty loss and a taxpayer's income level, different taxpayers sustaining identical casualty losses can be provided different amounts of tax relief, due to such factors as the 10 percent threshold, the $100 minimum-loss requirement, and differences in marginal income tax rates. For example, a high-income taxpayer may not be able to claim any deduction for a $5,000 casualty loss due to the 10 percent threshold, whereas a low-income taxpayer would qualify for a large deduction. Conversely, the dollar amount of tax relief provided for a given dollar amount of casualty loss in excess of the 10 percent threshold will be greater for a higher-income taxpayer than for a lower-income taxpayer, due to the difference in their marginal tax rates.

The estimated revenue amounts shown above are for revenue reductions associated only with the deduction for casualty losses. The revenue reduction estimates for disaster-related losses depend on the type and scope of the disaster, and reflect larger carryback/carryforward deduction allowances.

Deduction:

MEDICAL AND DENTAL EXPENSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17201, which conforms to Internal Revenue Code Section 213.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$110
1997-98	115
1998-99	120

DESCRIPTION

This program allows taxpayers to claim a deduction for specified medical and dental expenses related to treatment of the taxpayer, spouse, and dependents, to the extent that these expenses exceed 7.5 percent of federal adjusted gross income (AGI) and are not compensated for by insurance or other means.

Qualifying medical expenses include payments for diagnosis, cure, mitigation, treatment, or prevention of disease, including certain related travel costs and lodging expenses. They also include the costs of prescription drugs, plus nonprescription insulin. For tax years after 1996, the definition of medical care was expanded to include qualified long-term care and long-term care insurance premiums.

RATIONALE

This program provides tax relief to individuals who incur nonreimbursed medical expenses. The rationale for the program is that such expenses can impose extraordinary and involuntary financial burdens. In addition, the program provides some incentive for taxpayers to seek proper medical attention and preventive medical care, thereby improving the overall level of public health.

DISTRIBUTION OF BENEFITS

As shown in the accompanying table, the number of taxpayers benefitting from medical and dental expense deductions is broadly distributed, but concentrated in the lower and moderate income categories. Total dollar deductions are also concentrated in the lower-to-middle income categories, with over 40 percent of the total deductions going to those taxpayers earning $60,000 annually or

Medical and Dental Expense Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	12.2%	2.5%	$51
20-40	33.3	16.8	124
40-60	25.6	21.0	202
60-80	15.3	17.7	284
80-100	6.0	12.6	517
100-150	5.4	14.3	654
150-200	1.2	7.6	1,500
200-250	0.4	2.5	1,500
250-500	0.6	4.2	1,667
Over 500	0.1	0.8	NA

less. The average benefit from the program increases with income except in the highest income group.

COMMENTS

Although the basic rationale for this program relates to the involuntary nature of many medical expenses, the deduction itself can be claimed for a variety of expenses that do not necessarily fall into this category. Such expenses include those for rest cures, and other basically "optional" expenses, many of which are not covered under medical insurance programs because insurers consider them to be discretionary.

This program gives rise to a number of economic side effects and tax-equity considerations. For example, because the program essentially shifts certain health-related expenses to the general taxpayer, it provides a form of indirect health insurance to individuals. Thus, it can give individuals an incentive to purchase less private health insurance than they otherwise might.

The tax subsidy given for a dollar of medical expenses also can differ under the program, depending on such factors as a taxpayer's income level and amount of total medical expenses. For instance, the tax subsidy for low dollar amounts of medical expenses can be greatest for certain low-income taxpayers, since the 7.5 percent threshold can disqualify higher-income taxpayers from claiming them. On the other hand, the tax subsidy for high dollar amounts of medical expenses can be greatest for higher-income taxpayers, due to their higher marginal income tax rates.

Deduction:

CERTAIN TAXES PAID

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17220, and 17222, which partially conform to Internal Revenue Code Section 164.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	*PIT*
1996-97	*$658*
1997-98	*671*
1998-99	*706*

DESCRIPTION

This program allows taxpayers to claim an itemized deduction for the amount of certain property taxes, vehicle taxes, and other taxes paid to the state and its local governments. Specifically, the program allows a deduction for: (1) state, local, and foreign real property taxes; (2) state and local personal property taxes (including only the portion of the state vehicle license fee that does not represent annual charges for vehicle registration and vehicle weight); (3) one-half of self-employment taxes; and (4) other state, local, and foreign taxes relating to a trade or business, or to a property held for the production of income. Generally, California law is the same as federal law except that California specifically prohibits the deduction of state, local, and foreign income, war profits, and excess profits taxes.

RATIONALE

This program provides tax relief under the rationale that already-paid taxes reduce the amount of a taxpayer's net income, thereby reducing the taxpayer's ability to pay state income taxes. The program also has been justified on the grounds that income should not be subject to double taxation by California state and local governments.

DISTRIBUTION OF BENEFITS

The largest portion of taxes which is deductible under PIT is the local property tax. The income distribution of the deductibility of property taxes is shown in the accompanying table. The program largely benefits middle-income taxpayers, both in terms of the of number of taxpayers benefitting, as well as the distribution of total deductions. Average benefits increase along with income due to the high correlation between income and home values.

Real Property Taxes Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	1.8%	0.2%	$16
20-40	11.3	3.5	56
40-60	21.6	11.9	102
60-80	21.6	17.0	145
80-100	14.7	15.9	200
100-150	16.6	23.2	258
150-200	5.0	9.0	331
200-250	2.5	5.3	395
250-500	3.3	8.8	491
Over 500	1.7	5.3	586

COMMENTS

This program is available only to taxpayers who claim itemized deductions on their state income tax returns. These taxpayers tend to fall disproportionately into moderate-income and higher-income brackets. Because of this tendency, along with both the state's graduated marginal tax bracket structure and the positive relationship between increases in the level of taxes paid and income, the tax relief provided by this program generally increases with income levels.

By allowing deductions for local taxes paid, this program makes it less expensive on an after-tax basis for individuals to consume a given level of publically provided services. It enables individuals living in communities with a high appetite for public services to avoid bearing the entire cost of the increase in taxes necessary to support such services, since a portion of the cost can be offset in the form of lower state income tax liabilities. This issue is less important at the state level than at the federal level, but still has ramifications for state fiscal policy.

The federal Budget Reconciliation Act of 1990 limited the aggregate amount of itemized deductions including this one, which can be claimed by taxpayers with adjusted gross income (AGI) over a certain amount, depending on the year involved. This amount was $124,500 in 1998 for joint-return filers and $62,250 for married, filing separately taxpayers. California law limits 1998 itemized deductions for taxpayers with AGI in excess of $116,777 for single-filers and married taxpayers filing separately, and $233,556 for joint-return filers.

Deduction:
MORTGAGE INTEREST EXPENSES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17201, which conforms to Internal Revenue Code Section 163.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***PIT***
1996-97	*$2,770*
1997-98	*2,880*
1998-99	*3,030*

DESCRIPTION

This program generally allows taxpayers to deduct the amount of qualified mortgage interest expenses paid or accrued within a taxable year. Qualified mortgage interest includes interest on indebtedness secured by a taxpayer's residence, including interest incurred in acquiring, constructing, substantially improving, or refinancing the residence. Interest on indebtedness to purchase second homes and vacation homes, and interest on home-equity borrowing, also qualify for the deduction. The aggregate amount of indebtedness incurred to purchase, construct, or improve a home may not exceed $1 million (or $500,000 for a married individual filing a separate return). The total amount of interest on a home-equity loan generally may not exceed interest on indebtedness of more than $100,000 (or $50,000 for a married taxpayer filing a separate return).

RATIONALE

This program provides an incentive for home ownership. This is because most home purchases require mortgage financing, and this deduction reduces the net after-tax costs of such borrowing. It often is claimed that home ownership is worth encouraging on the grounds that it generates substantial public benefits, including neighborhood stability, promotion of civic responsibility, and encouragement of proper maintenance of residential structures by occupants.

DISTRIBUTION OF BENEFITS

The accompanying table indicates by income class the distribution of the mortgage interest deduction. The program provides a substantial

Mortgage Interest Expense Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	2.2%	0.3%	$104
20-40	12.7	3.9	266
40-60	22.9	12.8	481
60-80	21.0	18.2	745
80-100	14.2	16.7	1,020
100-150	15.7	23.8	1,307
150-200	4.7	8.9	1,642
200-250	2.3	5.1	1,925
250-500	3.0	7.6	2,179
Over 500	1.4	2.9	1,760

proportion of benefits to middle and upper-middle income classes, with over 70 percent of total deductions accruing to taxpayers earning between $40,000 and $150,000 annually. The average benefit increases with income for all but the highest income class. The latter is due to a decline in the prevalence of mortgages in this income class, as well as the effect of limitations on itemized deductions.

COMMENTS

One of the side-effects of this program is that it encourages consumers to finance their homes and other purchases through borrowing, even if their income level is high enough to avoid the need to do so. In this sense, some might argue that the program provides some incentive for "over-borrowing." The program also encourages taxpayers to increase the amount they spend on housing because it reduces the after-tax costs of such expenditures. In addition, the program disproportionately benefits higher-income individuals, who are most likely to purchase their own homes. Higher-income individuals also realize greater tax savings for a given dollar amount of interest deductions due to their higher marginal income tax rates.

It should be noted that the federal Budget Reconciliation Act of 1990 placed additional limitations on the aggregate amount of itemized deductions (including this one) which can be claimed by a taxpayer with adjusted gross income (AGI) over a specified amount. California law also has limits on the aggregate amount of deductions which may be claimed by taxpayers. These limits are discussed under the program entitled, "Certain Taxes Paid."

We previously reviewed the economic and fiscal effects of this program (see Legislative Analyst's Report on the *1988-89 Tax Expenditure Budget: Overview and Selected Reviews*, and *The Personal Income Tax Itemized Deduction for Mortgage Interest Expenses*). Our major findings, which we believe still are applicable, were that although the program is at least partially successful in enabling certain taxpayers to buy homes, it is relatively inefficient. For example, the interest rate subsidies made available under the program provide "windfall" benefits to many taxpayers who would have purchased homes in the absence of the program, and encourage certain individuals to over-consume housing by buying bigger and more expensive homes than they otherwise would. The result may be that this program, coupled with other programs granting housing preferential treatment, results in a misallocation of resources. Reducing, but not eliminating, subsidies for housing could result in a more efficient allocation of resources while still preserving the social benefits that result from home ownership.

Given these findings, we previously have recommended that the Legislature consider the following options: (1) limit the amount of mortgage interest which may be deducted, (2) eliminate or limit the deduction for second homes and nonhousing expenses, (3) convert the current deduction into a maximum tax *credit* that reduces the overall regressivity of the derived tax benefit from the program and potentially reduces its revenue effect, and (4) use the savings from "tightening up" eligibility under this program to provide additional subsidies targeted at low-income households and first-time home buyers.

Deduction:
CHARITABLE CONTRIBUTIONS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17251.5, 17275.5, 18648.5, 24344, and 24357 through 24359.1 which especially conform to Internal Revenue Code Section 170.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$740	$39
1997-98	750	40
1998-99	810	41

DESCRIPTION

This program allows taxpayers to deduct cash and specified noncash contributions to charities, religious organizations, governmental bodies, and other qualifying nonprofit organizations. The itemized deduction for PIT taxpayers is generally limited to 50 percent of adjusted gross income (AGI). The deduction available under BCT law may not exceed 10 percent of California taxable income. Contributions that exceed these percentage limitations may be carried forward for use in future tax years for up to five years.

RATIONALE

This program provides an incentive for taxpayers to donate cash, property, or services to qualifying charitable organizations. It does this by reducing the net after-tax cost to the giver making a contribution. The underlying rationale for the program is that qualifying charitable organizations provide socially beneficial services which are viewed as being worthy of indirect state financial support.

DISTRIBUTION OF BENEFITS

Charitable contributions are a flexible expenditure for many taxpayers, especially those in the higher-income categories. The concentration of the benefits of this program in the high income categories is shown in the accompanying figure. For example, over 40 percent of the deductions claimed are by those taxpayers earning at least $150,000 per annum, with over 20 percent by those earning $500,000 or more. The average deduction for those in the highest income class is more than four times as large as that for the next highest income class.

Charitable Contributions Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	1.8%	0.3%	$31
20-40	12.0	3.4	67
40-60	21.8	9.4	101
60-80	21.4	13.1	143
80-100	14.5	12.5	201
100-150	16.4	18.9	268
150-200	4.9	7.7	364
200-250	2.4	4.5	440
250-500	3.2	9.7	699
Over 500	1.7	20.5	2,879

COMMENTS

One effect of this program is that, for PIT taxpayers, the state government provides donors with a subsidy that, per dollar of donation, increases in value as the donor's marginal income tax bracket rises. Economists widely agree that permitting a deduction for charitable contributions tends to stimulate the volume of charitable donations, although there are differences of opinion regarding the exact nature and magnitude of this response.

Deduction:

CONTRIBUTIONS OF COMPUTERS AND SCIENTIFIC EQUIPMENT TO EDUCATIONAL INSTITUTIONS

Program Characteristics	
Tax Type:	*Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 24357 and 24357.9.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	BCT
1996-97	NA
1997-98	NA
1998-99	$4

DESCRIPTION

This program allows corporations to claim a larger-than-normal deduction for contributions of computers, software, and scientific equipment to institutions of higher education. The deduction is equal to the lesser of: (1) the taxpayer's "basis" in the equipment, plus one-half of the difference between this basis and the equipment's market value; or (2) twice the taxpayer's basis in the equipment. For example, if a computer manufacturer donated two computers and a printer to a community college with a total production cost of $500,000 and a market value of $800,000 under this program, the company could have claimed a deduction of $650,000 ($500,000 for the depreciable basis plus one-half of $300,000). Without this program, the deduction would have been limited to $500,000.

RATIONALE

This program provides companies with an incentive to donate computers, computer software, and other scientific equipment to colleges and universities. The view was that these donations would enhance student performance at less cost than if the equipment was directly provided by the government.

COMMENTS

This program, which was originally scheduled to sunset was continued in conformity with federal tax provisions pursuant to Chapter 322, Statutes of 1998 (AB 2797, Cardoza).

Deduction:

CONTRIBUTIONS MADE THROUGH TAX RETURN "CHECKOFFS"

Program Characteristics	
Tax Type:	Personal Income Tax (PIT)
Authorization:	California Revenue and Taxation Code Sections 18711 through 18444.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program allows taxpayers to make certain tax-deductible contributions simply by designating a specific contribution amount for one or more specified purposes on their state income tax return.

The recipient programs to which such tax deductible "check-off" contributions may be designated under this provision include:

- California Fund for Senior Citizens.
- California Seniors' Special Fund.
- Endangered and Rare Fish Fund.
- Wildlife and Plant Species Conservation and Enhancement Account (in the Fish and Game Preservation Fund).
- State Children's Trust Fund.
- Alzheimers' Disease and Related Disorders Research Fund.
- California Breast Cancer Research Fund.
- California Public School Library Protection Fund.
- California Firefighters' Memorial Fund.
- California Drug Abuse Resistance Education Fund (D.A.R.E.).
- California Military Museum Fund.

RATIONALE

his program provides an incentive for taxpayers to make donations to specified programs. The underlying rationale for this is that these programs are socially beneficial, and viewed as deserving of governmental encouragement and financial support.

COMMENTS

These check-off contributions on state tax returns are deductible on federal income tax returns as itemized charitable deductions because they are contributions to a state government. For state income tax purposes, this program provides that they are deductible charitable contributions on the income tax return for the year in which the check-off contributions were made.

Deduction:

EMPLOYEE BUSINESS AND MISCELLANEOUS EXPENSES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17072,17076, 17201, 17269, and 17270, which partially conform to Internal Revenue Code Sections 67, 68, 162, and 212.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT
1996-97	$400
1997-98	420
1998-99	450

DESCRIPTION

This program allows a taxpayer to deduct from gross income a portion of certain unreimbursed expenses. These include:

- Business expenses, including travel, meals, entertainment, and lodging.
- Miscellaneous expenses related to: (1) producing or collecting taxable income; (2) management, conservation, or maintenance of income-producing property; and (3) tax return preparation fees.

Generally, a taxpayer may claim a deduction for 50 percent of meal and entertainment expenses to the extent that this 50 percent amount exceeds 2 percent of the taxpayer's federal adjusted gross income (AGI). Prior to 1995, taxpayers could deduct 80 percent of meals and entertainment expenses—a percentage that was reduced pursuant to Chapter 881, Statutes of 1993 (SB 671, Alquist).

RATIONALE

This program provides tax relief to employees on the grounds that qualifying expenditures are a direct cost of earning income and, therefore, should be deductible.

DISTRIBUTION OF BENEFITS

This program is used by all income groups, but most heavily by those in the middle-income categories. Over three-quarters of taxpayers benefitting from the deduction earn $100,000 annually or less. In terms of benefit dollars, however, these taxpayers receive only about half of the deductions claimed.

Employee Business and Miscellaneous Expense Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	2.1%	0.4%	$77
20-40	12.5	5.1	153
40-60	24.1	15.1	235
60-80	22.7	18.1	298
80-100	14.6	15.4	393
100-150	15.5	22.6	546
150-200	3.9	7.9	755
200-250	1.7	3.4	762
250-500	2.2	6.2	1,074
Over 500	0.9	5.8	2,455

COMMENTS

This program provides an incentive for employers to require, and employees to be willing to incur, certain job-related expenses. For example, the program increases the likelihood that an employee will be willing to pay his/her own way to a business conference, particularly if the conference is of personal interest because of its location or the professional opportunities it offers.

Federal and California tax law place additional limitations on the aggregate amount of deductions, such as this one, which can be claimed by a taxpayer with AGI over a specified amount. These income limits are discussed under the section regarding the deduction for "Certain Taxes Paid."

Deduction (Accelerated Depreciation):
AMOUNTS IN EXCESS OF STRAIGHT-LINE

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 24349, and 24354.1, which generally conform to Internal Revenue Code Sections 167 and 168.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	$287	NA
1997-98	294	NA
1998-99	305	NA

DESCRIPTION

Depreciation deductions enable taxpayers to recover their investments in income-producing assets, such as equipment and buildings, over specified periods of time. This program allows taxpayers to claim depreciation deductions in excess of "straight- line" depreciation on physical assets that are used in the production of income. Under the traditional straight-line depreciation method, a property's value is depreciated evenly over its useful economic life span.

Under this program, several more-generous accelerated depreciation methods are allowed. The permitted methods vary, depending on the type of property involved and when it is placed in service. These alternative methods include: (1) 200 percent, 150 percent, and 125 percent *declining-balance* methods; (2) the *sum-of-years-digits* method; and (3) other methods, such as the *sinking-fund* method.

Accelerated depreciation methods enable taxpayers to recover the costs of replacing their income-producing capital assets sooner than they otherwise would, through the deferral of tax liabilities, and thereby realize an increased rate of return on investments. For example, if a machine purchased for $20,000 had a useful life of 20 years and a salvage value of $2,000 after this period of time, under the straight-line method, the taxpayer could claim a depreciation deduction of $900 per year.

In contrast, under the 200 percent declining balance method, the taxpayer could claim an annual depreciation allowance twice the percentage amount permitted under the straight-line method. Thus, the first year's depreciation allowance for this property would be $1,800.

RATIONALE

By enabling taxpayers to defer some of their tax liabilities, the program provides an incentive for taxpayers to invest in income-producing assets. This is due to the fact that the deferral of tax liabilities amounts to an interest-free loan from the government, which increases the rate of return on capital investments. In addition, such tax deferments reduce investment payback periods, thus improving the financial liquidity of investors. Another rationale for the program is that it compensates property owners for the failure of the tax code to adjust the depreciable basis of property upward over time for the effects of inflation.

COMMENTS

Estimated revenue reductions for PIT under the accelerated depreciation program are for equipment and property (including rental property) and are based on federal estimates adjusted for California. The BCT estimates are not provided since comparable federal data are not available and since California has not fully conformed to the modified accelerated cost recovery system (MACRS) for depreciation.

In theory, depreciation allowances are intended to permit taxpayers to deduct the true economic costs of using assets that are incurred in the production of their income. Another way of looking at this is that depreciation allowances compensate taxpayers for the loss in productive capability of their income-producing property as it ages, so that, at the end of the property's life, the accumulated depreciation benefits permit it to be replaced. The revenue reductions associated with this program are based on the cost of allowable depreciation above and beyond that allowed under the straight-line method.

From a pure economic perspective, however, the technically correct measure of depreciation-related tax expenditure costs is the amount by which *actual* depreciation claims (however computed) exceed *pure* economic depreciation (that is, the decline in physical productivity of an asset) over time. This technically correct tax expenditure amount is likely to be less than that reported above, because the tax code does not adjust the depreciable basis of property for inflation. Many view the mid-point asset depreciation range (ADR) system based on 150 percent declining balance depreciation as a reasonable approximation of the economic life of corporate capital investment. The ADR system was used for federal purposes between 1971 and 1980, and assigned particular classes of assets with a prescribed useful life.

Deduction (Accelerated Depreciation):
POLLUTION CONTROL EQUIPMENT

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17250 and 24372.3, which generally conform to Internal Revenue Code Section169.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	—	NA
1997-98	—	NA
1998-99	—	NA

DESCRIPTION

This program allows taxpayers to depreciate the cost of pollution control facilities over a 60-month period, as opposed to a 10-year period which would otherwise apply. Qualifying facilities must be located within California and be appropriately certified by the California Air Resources Board or the State Water Resource Control Board.

RATIONALE

This program provides tax relief for businesses that are required by federal, state, and/or local regulations to install pollution control equipment. This tax relief takes the form of allowing taxpayers to, in effect, defer some of their tax liabilities by giving them larger depreciation write-offs during the early years following an investment in qualifying pollution control equipment. This tax deferral amounts to an interest-free loan from the government, which, in turn, increases the financial ability of taxpayers to make such required investments.

COMMENTS

Revenue estimates for this program are based on federal sources. The PIT revenue reductions stemming from this program are included in the revenue reduction estimates in the earlier section "Amounts in Excess of Straight-Line." The BCT estimates are not provided due to the absence of comparable federal data upon which to base the estimates.

Deduction (Accelerated Depreciation):
REFORESTATION EXPENDITURES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17278.5, and 24372.5, which partially conform to Internal Revenue Code Section 194.*

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

This program allows PIT and BCT taxpayers to amortize over a seven-year period up to $10,000 per year of certain qualifying reforestation expenditures. Qualifying expenditures include the direct costs of forestation and reforestation, including site preparation, seeds or seedlings, labor, and equipment costs.

RATIONALE

This program apparently is intended to give taxpayers an incentive to reforest private lands where logging and timber-related activities have depleted available stocks of timber. Thus, the program provides an incentive for increasing the future supply of harvestable timber. It accomplishes this by permitting taxpayers to recover their capital costs more quickly, thereby deferring tax liabilities. The tax deferral amounts to an interest-free loan from the government, which, in turn, increases the rate of return on such investments. Rapid amortization for activities with lengthy payoff periods, such as reforestation, also dramatically improves the cash-flow position of investors, and thus, their financial liquidity.

COMMENTS

California law is the same as federal law with the following modification: effective for taxable years beginning after 1996, California law limits the tax deduction to expenses associated with qualified timber located in California. In contrast, for income years beginning before 1997, there was no limitation as to where the timber property had to be located.

Deduction (Accelerated Depreciation):
PROPERTY USED IN ECONOMICALLY DEPRESSED AREAS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17266, 17267.6, 17268, 18036, 24356.4, and 24356.8.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

This program allows taxpayers to claim accelerated depreciation write-offs for certain qualified business property used in designated economically depressed areas of the state, including an Enterprise Zone, Local Agency Military Base Recovery Area (LAMBRA), Targeted Tax Area, and the Los Angeles Revitalization Zone (LARZ). In general, the program permits a taxpayer to "expense" (that is, *immediately* deduct as a current business-related expense) a certain portion of the costs of these types of property. Sunset dates under two components of the program are January 1, 1998 (LARZ) and January 1, 2003 (LAMBRA).

RATIONALE

This program provides an incentive for taxpayers to make business investments in economically depressed areas of the state. It does this by enabling taxpayers to use expensing to defer tax liabilities. This deferral amounts to an interest-free loan from the government, which, in turn, increases the rate of return on taxpayers' investments and improves their cash-flow position. The underlying rationale for this program is that the stimulation of investments in economically depressed areas can lead to improved economic conditions. This in turn, can result in various social benefits, including reduced state costs for unemployment and welfare benefits.

COMMENTS

Taxpayers are permitted to expense a certain portion of the cost of qualified property under this program, depending upon the type of area. In the case of property located in a Targeted Tax Area (for taxable years beginning after 1997), or Enterprise Zone (for taxable years after 1996), a taxpayer can expense 40 percent of the cost of the property subject to a dollar limit of $100,000 in years one and two of the area's designation, $75,000 in years three and four, and $50,000 thereafter. The remaining 60 percent of a property's depreciable basis is subject to being written-off using standard depreciation options.

In the case of property located in a LAMBRA, for taxable years beginning after 1994 but before 2003, taxpayers may elect to expense a portion of the cost of qualifying property. The cost that may be taken into account is $5,000 for the first two years following designation as a LAMBRA, $7,500 for the second and third taxable years after designation, and $10,000 for every year thereafter.

In the case of property located in LARZ, for taxable years beginning after 1991 and before 1998, the taxpayer may elect to expense property purchased for exclusive use in a trade or business located within the zone.

In each case, the expensing deduction is recaptured (included in income) if the property ceases that is, to be used in the designated area at any time before the close of the second taxable year after the property was placed in service.

Deduction (Accelerated Depreciation):
AGRICULTURAL COSTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 24369, and 24377, which conform to Internal Revenue Code Sections 175 and 180.*

Estimated Revenue Reduction *(In Millions)*

Fiscal Year	PIT	BCT
1996-97	$7	$7
1997-98	7	7
1998-99	7	8

DESCRIPTION

This program allows taxpayers to "expense" (that is, *immediately* deduct as a current business-related expense) soil, water conservation, and fertilizer expenditures, up to a maximum of 25 percent of their gross income from farming. Any qualified expenses in excess of the 25 percent limitation, however, may be carried forward and expensed in future years. In the absence of this program, the qualifying expenditures would be considered capital expenditures to be written off.

RATIONALE

This program provides a tax incentive to encourage certain types of farming-related conservation investments, particularly those with lengthy developmental and payback periods. The program accomplishes this by allowing very rapid cost write-offs that, in effect, permit the deferral of taxes on farming income. This amounts to an interest-free loan from the government, which in turn, raises the rate of return on qualifying investments and shortens their payback periods. The program also has been rationalized as a way of simplifying record-keeping for small farming businesses.

COMMENTS

Qualifying expenditures include those for: the treatment or moving of earth (including leveling, grading, furrowing, and other improvements); the fertilization of land; the construction of water channels, drainage ditches, and similar water conservation projects; the eradication of brush; and the planting of windbreaks.

The federal 1986 Tax Reform Act restricted a taxpayer's ability to expense agricultural costs for federal tax purposes to those expenditures which are consistent with a soil conservation plan approved by the Soil Conservation Service of the Department of Agriculture. California has adopted these limitations as well.

Deduction (Accelerated Depreciation):

EMPLOYER-PROVIDED RIDESHARING PROGRAM COSTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17090, 17149, and 24343.5.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

This program allows taxpayers to "expense" (that is, *immediately* deduct as a current business-related expense) costs associated with providing ridesharing programs for employees. The deduction covers a taxpayer's expenses to provide for: company commuter vans or bus service to employees; subsidizing employee commuting expenses in third-party vanpools, private commuter buses, or subscription taxipools; free parking facilities for carpools; and certain other ridesharing programs. In addition, taxpayers are allowed an accelerated (36-month) depreciation deduction for costs of facility improvements for employee ridesharing, bicycling, and walking programs.

RATIONALE

This program provides an incentive for employers to establish ridesharing programs for their employees. It does this by allowing employers to partially offset their costs for sponsoring such programs by deferring tax payments. The program is based on the argument that state tax incentives are needed to encourage employees and employers to use ridesharing programs so as to alleviate traffic congestion, reduce air pollution, and reduce gasoline consumption.

COMMENTS

It is possible that certain noncapital ridesharing expenses, such as subsidies for monthly transit passes, may be deductible by the employer as a business expense, even *without* this program. This is because an employer may consider such expenses to be "ordinary and necessary" in some situations and therefore deductible as a regular business expense. Thus, in some cases, employers benefit from the program only to the extent that it allows them to recover their costs for capital-related ridesharing expenditures (such as for vehicles and facilities) over a shorter-than-normal time period.

The argument traditionally put forth in explaining this type of program revolves around achieving the optimal amount of driving by individuals. Because of the social costs associated with car travel (like air and noise pollution), individuals do not bear the entire costs of car transportation. As a result, an over-consumption of car travel by individuals may occur. By lowering the costs of ridesharing and other related policies, this program makes alternative forms of transportation more attractive, leading to an increase in participation. Proponents argue that the result of such intervention is a decrease in congestion and a more efficient deployment of transportation-related economic resources.

Deduction (Accelerated Depreciation):

EXPLORATION, DEVELOPMENT, RESEARCH, AND EXPERIMENTAL COSTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17260, 17681, 24423, and 24365, which generally conform to Internal Revenue Code Sections 174, 193, and 263A.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	$7	$81
1997-98	10	87
1998-99	10	93

DESCRIPTION

This program allows taxpayers to either "expense" (that is, *immediately* deduct as a current business-related expense) or amortize more rapidly the costs of (1) research or experimental activities, and (2) qualified mining-related exploration and development costs for mines and mineral deposits.

Qualified expenditures associated with *research and experimental* activities may be either deducted currently or amortized over a 60-month period at the election of the taxpayer. The option to immediately deduct versus amortize research and experimental expenditures applies only to expenditures that are deemed reasonable.

Qualified *exploration and development* activities may be either expensed or, for development activities only, amortized at the taxpayer's election. *Exploration* expenses are those paid prior to the development period. *Development* expenses are those that are incurred after the existence of ores or minerals in commercially marketable quantities has been established. If amortization is chosen over expensing, this must occur over a 10-year period.

RATIONALE

This program provides an incentive for taxpayers to undertake research and experimental projects, and to locate and recover minerals from the earth, by enabling them to more quickly deduct their associated costs. This faster deduction, in effect, enables taxpayers to defer their taxes. The tax deferral amounts to an interest-free loan from the government, which, in turn, raises the real rate of return on qualifying expenditures and improves the taxpayer's cash-flow position.

The underlying rationale for the program is that research and experimental projects, and exploration and development activities—while often of great long-term importance to the state and its citizens—are inherently risky, and often do not generate any income for the taxpayer until a considerable period of time has passed.

Deduction (Accelerated Depreciation):
CIRCULATION COSTS FOR PERIODICALS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17201 and 24364, which conform to Internal Revenue Code Section 173.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	$2	$2
1997-98	2	2
1998-99	2	2

DESCRIPTION

This program allows taxpayers to "expense" (that is, deduct *immediately* as a current business-related expense) costs for establishing, maintaining, or increasing the circulation of a periodical. Alternatively, the program allows such costs to be amortized over a three-year period. In the absence of this program, these costs would have to be capitalized, and then amortized over whatever period of time the taxpayer was able to determine that the expenditure resulted in increased income.

Suppose for example, that a taxpayer spends $100,000 for advertising and promotional activities during the current year in order to increase over the next five years the circulation of a magazine the taxpayer publishes. This program allows the taxpayer to deduct the entire $100,000 as an expense on his or her current-year tax return or, if the taxpayer prefers, deduct it over a three-year period—as opposed to having to spread the $100,000 deduction over five years.

RATIONALE

The rationale for this program appears to be administrative in nature, and relates to the difficulty of identifying exactly when the benefits of circulation-related expenses are realized. In principle, these costs should be deductible when the benefits they generate are experienced in the form of increased income. In practice, however, it often is difficult to determine which individual periodical subscriptions result from advertising or promotional expenses, including how to treat multiple renewals of subscriptions over time. For this reason, it is simpler from a tax administration perspective not to require taxpayers to capitalize their costs, but rather to allow taxpayers to deduct them either immediately or over a fairly moderate, specified time period.

Deduction (Accelerated Depreciation):
SMALL BUSINESS EXPENSING

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17201 and 17255, which generally conform to Internal Revenue Code Section 179(b)(1).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$2
1997-98	5
1998-99	11

DESCRIPTION

This program permits small businesses to *expense* rather than *depreciate* up to a specified amount of business personal property acquired each year. For 1997, the maximum expensing allowed was $13,000. This amount will increase to $16,000 for 1998 and incrementally thereafter until it reaches $25,000 in 2003. However, the expensing deduction cannot exceed the taxable income derived from the associated trade or business during the tax year involved. This program does not apply to C corporations, but does apply to most small businesses (partnerships, proprietorships, limited liability corporations, and S corporations).

RATIONALE

This program provides tax relief to small businesses for the purchase of business personal property (such as adding machines, furniture, and computers). It accomplishes this by allowing businesses to offset their costs by deferring tax payments. The tax deferral amounts to an interest-free loan from the government, which in turn improves the taxpayer's cash-flow situation and rate of return.

COMMENTS

For 1997, the *federal* government allowed taxpayers to expense up to $18,000 of business personal property. Beginning in 1998, this amount is scheduled to incrementally increase until the year 2003, when the annual expensing limit will be $25,000. For both federal and California purposes, the deduction under this program is reduced (but not below zero) by the excess of the total investment in qualified property over $200,000 in a given tax year. The excess of the deduction over otherwise-allowable depreciation is recaptured if the property ceases to be used predominantly in the particular trade or business before the end of its recovery period.

Deduction:
CARRYFORWARD OF NET OPERATING LOSSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17041, 17276 through 17276.3, 24416, 24416.1 through 24116.3, 25108, and 25110, which partially conform to Internal Revenue Code Section 172.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	$97	$360
1997-98	102	365
1998-99	90	375

DESCRIPTION

General Provisions. This program generally allows taxpayers to carryforward, for up to five years, a portion of their net operating losses (NOLs). Generally, most businesses may carryforward 50 percent of their "excess" net operating losses in any given year (that is, the unrecovered losses that exceed their taxable incomes in that year) to offset their income in the following five years, and thereby reduce their cumulative state tax liabilities. For an NOL incurred prior to August 6, 1997, a 15-year carryover is permitted.

Extensions to the carryover period are available for NOLs incurred prior to or during 1991 and 1992, when NOL deductions were temporarily suspended due to state budgetary problems associated with the early-1990s' recession. Additional restrictions on NOL deductibility apply to water's-edge corporations and those taxpayers subject to income allocation and apportionment. California does not allow NOL carrybacks (that is, the application of deductions to a previous year's income), unlike treatment under the parallel federal program.

Special Provisions. Special rules apply to NOLs incurred by small businesses, new businesses, bankrupt taxpayers, and businesses operating in an Enterprise Zone, the Los Angeles Revitalization Zone (LARZ), or a Local Agency Military Base Recovery Area (LAMBRA). Businesses operating in Enterprise Zones, the LARZ, or LAMBRAs may carryforward 100 percent of their net operating losses for 15 years, and use them to offset income earned in future years attributable to those designated areas. Under certain circumstances, 100 percent carryover also is available to small and new businesses, but with truncated carryover periods. For bankrupt taxpayers, a ten-year carryover period applies.

Example. Consider a business that incurs an excess net operating loss of $70,000 during one tax year. If the business earns a net profit of $25,000 in the second year and $40,000 in the third year, under this program using a 50 percent carryforward, the taxpayer can apply $25,000 in losses to the second-year profits, thus completely eliminating his tax liability in that year. In addition, the $10,000 in net operating losses "left over" can be applied to the third-year profits, reducing his taxable income in that year to $30,000.

RATIONALE

This program is intended to provide tax relief for businesses that incur operating losses. In addition, it is an attempt to recognize that a taxable year is an arbitrary period of time with respect to measuring income and losses. For example, a firm might incur expenses in an early year (that result in net operating losses), in order to produce income (resulting in profits) in a later year. From an economic perspective, these losses and profits are related, and basing the firm's tax only on its reported net profits in individual years, but not accounting for loss years, overstates the net economic income resulting from the investment for the period as a whole.

The tax benefits associated with carryforward of net operating losses is heavily weighted towards smaller business in terms of the proportion of those claiming the deduction. Figure 1 below indicates that almost three-quarters of those claiming the deduction are from businesses with total receipts of less than $1 million. Total benefits are more evenly distributed across all sizes of industry, although a large proportion goes to businesses with total receipts of $1 billion or more. Figure 2 shows the distribution of benefits according to type of industry.

DISTRIBUTION OF BENEFITS

The tax benefits associated with carryforward of net operating losses is heavily weighted towards smaller business in terms of the proportion of those claiming the deduction. Figure 1 below indicates that almost three-quarters of those claiming the deduction are from businesses with total receipts of less than $1 million. Total benefits are more evenly distributed across all sizes of industry, although a large proportion goes to businesses with total receipts of $1 billion or more. Figure 2 shows the distribution of benefits according to type of industry.

Figure 1

Carryforward of Net Operating Losses Deduction by Receipt

1998 Income Year

	Percent of	
Total Receipts (In Millions)	Total Taxpayers Benefitting	Total Amount Claimed
Under $1	73.0%	10.6%
1–10	20.9	17.5
10–50	4.1	15.1
50–100	0.4	7.2
100–500	1.2	18.3
500–1,000	0.2	5.0
Over 1,000	0.3	26.3

Figure 2

Carryforward of Net Operating Losses Deduction by Industry

1998 Income Year

	Percent of		
Industry Type	Gross State Product	Total Taxpayers Benefitting	Total Amount Claimed
Agriculture, Forestry & Fishery	3.0%	2.2%	1.9%
Construction	3.8	8.1	3.2
Manufacturing	15.9	9.3	26.5
Services	25.1	38.7	16.8
Trade	18.2	20.8	14.4
Finance, Real Estate & Insurance	25.9	18.7	29.1
Utilities & Transportation	8.2	2.1	8.0

COMMENTS

For federal tax purposes, a 100 percent carryforward of NOLs for 20 years is permitted along with a two-year carryback. The carrybacks must be applied, when possible, *before* any carryforward is allowed.

Deduction:

PERCENTAGE RESOURCE DEPLETION ALLOWANCE

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17681, and 24831 through 24833.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	$10	$25
1997-98	10	30
1998-99	10	30

DESCRIPTION

This program allows taxpayers to claim a fixed percentage deduction for resource depletion, which generally proves to be in excess of the deduction amount that otherwise would be allowed under the normal cost-depletion method. Under the program, a specified percentage of gross income (depending on the type of resource involved) may be deducted as a depletion allowance, except that this depletion amount cannot exceed 50 percent of a taxpayer's related net income before applying the depletion deduction, or 100 percent in the case of oil and gas properties.

California conforms to federal tax law regarding the percentage depletion for oil and gas wells, and for geothermal deposits. Depletion rates are limited to: (1) 22 percent for regulated domestic natural gas; (2) 10 percent for natural gas from geopressurized brine; (3) 15 percent for domestic crude oil and natural gas from certain independent producers; and (4) 15 percent for geothermal deposits located in the U.S. California also adopts federal percentage depletion provisions for depletable assets other than oil, gas, and geothermal deposits, and with regard to natural resources located in continental shelf areas.

Under this program, a taxpayer who owns and operates a natural gas well that produces, for example, $100,000 in gross income, is allowed to claim a deduction for 22 percent of this amount ($22,000). This deduction is intended to offset the physical and economic resource costs associated with depleting the oil reserves in the well.

RATIONALE

This program provides an incentive for taxpayers to explore for and develop oil, gas, and other mineral resources. The underlying rationale for the program is that such activities can be extremely costly and inherently risky.

COMMENTS

The term "percentage depletion" differs from "cost depletion." *Cost* depletion allows for the recovery of the initial costs of discovering, purchasing, and developing mineral reserves over the period during which a reserve produces income. Each year the taxpayer deducts the portion of the cost that is proportional to the fraction of the resource reserve that has been depleted in that year. Thus, under *cost* depletion, the amount of cost recovered through depletion allowances cannot exceed the original cost of acquiring and developing the reserve.

In contrast, under the *percentage* depletion method, a taxpayer deducts a fixed percentage of *gross income* from the reserve as a depletion allowance, regardless of the amount actually invested.

Deduction:
RESERVE ALLOWANCE FOR BAD DEBTS

Program Characteristics	
Tax Type:	Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Section 24348, which generally conforms to Internal Revenue Code Section 166.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	BCT
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows financial institutions to elect to use the "reserve allowance" for deducting their losses from bad debts. Under this method, a deduction is allowed for a reasonable addition to what is known as a "bad debt reserve account." These are accounts set up by the taxpayer as an allowance against the possibility that some debts may be uncollectible. The amount allowed in the account is generally based on the taxpayer's past experience with bad debts.

During a given year, debts that become uncollectible are charged against a taxpayer's bad debt reserve, which reduces the balance in the reserve. The taxpayer makes additions to the reserve account to (1) offset the amount of bad debts which have been charged off and (2) allow for future bad debt charge-offs (attributable to increases in accounts receivables). The deduction is allowed for both of these kinds of additions to a bad debt reserve. In the absence of the program, the taxpayer would be required to use the "specific charge-off method," under which the taxpayer would deduct bad debts only when they are found to be uncollectible.

RATIONALE

This program provides tax relief to financial institutions that incur bad debts, to the extent that it allows them to claim a deduction for bad debt losses prior to the time the losses actually occur. The tax relief takes two forms. First, the early claiming of bad debt losses increases the "present value" of the deduction for bad debts to the taxpayer. Second, by "spreading out" deductions for bad debts, the program lessens the chance that a taxpayer will be unable to deduct the full amount of such debts, due to having insufficient offsetting income in any one year.

COMMENTS

According to federal reports, the federal deduction (to which California generally has conformed) for bad debt reserves was first allowed in 1947, when there was fear of a postwar economic downturn. It was intended to reflect the banking industry's experience with bad debts during the depression period. The difference in annual bad debt deductions between the reserve and specific charge-off methods could be a gain or a loss in any given year.

Deduction:

EMPLOYEE STOCK OWNERSHIP PLANS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 18042 and 24601 through 24612, which generally conform to Internal Revenue Code Sections 401 through 424, and 1042.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$1	$5
1997-98	1	3
1998-99	1	3

DESCRIPTION

This program allows California employers that provide employee stock ownership plans (ESOPs) to their employees a PIT and BCT deduction for dividends paid to an ESOP, when those dividends are paid by the ESOP to participants or used to retire ESOP debt. It also allows the deferral of capital gains on the sale of stock to an ESOP if the proceeds are used to acquire a similar type security.

RATIONALE

This program conforms California ESOP provisions with federal law, thereby simplifying tax administration and compliance. It also gives an incentive to employers to provide their employees with this form of compensation as an option.

COMMENTS

Effective for income years beginning after 1997, this deduction is unavailable to Subchapter S corporations under both California and federal law.

Credit (Person Specific):
PERSONAL EXEMPTION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17054, 17054.1, 17056, and 17733.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**PIT**
1996-97	$800
1997-98	825
1998-99	860

DESCRIPTION

This program allows *all* individual taxpayers to claim a personal exemption tax credit. The amount of the credit depends on the taxpayer's filing status. The credit is indexed annually, based on the California Consumer Price Index. For 1998, the credit amounts are $70 for single taxpayers and $140 for married couples filing jointly. Nonresidents who are required to file a California tax return are allowed partial personal exemption credits, based on the ratio of their California adjusted gross income (AGI) to their total (multistate) AGI.

The exemption credits are phased out for taxpayers whose AGI exceeds a threshold amount. For 1998, for single taxpayers the credit is reduced by $6 for each $2,500 or fraction thereof by which the taxpayer's AGI exceeds $116,777; for married taxpayers filing jointly, the credit is reduced by $12 for each $2,500 or fraction thereof by which the taxpayer's AGI exceeds $233,556.

In addition, California's personal exemption credits may be reduced or eliminated altogether under the state's Alternative Minimum Tax (AMT).

RATIONALE

This program provides broad-based tax relief to California taxpayers. The rationale for the program is that taxpayers have a certain minimum amount of expenses and this program provides assistance through the tax system in meeting those expenses.

DISTRIBUTION OF BENEFITS

The personal exemption credit is a program which benefits primarily lower- and moderate-income groups. As shown in the accompany-

Personal Exemption Credit

1998 Tax Year

Adjusted Gross Income ($000)	Percent of: Total Taxpayers Benefitting	Percent of: Total Amount Claimed	Average Amount Claimed
$0-20	22.8%	14.2%	$57
20-40	26.9	24.1	82
40-60	19.9	21.9	101
60-80	12.5	16.0	117
80-100	7.3	9.8	124
100-150	7.5	10.2	124
150-200	2.0	2.8	130
200-250	1.0	1.2	122
250-500	0.1	0.1	NA
Over 500	—	—	—

ing table (see next page), almost 70 percent of tax returns receiving benefits and over 60 percent of the total benefits received go to taxpayers earning $60,000 or less annually. As indicated above, there are income limits placed on the program, making its use more infrequent in the higher-income categories. Average benefits are quite similar across income groups except in the lowest category, where low tax liabilities can keep the entire credit from being utilized (the credit is not refundable).

COMMENTS

Federal law allows exemptions in the form of deductions from AGI, as opposed to the use of tax credits, as under this program. The federal exemption amount for 1998 is $2,700 per taxpayer, taxpayer's spouse, and for each dependent.

Credit (Person Specific):
DEPENDENT EXEMPTION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17054, 17054.1, 17056, and 17733.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	*PIT*
1996-97	*$380*
1997-98	*390*
1998-99	*1,356*

DESCRIPTION

This program allows all taxpayers to claim a tax credit for each of their dependents. For 1997, the credit amount was $68 per dependent. Under California's 1997 tax relief package, this amount was to be increased to $120 in 1998 and $222 in 1999. However, these amounts were changed as part of the 1998-99 budget agreement, in Chapter 322, Statutes of 1998 (AB 2797, Cardoza). The amount for 1998 was increased to $253 and the amount for 1999 will be $227. In addition, the exemption amount will be indexed annually based on the California Consumer Price Index, beginning in 2000.

The phase-out provisions with respect to the credit for high-income taxpayers and requirements for nonresident taxpayers are the same as those listed under the immediately preceding tax credit program "Personal Exemption." In addition, California's dependent exemption credits can be reduced or eliminated altogether under the state's alternative minimum tax (AMT).

RATIONALE

This program provides tax relief to taxpayers who are financially responsible for the support of dependents, such as children or the aged. The rationale for this program is that such financial responsibilities reduce the ability of individuals to pay taxes.

DISTRIBUTION OF BENEFITS

The accompanying table shows the distribution of benefits from this program, based on income class. The program is one which largely benefits taxpayers in the lower- and moderate-income categories. Roughly two thirds of all returns receiving some benefit from the program involve taxpayers earning $60,000 or less on an annual basis. Over one-

Dependent Exemption Credit

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	13.9%	2.3%	$55
20-40	31.0	21.3	231
40-60	20.4	27.5	453
60-80	13.7	19.9	486
80-100	8.4	11.8	472
100-150	8.5	12.0	474
150-200	2.4	3.3	449
200-250	1.1	1.5	435
250-500	0.7	0.4	207
Over 500	—	—	—

half of the total benefits from the program also go to this group of taxpayers. Average benefits are very similar over most income classes. They are smaller only for the two highest and two lowest income categories, due to the effect of income limits and the nonrefundable nature of the credit, respectively.

COMMENTS

Federal law allows a dependent exemption in the form of a *deduction* from adjusted gross income, as opposed to providing a tax *credit*, as under this program. The federal exemption amount for 1998 was $2,700 for each dependent. In general, California allows a dependent credit for everyone for whom a federal dependent exemption is allowed.

Credit (Person Specific):
BLIND EXEMPTION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17054, 17054.1, 17056, and 17733.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program allows a taxpayer who is blind to claim an additional personal exemption tax credit. The amount of this credit (which is indexed annually for inflation based on the California Consumer Price Index) is $70 for 1998.

RATIONALE

This program provides tax relief to those who are blind, based on the rationale that individuals with certain types of diminished physical abilities have increased expenses and/or decreased earnings potential.

COMMENTS

Instead of a tax credit, federal law (Internal Revenue Code Section 63 [f]) provides an additional deduction from adjusted gross income (AGI) for blind taxpayers who do not itemize their deductions. In 1998, the amount of this deduction is $850 for married taxpayers (whether filing separately or jointly) and surviving spouses, and $1,050 for single taxpayers.

Credit (Person Specific):
SENIOR EXEMPTION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17054, 17054.1, 17056, and 17733.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT
1996-97	$81
1997-98	82
1998-99	87

DESCRIPTION

This program allows taxpayers over the age of 65 to claim an additional personal exemption tax credit. The amount of this credit (which is indexed annually for inflation) is $70 in 1998. In the case of a husband and wife filing a joint return, if both are over the age of 65, the amount of the credit is $140 in 1998.

RATIONALE

This program provides tax relief to those over the age of 65 under the rationale that such persons are more vulnerable to high medical or personal care expenses as a result of illness or infirmity.

COMMENTS

Federal law allows an additional deduction from adjusted gross income for taxpayers age 65 or over. For 1998 the amount of this deduction is $850 for married individuals (whether filing separately or jointly) and surviving spouses, and $1,050 for single individuals.

Credit (Person Specific):

RENTERS' CREDIT

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17053.5.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	PIT
1996-97	—
1997-98	—
1998-99	$133

DESCRIPTION

The renters' credit allows taxpayers to deduct a specified amount from their tax liabilities, providing that they rent their principal place of residence. For the years 1993 through 1997, the credit was suspended for reasons largely related to state budget problems. As part of the 1998-99 budget plan, (Chapter 322, Statutes of 1998 [AB 2797, Cardoza]), the credit was restored and modified. Beginning in the 1998 tax year, the credit will be $60 for single filers and $120 for joint filers, and will be available only on a *nonrefundable* basis. In addition, the credit is income-limited, with the single-return and joint-filer annual income limits set at $25,000 and $50,000, respectively. At various times, this program has allowed qualified renters to claim a *refundable* tax credit and was *not* income limited.

RATIONALE

The renters' credit provides tax relief to renters, and is intended to offset the property taxes that renters indirectly pay through their rental payments. Although landlords actually pay the property taxes on rental properties and are allowed to deduct them as a business expense, it is generally acknowledged that at least a portion of such payments are "passed-on" to tenants in the form of higher rental payments. Thus, proponents argue that in the absence of this program, renters would be treated inequitably relative to homeowners who receive the homeowners' exemption as a form of tax relief. As such, the credit is sometimes viewed as the renters' equivalent of the homeowners' exemption.

Another rationale often offered for the program is that it provides tax relief to renters; many of whom have low incomes. With its current structure of income limits, the credit will now only be received by renters with lower incomes.

DISTRIBUTION OF BENEFITS

As indicated above, the renters' credit program is limited to those taxpayers with lower and moderate incomes. The accompanying

Renters' Credit

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed
$0-20	2.7%	0.1%
20-40	46.0	36.8
40-60	21.3	16.5
60-80	17.2	26.3
80-100	12.9	20.3
Over 100	—	—

table indicates the distribution of its benefits by income class both in terms of the numbers of returns and share of total benefits received. These distributional estimates are based on the past use of the program prior to its suspension, and adjusted for the effect of subsequent income limits.

COMMENTS

The renters' credit was established in 1972 with amounts ranging from $25 to $45, depending on the taxpayer's adjusted gross income. Program changes in 1976 resulted in a fixed dollar amount for the credit of $37. This amount was increased to $60 (for single taxpayers) and $137 (for joint and head-of-household filers) in 1979. In 1982, legislation established a separate credit amount of $99 for joint-custody, head-of-household taxpayers. This separate amount for joint-custody, head-of-household taxpayers was eliminated in 1987. The current credit amounts represent a reduction from $137 to $120 for married couples filing joint returns, heads of households, and surviving spouses. The $60 credit for single taxpayers has remained the same since 1979.

Originally, this program was funded through an annual General Fund appropriation because of requirements related to the discontinued Federal Revenue Sharing program. Under that program, the amount of federal funds available to the state depended partially on its level of "tax effort" relative to other states, which was computed by taking into account the state's level of revenue collections. Thus, by funding the renters' credit through an appropriation instead of a revenue reduction, the state was able to show a greater "tax effort" and thereby increase its revenue-sharing allocation. The program is currently classified as a revenue program.

Credit (Person Specific):

SENIOR HEAD OF HOUSEHOLD

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17054.7.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program allows elderly taxpayers who qualify as head of household to claim a personal income tax credit in an amount equal to 2 percent of their taxable income, not to exceed $860 in 1998. This credit is only available to taxpayers with adjusted gross income of less than $45,675.

RATIONALE

This program provides tax relief to elderly taxpayers 65 years or older who have low or moderate incomes. The rationale for this is that the ability of such individuals to pay taxes often is limited, given their income constraints and their need to provide for special retirement expenses, such as health care.

COMMENTS

This program was established by Chapter 1154, Statutes of 1990 (SB 389, Seymour) and applies to tax years beginning on January 1, 1990 and thereafter. The maximum credit amount is indexed annually for inflation, and the credit is not refundable.

Credit (Activity Based):

PRISON INMATE LABOR COSTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17053.6 and 23624.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	Minor	Minor
1997-98	Minor	Minor
1998-99	Minor	Minor

DESCRIPTION

This program allows employers a tax credit equal to 10 percent of the wages they pay to each state prison inmate employed in a joint-venture program for the purpose of producing goods or services. For purposes of this program, a joint-venture employer is any public entity, nonprofit or for-profit entity, organization, or business which contracts with the California Department of Corrections for the purpose of employing inmate labor. These work programs are to be patterned after business operations found outside of prison, and priority consideration is given to inmate employment which will retain or reclaim jobs in California, support emerging California industries, or create jobs to fill a void in the labor market.

RATIONALE

This program provides an incentive for California businesses to use state prison inmate labor. The rationale for the program is that it will provide meaningful work to prison inmates that will enhance their prospects for employment once they are released from prison, and also will benefit the California economy. In addition, the wages earned by inmates are subject to deductions for taxes, prison room and board, restitution to crime victims, and support of the inmate's family.

COMMENTS

The revenue losses associated with this program are speculative due to uncertainties regarding the number of qualifying joint-venture programs and the annual compensation of those employed. This program was enacted by Proposition 139 in the statewide general election in November 1990.

Credit (Activity Based):

ACTIVITIES IN ENTERPRISE ZONES AND OTHER ECONOMICALLY DEPRESSED AREAS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 7089, 17052.13, 17052.15, 17053.8, 17053.9, 17053.10, 17053.11, 17053.17, 17053.33, 17053.34, 17053.45, 17053.46, 17053.70, 17053.74, 17053.75, 23612, 23612.5, 23622, 23623, 23623.5, 23625, 23645, and 23646.*

Estimated Revenue Reductions

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$50	$102
1997-98	58	107
1998-99	19	114

DESCRIPTION

These programs allow qualified taxpayers to claim tax credits for certain expenditures or income earned in economically depressed areas of the state, including those that have been designated as Enterprise Zones, Local Agency Military Base Recovery Areas (LAMBRA), the Los Angeles Revitalization Zone (LARZ) or, for specified types of activities, within Targeted Tax Areas and Manufacturing Enhancement Areas. There are three types of income tax credits available.

Wages Paid to Disadvantaged Persons. Employers can receive a credit equal to a portion of the wages paid to qualified "disadvantaged individuals." Generally, qualified individuals are those who were unemployed or economically disadvantaged prior to the date of hiring. For employers in Enterprise Zones, LAMBRA, LARZ, Targeted Tax Areas and Manufacturing Enhancement Areas, the available tax credit is 50 percent of the wages paid during the first year, 40 percent for the second year, 30 percent for the third year, 20 percent for the fourth year, and 10 percent for the fifth year. In addition, a credit of 50 percent of wages paid to area residents who were hired to do construction work within the zone was available to LARZ employers through 1997. A credit claimed under this program, together with the sales and use income tax credit (see below), is limited to the tax attributable to income from the designated area.

Credits are generally recaptured if employees are terminated prior to a prescribed time period (generally one year). Unused credits may be carried over and applied to offset taxes on income from the area in succeeding tax years. Generally, the available credit is reduced to the extent other credits are granted to the same employer for area activities. The eligibility for employers in LARZ expired January 1, 1998. Eligibility for employers in a LAMBRA expires January 1, 2003.

Taxes Paid by Enterprise Zone Employees. Enterprise Zone employees can receive an income tax credit of 5 percent of their "qualified wages," up to a maximum of $525. The credit is reduced by 9 cents for each $1 in wages in excess of "qualified wages," as defined in the federal Internal Revenue Code, Section 3306(b). The credit is nonrefundable, and unused portions may not be carried forward.

Sales Tax on Machinery. An employer can receive an income tax credit for the amount of sales and use taxes paid on the purchase of machinery or parts used for specific purposes in Enterprise Zones, LAMBRA, LARZ, and for certain activities, within Targeted Tax Areas. The credit, together with amounts claimed under the wages credit (discussed above), is limited to the amount of income tax attributable to the incentive area. The credit is nonrefundable, but unused portions may be carried forward into succeeding tax years.

Rationale

These programs are intended to provide incentives for stimulating employment and business activity in economically depressed areas of the state. These areas typically either have higher costs associated with conducting economic activity or are perceived as being high-cost, low-productivity areas. The credits represent an attempt to reduce costs and make the areas more attractive for undertaking investments and conducting economic activity.

Comments

These programs were initially established in 1984 by the state's Enterprise Zone Act and Employment and Economic Incentive Act, and amended in 1985. The Employment and Economic Incentives Act was repealed and essentially replaced by the Enterprise Zone Act of 1996. The LARZ, LAMBRA, Targeted Tax Areas, and Manufacturing Enhancement Areas were added later as qualifying for certain tax credits under these programs.

Pursuant to Chapter 323, Statutes of 1998 (AB 2798, Machado), the credits available under these programs were expanded and enhanced. For additional related information, see comments regarding the effectiveness of tax incentives for Enterprise Zones and related areas discussed under the program "Income From Investments in Economically Depressed Areas."

Credit (Activity Based):
INCREASED RESEARCH AND DEVELOPMENT EXPENSES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17052.12 and 23609, which partially conform to Internal Revenue Code Section 41.*

Estimated Revenue Reduction *(In Millions)*

Fiscal Year	PIT	BCT
1996-97	$10	$270
1997-98	11	330
1998-99	12	350

DESCRIPTION

This program allows taxpayers to claim a tax credit for a portion of certain additional increments to their research and development (R&D) expenses. The credit may be applied to "qualified" research conducted either "in-house" or by contract. Qualified research is defined as research that is: (1) technological in nature; (2) intended to be useful in the development of a new or improved product, service, computer software, technique, formula, or invention of the taxpayer; (3) held for sale, lease, or license, or used by the taxpayer in a trade or business; and (4) performed in California.

Beginning in 1997, the R&D credit is equal to 11 percent of the taxpayer's *additional* qualified research expenses for the tax year, over a specified percentage of the taxpayer's average annual gross receipts for the four preceding taxable years. For BCT taxpayers, an additional credit equal to 24 percent of the taxpayer's basic (defined as university) research is availaable. To the extent that the credit exceeds the taxpayer's net tax liability in the taxable year, the excess may be carried forward and used to reduce tax liabilities in subsequent years.

Under certain conditions, a specified formula may be used to calculate an alternative incremental credit. This alternative incremental credit was increased pursuant to Chapter 323, Statutes of 1998 (SB 2798, Machado).

RATIONALE

This program provides an incentive for taxpayers to invest in R&D activities by reducing the after-tax cost of making such investments. The underlying rationale is that if such incentives were not available, industry would "underinvest" in R&D activities from a social point of view.

DISTRIBUTION OF BENEFITS

The accompanying table (see next page) shows the distribution of benefits from the program by industry, based on number of returns and the amount of tax benefits received. Almost 60 percent of the returns claiming the credit are from electronics firms and other manufacturing enterprises. The dollar amount of tax benefits are even more heavily weighted towards these types of industries, with over two-thirds of the total benefits going to these two industry groups. Electric and electronic equipment industries alone claimed almost one-half of the credits.

Increased Research and Development Expenses Tax Credit

1998 Income Year

Industry Type	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed
Electrical and Electronics Equipment	26.8%	46.6%
Chemicals and Allied Products	3.9	10.0
Food and Kindred Products	0.9	0.3
Other Manufacturing	29.2	20.9
Other	39.2	22.3

Comments

According to the Research Institute of America, over one-third of all states offer a tax credit to businesses for R&D conducted within their state. The amount of the tax credit a business can claim varies from state to state largely due to the differences in the base period used and the percent of expenses applicable. The federal government also provides a tax credit for R&D expenditures, which differs in several respects from the California credit.

Supporters of R&D credits argue that the subsidy they provide is needed to encourage increased investment by private industry in emerging areas of technological change and development—investment which would not occur in the absence of the credit. A number of economists support this view.

Some opponents of the credit, however, argue that it does little to spur additional investment, and that its costs far outweigh the benefits to society. Other critics of R&D credits argue that while underinvestment in R&D would occur in the absence of intervention programs, tax credits are an inappropriate *mechanism* through which to address the problem. Some, for example, put forth a direct R&D subsidy as an alternative approach.

Evidence regarding the effectiveness of the R&D credit remains ambiguous. Although there do not appear to be any studies that have analyzed the effectiveness of California's R&D tax credit, numerous analyses of the federal credit have been conducted. The U.S. General Accounting Office (GAO), for example, reports that some additional research spending was stimulated by the tax credit, with most of the benefits going to large manufacturing corporations. However, GAO also reported that in 1992, 79 percent of corporations earning R&D credits had accumulated more general business tax credits than could be used. Thus, the marginal incentive provided by additional R&D tax credits was reduced (see U.S. GAO, *Tax Policy: Additional Information on the Research Tax Credit*, 1995). Some studies regarding the effectiveness of the credit found it to have a relatively minor impact on R&D spending by U.S. corporations (see, for example, Eisner, Albert and Sullivan, *The New Incremental Tax Credit for R&D: Incentive or Disincentive?*, National Tax Journal, V. 37, 1984; and Karier, *Closing the R&D Gap: Evaluating the Sources of R&D Spending*, Jerome Levy Economics Institute, Working Paper #22, 1995).

The GAO's recent review of eight separate studies regarding the R&D credit indicates that the effectiveness of the credit is still open to debate. While four of the reviewed studies linked the R&D credit to additional research spending that exceeded the cost of the credit, the remaining four did not support this claim or were inconclusive. The GAO determined that, due to data limitations and methodological issues, available studies are inadequate to the task measuring the effectiveness of the credit (see U.S. GAO, *Tax Policy and Administration: Review of the Effectiveness of the Research Tax Credit*, 1996).

Credit (Activity Based):

EMPLOYER-PROVIDED CHILD CARE EXPENSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17052.17, 17052.18, 23617, and 23617.5.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	$1	$5
1997-98	1	5
1998-99	Minor	3

DESCRIPTION

The PIT and BCT provide employers several tax credits for child care assistance programs. These tax credit programs allow employers to deduct the costs of certain contributions toward employee child care expenses incurred between January 1, 1988 and January 1, 2003. Specifically, employers may deduct:

- Thirty percent of the startup costs of establishing a child care program, the costs of constructing a child care facility, and/or the costs of child care referral services, up to $50,000 per tax year.

- Thirty percent of the cost of contributions to a qualified child care plan. A qualified care plan may include onsite or offsite child care centers, in-home care, and specialized centers which provide care for children with short-term illnesses. Qualifying contributions may not exceed $360 per qualified dependent per tax year.

In order to qualify for the tax credit, these costs must be associated with programs primarily used by children of the taxpayer's employees who are under the age of 15. To the extent that the credit amounts exceed a taxpayer's net tax liability in the year the expenses are incurred, they may be carried forward and used to offset the taxpayer's liability in future years, but not by more than $50,000 in any one tax year.

RATIONALE

This program is intended to give employers a financial incentive to provide for the child care needs of their employees. It does this by reducing the after-tax cost of making these provisions.

COMMENTS

Employers must reduce their *basis cost* (which is used for purposes of determining capital gains and losses when property eventually is sold) in child care facilities on which a tax credit is claimed, by the amount of the credit claimed for those facilities. A taxpayer can elect to take depreciation in lieu of claiming the credit. Pursuant to Chapter 323, Statutes of 1998 (AB 2798, Machado), this program was extended from January 1, 1998 to January 1, 2003.

Credit (Activity Based):

LOW-INCOME RENTAL HOUSING EXPENSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17058 and 23610.5, which partially conform to Internal Revenue Code Section 42.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	$6	$23
1997-98	6	24
1998-99	6	24

DESCRIPTION

This program provides a tax credit for investors for a portion of the costs of investing in low-income rental housing projects. The amount of the credit depends on the amount needed by the investor in order to make the project economically feasible. This amount is determined by the California Tax Credit Allocation Committee, which reviews program applications and allocates credits based on certain previously established legislative priorities.

Generally, the percentage of costs for which credits may be claimed is based on federal guidelines. The maximum amount the committee may award to a project is designed so that the present value of four annual credit payments generally equals 30 percent of an investor's qualified basis in the low-income housing units. "Qualified basis" is roughly equal to the acquisition, construction, and/or rehabilitation costs of the units. In exchange for the tax credits, the investor must commit to renting a specified percentage of units to low-income individuals based on one of the following options:

- Renting 20 percent of the units to individuals whose income is no more than 50 percent of area median income.
- Renting 40 percent of the units to individuals whose income is no more than 60 percent of area median income.

The rent on these program units based on either option may not exceed 30 percent of these specified income limits.

RATIONALE

This tax credit program is intended to increase the number of affordable rental housing units available to low-income households in California, by reducing the after-tax costs to developers and investors who produce and invest in such units.

COMMENTS

This program complements a federal tax credit program which also works to promote the development of low-income housing. The maximum federal tax credit that can be awarded is generally equal to 70 percent (on a present-value basis) of a taxpayer's qualified basis in the project, spread over a ten-year period. A project that receives the maximum in both state and federal credits receives 100 percent of the taxpayer's qualified basis over a 10-year period. Both the state and federal programs are administered by the California Tax Credit Allocation Committee.

The state program is authorized as long as the federal program continues in existence. California requires that the compliance period over which the program requirements noted earlier must be adhered to extend for 30 consecutive years, rather than the 15-year federal period.

Chapter 1222, Statutes of 1993 (AB 1438, Caldera), expanded this credit to allow insurance companies to qualify. Specifically, insurance companies are allowed a share of the annual credit allocated for investments in low-income housing and can use the credit to offset their gross premiums tax.

Credit (Activity Based):
JOINT CUSTODY HEAD OF HOUSEHOLD

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17054.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	PIT
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows a tax credit for divorced or separated individuals who *do* bear significant costs in order to maintain a home for a dependent for part of the year, but do *not* provide the principal residence for a dependent (and, therefore, do not qualify for the more-advantageous "head-of-household" filing status).

Specifically, the program allows a tax credit equal to the lesser of (1) 30 percent of a taxpayer's net tax or (2) a maximum amount determined annually ($281 in 1998). The program is available to divorced or separated taxpayers who (1) live apart from a spouse for at least six months prior to the end of the tax year, and (2) provide for at least one-half of the cost of maintaining the principal residence of a dependent for at least 146 days but not more than 219 days of the tax year. (A taxpayer who maintains the principal residence of a dependent for more than 219 days of the tax year qualifies for the more-advantageous head-of-household filing status.)

RATIONALE

This program is intended to provide tax relief to taxpayers who are single, or married and living apart, and who care for dependents such as children for a significant portion of the tax year. The program's rationale reflects the view that, in the case of taxpayers who have to maintain households in order to care for dependents, their economic burdens are greater than those of individuals with no such responsibilities.

COMMENTS

Federal law defining "head of household" was incorporated into California law by reference for post-1986 tax years. In order for the head-of-household filing status to be claimed, the household must be the principal residence of the qualifying dependent for more than 219 days of the year. Chapter 1537, Statutes of 1982 (AB 2520, Sher) created a special "joint custody" head-of-household filing status with its own personal exemption credits and tax rates. This separate filing status was replaced with this tax credit by Chapter 1138, Statutes of 1987 (AB 53, Klehs).

Credit (Activity Based):

SALMON AND STEELHEAD TROUT HABITAT RESTORATION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17053.66 and 23666.*

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	Minor	Minor
1997-98	Minor	Minor
1998-99	Minor	Minor

DESCRIPTION

This program, which sunsets on December 1, 2000, provides a tax credit equal to the lesser of (1) 10 percent of the qualified costs paid or incurred for salmon or steelhead trout habitat restoration, up to $50,000 per taxpayer, or (2) the amount certified by the California Department of Fish and Game (DFG). The credit may be used to offset tax liabilities during years in which the expenses are incurred, and any unused credit may be used to offset tax liabilities in future years.

To be able to claim the credit, the taxpayer must apply to the DFG. The department is responsible for certifying that the taxpayer's project has met specified criteria and for authorizing the actual amount of credit that the taxpayer may claim. The project must meet the following criteria: (1) meet the objectives of the Salmon, Steelhead Trout, and Anadromous Fisheries Program Act and contribute to the increase in production of salmon and trout by improving certain habitat conditions; (2) provide employment to unemployed fishing or forestry industry persons in counties with a higher-than-average annual rate of unemployment as specified by the Employment Development Department; and (3) undertake work that does not include construction of office, storage facilities, garages, maintenance buildings, hatchery facilities, permanent surface roadways, bridges, wells, or pumping equipment. The amount of credit allowable must be reduced by the amount of any grant or cost-sharing payment for the project made by a public entity.

RATIONALE

This program provides an incentive for taxpayers to undertake projects to restore the habitats of salmon and steelhead trout. It does this by offsetting a portion of the costs incurred through a credit that is applied towards the taxpayer's tax liability.

Credit (Activity Based):

MANUFACTURERS' INVESTMENT TAX CREDIT

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17053.49 and 23649.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	$34	$390
1997-98	34	395
1998-99	34	390

DESCRIPTION

This program provides a tax credit intended to encourage manufacturing activity and investment in the state. It provides *qualified* taxpayers an income tax credit equal to 6 percent of the *qualified* costs incurred for construction, acquisition, or lease of *qualified* property that is placed in service in California.

- "Qualified taxpayers" are persons engaged in specified businesses as described in the Standard Industrial Classification (SIC) Manual.
- "Qualified costs" include (1) amounts on which the taxpayer paid sales and use tax and that are considered capital acquisitions, and (2) the value of any capitalized labor costs that are directly related to the construction or modification of qualified property.
- "Qualified property" means tangible personal property that is depreciable or computer software used primarily in manufacturing, research, pollution control, recycling, or in maintaining, repairing, measuring, or testing property used in such activities. It also includes, for certain activities, special purpose buildings and foundations that are primarily used in connection with manufacturing, refining, processing, fabricating, or research and storage.

If the property is removed from California, the credit is "recaptured" by adding the credit amount received back on to the appropriate year's net tax liability of the taxpayer. In general, unused credits may be carried forward for up to eight years to offset tax liabilities. In the case of qualified small businesses, the carryforward period is ten years.

RATIONALE

This program provides an incentive for qualified taxpayers to expand their investments in manufacturing and research property in California. It does this by offsetting a portion of the costs incurred through a credit that is applied towards their tax liabilities.

DISTRIBUTION OF BENEFITS

The accompanying table (see next page) shows the distribution of benefits of the program for various industries, based on number of returns and by total amount of tax benefits involved. Over one-half of the total dollar amount of benefits of the program goes to electronics and petroleum refining firms. Another one-quarter accrues to other types of manufacturing enterprises.

Manufacturers' Investment Tax Credit

1998 Income Year

	Percent of	
Industry Type	Total Taxpayers Benefitting	Total Amount Claimed
Electrical and Electronics Equipment	13.2%	26.9%
Petroleum Refining	0.7	25.1
Chemicals and Allied Products	4.5	5.6
Food and Kindred Products	7.6	7.4
Other Manufacturing	56.5	27.4
Other	17.6	7.4

COMMENTS

A *sales and use tax* exemption of 5 percent is available for new businesses that first commence activity in California after 1993 and have not been in existence for more than three years. However, if a taxpayer claims this program's *income* tax credit, then the taxpayer *cannot* claim the sales and use tax exemption.

This credit essentially reduces the cost of capital acquisitions, and consequently could result in a relative shift away from labor and towards capital. This could be coupled with increased labor demand as a result of overall reduced manufacturing costs, and an increase in production.

Pursuant to Chapter 323, Statutes of 1998 (AB 2798, Machado), the credit was expanded to include taxpayers engaged in software development, computer programming, and computer integrated systems design.

Credit (Activity Based):

ENHANCED RECOVERY COSTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17052.8 and 23604, which generally conform to Internal Revenue Code Section 43.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	Minor	Minor
1997-98	Minor	$2
1998-99	Minor	2

DESCRIPTION

This program provides a tax credit for 5 percent of the qualified costs associated with "enhanced recovery" of oil and gas (such as pumping heated liquids or gasses into a well to enhance the flow of these materials). This credit applies only to nonvertically integrated producers for projects located within California. Unused credits may be used to offset tax liabilities in the future, for up to 15 years. If the taxpayer's costs qualify for another credit, the taxpayer must make an election between credits. No tax deduction is allowed for costs for which the credit is allowed.

RATIONALE

This program provides an incentive for businesses to use more efficient oil and gas recovery technologies by partially offsetting the associated costs.

COMMENTS

This program conforms with a federally enhanced oil recovery tax credit program. The federal program provides a tax credit for 15 percent of the qualified costs incurred.

Credit (Activity Based):

FARMWORKER HOUSING COSTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17053.14, 23608.2, and 23608.3.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	Minor	Minor
1997-98	Minor	Minor
1998-99	Minor	Minor

DESCRIPTION

This program provides a tax credit in the amount of the lesser of: (1) 50 percent of the costs associated with building, repairing, or donating farmworker housing; or (2) the amount certified by the California Tax Credit Allocation Committee. To claim the credit, the taxpayer must enter into an agreement with the committee to build or donate housing meeting specified criteria, with the credit available only during the year when the housing is completed and occupied.

A tax credit is also available to lenders who provide low-interest loans for farmworker housing. It is equal to half of the difference between market interest rates and the rates actually charged. California requires a compliance period of 30 years to be eligible for the credit.

RATIONALE

This program provides a tax incentive for taxpayers to provide suitable housing for farmworkers. The rationale is that the incentive to farm owners and others will stimulate the provision and construction of suitable housing for farmworkers.

Credit (Activity Based):

RICE STRAW

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17052.10 and 23610.*

Estimated Revenue Reduction (In Millions)		
Fiscal Year	*PIT*	*BCT*
1996-97	*Minor*	*Minor*
1997-98	*Minor*	*Minor*
1998-99	*Minor*	*Minor*

DESCRIPTION

Upon certification by the California Department of Food and Agriculture, this program provides a tax credit in the amount of $15 per ton of rice straw that is grown in California and purchased by the taxpayer. The taxpayer must be an "end user" of rice straw; that is, the taxpayer must use the rice straw for processing, generation of energy, manufacturing, export, prevention of erosion, or for any other purpose exclusive of open burning.

Under the program, the department issues taxpayers a certificate specifying the amount of any tax credit allocated. Up to $400,000 per year in total tax credits may be allocated on a first-come, first-served basis. Any claimed but unused credits may be carried forward by taxpayers to offset their tax liabilities in future years, for up to ten years.

RATIONALE

The program is aimed at reducing the open burning of rice straw by farmers, thereby reducing the air pollution impacts of such burning. It does so by providing an incentive for taxpayers to purchase rice straw for other purposes. The rationale is that rice straw can be put to more productive uses than simply open burning; however, it often is more costly for the user to choose such other options. This program is intended to partially offset the costs of purchasing the rice straw so that taxpayers will be encouraged to use rice straw in a more efficient manner.

Credit (Activity Based):

DISABLED ACCESS EXPENDITURES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17053.42 and 23642, which generally conform to Internal Revenue Code Section 44.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	PIT	BCT
1996-97	Minor	Minor
1997-98	Minor	Minor
1998-99	Minor	Minor

DESCRIPTION

This program provides a tax credit for 50 percent of up to $250 of qualified expenditures to eligible small businesses that provide access to disabled individuals. Thus, this program allows a California credit up to a maximum of $125. To qualify for the credit, the business must (1) have earned less than $1 million in gross receipts in the previous year, and (2) employ not more than 30 full-time employees.

Qualified expenditures include those costs associated with complying with the Americans With Disabilities Act of 1990. This includes removing physical barriers that block entrance to a business and acquiring equipment to aid in servicing individuals with specified disabilities, such as hearing and vision impairments. Any unused credit may be carried forward to offset tax liabilities in future years.

RATIONALE

This program complements an already-established federal tax credit. It also provides an incentive to qualified businesses to make certain "minor" improvements that may not exceed the threshold to qualify for the federal credit.

COMMENTS

The federal government provides a tax credit for 50 percent of qualified expenditures exceeding $250 and up to $10,250. This program covers the initial $250 of qualified expenditures.

Credit (Activity Based):

TRANSPORTATION OF DONATED AGRICULTURAL PRODUCTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17053.12 and 23608.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	Minor	Minor
1997-98	Minor	Minor
1998-99	Minor	Minor

DESCRIPTION

This program provides a tax credit for 50 percent of transportation costs paid or incurred by a taxpayer that are related to the transportation of donated agricultural products to a nonprofit, charitable organization. Upon receipt, the charitable organization furnishes the donor with a certificate specifying the transportation of donated agricultural products, including the type and amount of products donated and the distance transported. Any unused tax credit may be carried forward to offset tax liabilities in future years.

RATIONALE

This program provides an incentive for taxpayers to donate or incur the costs for transporting agricultural products to charitable organizations. The underlying rationale is that charitable organizations are providing a socially beneficial service by distributing agricultural products to needy individuals, and that this service is worthy of indirect state support. By partially offsetting the costs of transporting the agricultural products, the program encourages more taxpayers to donate or incur the costs of transporting these products. Thus, more agricultural products may reach charitable organizations than otherwise would without the incentive.

Credit (Activity Based):

CHILD ADOPTION EXPENSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17052.25.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program provides a tax credit equal to 50 percent of the qualified costs of an adoption of a minor child who is a legal resident or citizen of the United States and was in the custody of a public adoption agency of this state. Qualified costs include fees for required services, travel and related expenses for the adoptive family that are directly related to the adoption process, and medical fees and expenses not reimbursed by insurance that are directly related to the adoption. The tax credit may offset tax liabilities up to $2,500 per child in the year that the adoption papers are ordered. Any unused credit may be carried forward to offset tax liabilities in future years.

RATIONALE

This program provides tax relief to families choosing to adopt a child. The underlying rationale is that adoption provides a socially beneficial service which is worthy of public financial support.

Special Filing Status:
SUBCHAPTER S CORPORATIONS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17087.5, 18006, and 23800 through 23813, which partially conform to Internal Revenue Code Sections 1361 through 1379.*

Estimated Revenue Effect
(In Millions)

Fiscal Year	PIT	BCT
1996-97	+$217	$1,185
1997-98	+236	1,175
1998-99	+255	1,235

DESCRIPTION

This program allows eligible small business corporations to elect Subchapter S corporation status for purposes of determining their tax liability. The so-called "S" corporations pay taxes on corporate income at a reduced rate of 1.5 percent, except for financial institutions, which are subject to a 3.5 percent rate. The S corporations are *not* subject to the Alternative Minimum Tax (AMT) but *are* subject to the applicable corporate minimum tax. Individual shareholders of an S corporation pay personal income taxes on their pro rata share of corporate income.

In contrast to S corporations, a regular "C" corporation pays taxes on its corporate income at a rate of 8.84 percent (or 10.84 percent for financial institutions), for income earned beginning on or after January 1, 1996. Corporate shareholders in C corporations pay taxes on corporate earnings only to the extent that such earnings are paid out of dividends.

In order to be eligible to elect S corporation status, a corporation must have (1) a valid federal S election in effect, (2) fewer than 75 shareholders, and (3) only one class of stock. Those corporations which meet these criteria and make a federal S election are deemed to have made an S election for state purposes as well. However, a corporation may make a separate state election to be treated as a C corporation for state tax purposes, even if a federal S election has been made.

RATIONALE

This program is intended to provide tax relief to small corporations while still allowing them to take advantage of the limited liability aspect of corporate status. Generally, businesses that make an S election pay less in taxes than they would as C corporations.

DISTRIBUTION OF BENEFITS

The benefits of the Subchapter S special filing status accrue largely to small-to-mid-sized companies, as shown in Figure 1 (see next page). Almost three-quarters of the corporate taxpayers benefitting from the program are enterprises with receipts of less than $1 million per year. In terms of total benefits received, over two-thirds of benefits go to enterprises with receipts of $50 million or less. Figure 2 (see next page) indicates the distribution of benefits of Subchapter S filing status by type of enterprise. The industry sector that benefits the most in dollar terms from the Subchapter S filing status is manufacturing, which accounts for 36 percent of the total benefits. (The distribution of benefits is based only on the effects of the program on BCT revenues and does not include any offset due to increases in PIT revenues.)

Figure 1

Subchapter S Corporations Tax Benefits by Receipt

1998 Income Year

Total Receipts (In Millions)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed
Under $1	74.0%	7.3%
1–10	20.7	32.7
10–50	4.6	28.6
50–100	0.4	10.5
100–500	0.3	9.7
500–1,000	0.1	10.4
Over 1,000	0.1	0.8

Figure 2

Subchapter S Corporations Tax Benefits by Industry

1998 Income Year

Industry Type	Percent of Gross State Product	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed
Agriculture, Forestry & Fishery	3.0%	2.4%	3.0%
Construction	3.8	7.4	4.4
Manufacturing	15.9	10.5	35.9
Services	25.1	38.8	27.1
Trade	18.2	20.3	18.0
Finance, Real Estate & Insurance	25.9	16.9	8.3
Utilities & Transportation	8.2	3.7	3.4

COMMENTS

The revenue increases for PIT result from two factors: (1) unlike C corporation income, all operating income from S corporation earnings is passed through to shareholders and taxed as personal income; and (2) nonresident shareholders must pay California personal income taxes on earnings. These revenue increases may be partially offset by the pass-through of losses to shareholders, which can be deducted from income.

Under federal law, an election of S corporation status completely eliminates any tax liability of the corporation itself. All income and expenses are passed through to shareholders, and there is no entity-level tax imposed. Net income is taxed on a pro rata basis as if it were received as individual income.

According to data from the Franchise Tax Board, there were 118,514 S corporations in California in 1996, with a reported net income of $12.5 billion and tax liabilities of $282 million.

Federal conformity legislation in the form of Chapter 612, Statutes of 1997 (SB 1233, Lockyer), and Chapter 610, Statutes of 1997 (SB 5, Lockyer) contained several provisions affecting S corporations. In particular, scheduled increases in the tax rate were eliminated and the 1.5 percent entity-level tax rate was retained. In addition, the number of allowable shareholders was expanded from 35 to 75. The legislation also liberalized shareholder eligibility, allowed various financial institutions to be S corporations, and permitted S corporations to have wholly owned subsidiaries.

Special Filing Status:
HEAD OF HOUSEHOLD AND SURVIVING SPOUSE

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17042, 17046, and 17054, which partially conform to Internal Revenue Code Sections 2, 151, and 152.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows taxpayers who care for dependents to qualify for lower tax rates than are available to single persons or to married persons filing separate returns. This program is intended to provide tax relief to heads-of-households who are single, or married but living apart, and surviving spouses. Surviving spouses qualify for a larger personal exemption in addition to the lower tax rates.

RATIONALE

The program's rationale reflects the view that taxpayers who have to maintain households in order to care for dependents have greater economic burdens than do individuals with no such responsibilities. In addition, the program reflects the view that tax relief may be needed by many surviving spouses in order to be able to maintain their economic status.

COMMENTS

Federal law definitions for the head-of-household and surviving-spouse filing statuses were incorporated into California law by reference for post-1986 tax years. In order to claim the head-of-household filing status, a taxpayer must provide the principal home of the qualifying dependent for over one-half of the year. In addition, the taxpayer must pay more than one-half of the cost of maintaining that household. A surviving spouse is a taxpayer whose spouse died within two years prior to the taxable year involved, who cares for a dependent child, and has not remarried.

Chapter 846, Statutes of 1990 (AB 3086, Klehs), provides that taxpayers with a *non*dependent relative living in the home qualify for head-of-household filing status. For example, if a single custodial parent has moved into the home of her widowed father, the father would qualify as a head-of-household. Although the child is the custodial parent's dependent, the grandfather qualifies to claim the head-of-household filing status because he provides more than one-half of the cost of maintaining the home.

✦ Sales and Use Tax

✦ TABLE OF CONTENTS—SALES AND USE TAX

✦ SALES AND USE TAX—OVERVIEW

This section provides information on tax expenditure programs (TEPs) associated with the sales and use tax paid by individuals and businesses. These TEPs affect the amount of General Fund and special funds revenues raised by the sales and use tax, the second largest source of state revenues. These TEPs also have an impact on local government revenues since (except in certain instances) the programs affect both the state and local portions of sales and use tax receipts. The following provides a brief description of this tax.

GENERAL BACKGROUND INFORMATION

The sales and use tax is levied on the gross receipts of personal property sold or transferred to an individual or business considered to be the final consumer. The sales and use tax actually consists of *two* complementary taxes:

- ***Sales Tax.*** The *sales* tax portion is the more familiar of the two taxes and is levied on the total purchase price of tangible personal property sold in California, except for items specifically exempted from taxation by law.
- ***Use Tax.*** In contrast, the *use* tax generally applies to the storage, use, or other consumption in this state of goods purchased from retailers in transactions not subject to the sales tax, generally for purchases shipped into California from another state.

The following example is helpful in demonstrating how the use tax works. If an automobile is purchased in Oregon by a California resident who intends to use the vehicle in California, then the individual would pay the California use tax on the retail price of the car. Without a use tax, such a consumer could avoid paying a tax on a vehicle to be used within California, by purchasing it outside the state and then bringing it into California. State automobile registration requirements make feasible the collection of the use tax on vehicles brought in from out of state. Central registration requirements also facilitate the collection of use tax for water vessels, aircraft, and mobilehomes. For other types of purchases, registered taxpayers involved in sales activities are required to report taxable out-of-state purchases on their quarterly sales and use tax returns.

Collection Responsibility. A *seller* is responsible for remitting the sales and use tax to the state, although he/she may try to "pass" the tax on to the purchaser through higher prices. The extent to which the sales and use tax is passed on to the purchaser through higher prices is dependent on the supply and demand characteristics of the particular commodity and market involved. Regardless of who bears the ultimate financial burden or "incidence" of the tax, however, the seller is legally responsible for collecting and remitting all tax payments to the Board of Equalization (BOE), the state agency in charge of administering the sales and use tax.

CHARACTERISTICS OF THE CALIFORNIA SALES AND USE TAX

Tax Rate. The sales and use tax was first imposed in California in 1933. The tax *rate* has generally increased since that time, although there have been periodic decreases as well. Additions and subtractions to the sales and use tax *base* have also taken place through changes in exempted transactions.

The basic sales and use tax rate consists of both a *state* rate and a *local* rate. Figure 1 provides a breakdown of the current tax rate levied in California.

Figure 1

Sales and Use Tax Rates

State	
General Fund	5.00%
Local Revenue Fund	.50
Local Public Safety Fund	.50
Subtotal	6.00%
Local	
Uniform Local Taxes (Bradley-Burns)	1.25%
Optional Local Taxes[a]	1.50
Subtotal	2.75%
Total	**8.75%**

[a] Maximum optional local rate, except for San Francisco City and County (1.75 percent), San Mateo County (2 percent), and San Diego County (1 percent).

Source: Board of Equalization

- *State Tax Rate.* The current *state* sales and use tax rate is 6 percent. As Figure 1 shows, 5 percent of the state sales and use tax rate is dedicated to the General Fund. In addition, a 0.5 percent rate is dedicated to the Local Revenue Fund, which is earmarked for health and welfare costs associated with the 1991 state-local government realignment program. A second 0.5 percent state tax levy is dedicated for local public safety programs and is allocated directly to localities through the Local Public Safety Fund. Figure 2 summarizes how the state's General Fund tax rate has changed from the mid-1930s to the present.
- *Local Tax Rate.* As shown in Figure 1, the Bradley-Burns Uniform Local Tax is a 1.25 percent levy, consisting of a 1 percent tax that is allocated to local governments for general purposes and a 0.25 percent levy that is dedicated for county transportation purposes. Localities also have the option of imposing, with voter approval, up to a 1.5 percent transactions and use tax. (San Francisco City and County and San Mateo County, however, are allowed to exceed this maximum rate by 0.25 percent and 0.5 percent, respectively.) Some of these local revenues may be used for general purposes, but they have primarily been imposed for transportation-related purposes.

Figure 2

State Sales and Use Tax Rates (General Fund)

	Tax Rate
1933-34	2.50%
1935-42	3.00
1943-48	2.50
1949-66	3.00
1967-71	4.00
1972	3.75
1973	4.75
1973	3.75
1974-90	4.75
1991-92	5.50
1993 to present	5.00

Source: Board of Equalization

Given the above, the combined state-local sales and use tax rate in California varies by county. As shown in Figure 3, actual rates as of January 1, 1999, ranged from a low of 7.25 percent to a high of 8.5 percent. The estimated revenue reductions shown in the following TEP reviews include effects on both the state and local governments.

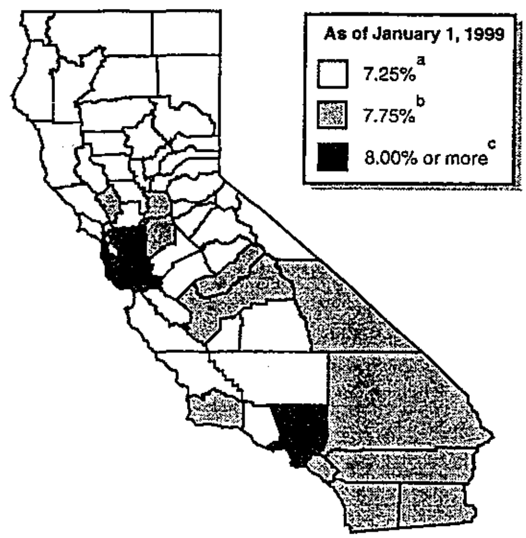
Tax Base. The sales and use tax base consists of all items that are potentially taxable under current law, minus various exemptions and exclusions (the latter are discussed in detail in the reviews that follow). In general, any tangible asset that is moveable (that is, not permanently attached to property) which is sold and subsequently used, consumed, or stored in California is subject to the sales and use tax. However, there are some general exceptions to this rule, including the following:

- *Federal Government Purchases.* The federal government, its agencies and instrumentalities that are deemed wholly owned by the federal government, various federally related contract activities, and the American Red Cross, are exempt from state and local sales and use taxes.
- *Out-of-State Sales.* Goods delivered to an out-of-state purchaser for use outside of California are exempt from California's state and local sales and use taxes.
- *Resale Purchases.* Goods purchased by a business which are subsequently resold as part of an intermediary transaction are exempt from the state and local sales and use tax. This includes both certain materials that will be *incorporated* into a final product, and finished products purchased for *resale* (such as furniture or artwork purchased by an interior designer that will be resold to clients).

While items purchased outside of California and transported into and used within the state *are* technically *subject* to the use tax, only

Figure 3

Sales Tax Rates Vary by County



a Includes Stanislaus, Nevada and Solano (7.38 percent) and Sonoma (7.50 percent).
b Includes Fresno (7.88 percent).
c Includes: Santa Cruz (8.00 percent); Alameda, Contra Costa, Los Angeles, San Mateo, and Santa Clara (8.25 percent); and San Francisco (8.50 percent).

in cases where there are centralized registration requirements or the purchases are made by registered sales tax payers does the state actually *collect* the tax. For example, no use tax is collected from individuals who purchase goods through mail-order, Internet, or other related means.

In addition, California generally does not directly tax services when these represent the final product (although there are a limited number of exemptions to this general rule, such as photocopying services and gift wrapping services). However, services that contribute to the production or delivery of a tangible product sold are *indirectly* subject to the sales and use tax through the explicit or implicit incorporation of the cost of such services in the price of the tangible product. Such services include, for example, food service at restaurants and assembly and delivery activities.

Exclusion/Exemption:

Gas, Electricity, Water, Steam, and Heat

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6353.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$3,000
1997-98	3,156
1998-99	3,264

Description

This program exempts from taxation the sale or transfer of gas, electricity, water (including steam), and geothermal brines or other heat sources delivered through mains, lines, or pipes. It also exempts water sold to an individual in bulk quantities (50 gallons or more) for household use, when the residence is not served by mains, lines, or pipes. In addition, the program exempts the transfer of steam, heat, or other energy produced by cogeneration technologies.

Rationale

The basic exemption for gas, electricity, and water dates back to the inception of the sales tax in 1933, when companies providing these services were subject to a gross receipts tax that was levied in lieu of other taxes under the State Constitution. The original tax exemption merely recognized that the Constitution prohibited the imposition of other taxes, such as the sales tax, on these companies. Although these constitutional provisions were subsequently repealed, the exemption nevertheless remained in effect.

Currently, there are two apparent rationales for this program. First, gas and electric bills are subject to municipal utility user taxes in many cities, often at rates higher than the sales tax rate. Thus, it is argued by some that the sales tax exemption avoids subjecting gas and electricity to double taxation.

Second, this program provides tax relief to consumers of gas, electricity, and water to the extent that sales and use taxes normally would be incorporated into the prices charged for these items. Proponents argue that these utilities provide basic and necessary services and, as such, such services should not be made any more costly to consumers by imposing the sales tax on them.

The exemption, however, is not limited to residential gas and electricity service. Rather, it also includes commercial and industrial purchases of electricity and natural gas, to which the "necessity of life" rationale does not apply.

Comments

Cities were receiving around $700 million from utility user taxes as of the late 1980s, but *counties* were not permitted to impose such levies. However, legislation at the start of the 1990s (Chapter 466, Statutes of 1990 [SB 2557, Maddy]) extended to counties the authority to levy such utility user taxes. In 1995-96, cities and counties raised approximately $1.3 billion from the utility users tax.

It is not clear that electricity, which is not a physical object or substance, would be subject to sales taxation even in the absence of this program.

Exclusion/Exemption:

ORGANIC PRODUCTS GROWN EXPRESSLY FOR FUEL PURPOSES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6358.1 (a)(1).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the sale or transfer of organic products grown expressly for fuel purposes.

RATIONALE

This program provides an incentive for the production and use of organic products as fuel. It accomplishes this to the extent that it reduces the cost of buying or using organic fuels, thereby making them more attractive relative to conventional fuel sources. The apparent underlying rationale for the program is to reduce the economy's reliance on depletable fossil fuels—especially crude oil—and to encourage profitable alternative uses of farmland.

COMMENTS

Grain purchases by an alcohol producer generally would be exempt, even in the absence of this program, as a purchase for resale. However, growers of organic products, such as wood, that are sold for direct use as fuel *do* benefit from this program.

A detailed review of this program appeared in Volume I, Part Two, of our *Analysis of the 1987-88 Tax Expenditure Budget*. This review recommended that the program be maintained on the basis of (1) tax equity (since competing energy sources are not taxed), and (2) administrative savings to the Board of Equalization from not having to establish taxable values for the exempt items.

Exclusion/Exemption:

AGRICULTURAL, TIMBER, MUNICIPAL, AND INDUSTRIAL WASTE BY-PRODUCTS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6358.1 (a)(2).*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale or transfer of qualified waste by-products from (1) agricultural and forest-products operations, (2) municipal refuse, and (3) manufacturing activities. In order to qualify, these by-products must be used as fuel in an industrial facility in lieu of either oil, natural gas, or coal.

RATIONALE

This program provides an incentive for industry to use waste by-products as an alternative fuel. It accomplishes this to the extent that it reduces the cost of buying or using waste by-product fuels, thereby making them more economically attractive relative to conventional fuel sources. The underlying rationale for the program is to reduce the economy's reliance on fossil fuels, especially crude oil, and to encourage the more effective and complete utilization of scarce resources. The program also equalizes the taxation of waste-fuel materials that are purchased with those that are self-generated.

COMMENTS

This program was established by Chapter 1248, Statutes of 1980 (SB 1576, Nielsen), and was permanently extended by Chapter 254, Statutes of 1986 (SB 1083, Boatwright). The program was amended by Chapter 1059, Statutes of 1983 (SB 1031, Boatwright) to delete the original requirement that qualifying by-products be "delivered in bulk." This change ensured that the program would apply to waste by-products consumed at the same site where they are generated, such as the burning of wood chips in a lumber mill.

A detailed review of this program appeared in Volume I, Part Two, of our *Analysis of the 1987-88 Tax Expenditure Budget.* This review recommended that the program be maintained on the basis of tax equity (since competing sources of fuel are not taxed), and the administrative savings to the Board of Equalization from not having to establish taxable values for the exempt items.

Exclusion/Exemption:

Use of Refiners' Gas

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6358.1 (b).*

Estimated Revenue Reduction *(In Millions)*	
Fiscal Year	**Amount**
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

Description

This program exempts from taxation the use of "still gas" which has been produced as a by-product during the refining of purchased crude oil.

Rationale

The underlying rationale for the program is to equalize the tax treatment of still gas used by refiners who purchase their crude oil, with those who use oil they produce themselves. It is agrued that the program also encourages resource conservation through more efficient use of crude oil supplies.

Comments

The use of still gas produced from proprietary (that is, nonpurchased) petroleum is not subject to the use tax, because state law requires that a formal transfer of a product occur in order to "trigger" a tax levy.

This program was established by Chapter 1059, Statutes of 1983 (SB 1031, Boatwright), as declarative of existing law under Chapter 1248, Statutes of 1980 (SB 1576, Nielsen), which provided a tax exemption for waste by-products derived from manufacturing activities. This program was permanently extended by Chapter 254, Statutes of 1986 (SB 1083, Boatwright).

A detailed review of this program appeared in Volume I, Part Two, of our *Analysis of the 1987-88 Tax Expenditure Budget*. This review recommended that the program be maintained on the basis of tax equity (since competing sources of fuel are not taxed) and the administrative savings to the Board of Equalization from not having to establish taxable values for refiners' gas.

Exclusion/Exemption:

Animal Life

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6358 (a).

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	$43
1997-98	46
1998-99	47

Description

This program exempts from taxation the sale or transfer of animal life, the products of which ordinarily constitute food for human consumption.

Purchases of dairy cows and of any livestock or poultry for breeding (or egg laying) purposes ordinarily would be subject to sales and use taxes in the absence of this program. This is because these animals are put to use by the purchaser, rather than simply fattened and resold, as with most beef cattle.

Rationale

This program provides tax relief to producers of animal-based food products, by eliminating the sales and use taxes that ordinarily would apply to animals that are not purchased solely for resale. By reducing the cost of producing animal-based food items, the program benefits consumers to the extent that these lower production costs reduce retail food prices. As such, this program basically is an extension of the sales and use tax exemption for food. The underlying rationale offered for the program is that food is a basic necessity of life, and that its price should not be increased by taxation.

Exclusion/Exemption:

ANIMAL FEED

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6358 (b).*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	*$191*
1997-98	*201*
1998-99	*207*

DESCRIPTION

This program exempts from taxation any sale or transfer of animal feed which is fed to qualified animals. Qualified animals are those whose products either ordinarily constitute food for human consumption, or are to be sold in the regular course of business.

RATIONALE

This program provides two basic types of tax relief. First, it provides tax relief to consumers of animal-based food products by reducing the prices of these products. As such, this aspect of the program basically is an extension of the sales and use tax exemption for food. The underlying rationale offered for this aspect of the program is that food is a basic necessity of life, and its price, therefore, should not be increased by taxation.

The second type of tax relief provided by the program is to consumers of *non*food animal products, to the extent that sales and use taxes on feed ordinarily would be incorporated into these products' prices. The rationale offered here is that feed is a "component part" of an item which subsequently is itself subject to taxation and, therefore, should not be double-taxed. An example is the use of feed to raise animals, the pelts of which are used to make coats, which in turn are subject to sales taxes.

Exclusion/Exemption:
SEEDS AND PLANTS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6358 (c).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$24
1997-98	25
1998-99	30

DESCRIPTION

This program exempts from taxation the sale or transfer of seeds and plants whose products either ordinarily constitute food for human consumption, or are to be sold in the regular course of business.

RATIONALE

This program provides two basic types of tax relief. First, it provides tax relief to consumers of seed and plant-related food products by reducing their prices. As such, this aspect of the program basically is an extension of the sales and use tax exemption for food. The underlying rationale for this aspect of the program is that food is a basic necessity of life and its price, therefore, should not be increased by taxation.

The second type of tax relief provided by the program is to consumers of *non*food products that are derived from qualifying seeds and plants, to the extent that sales and use taxes ordinarily would be incorporated into the prices of these seeds and plants. The rationale here is that these items are "component parts" of products which, themselves, are subsequently taxed and, therefore, should not be subjected to double taxation. An example is the purchase of flower seeds by a nursery in order to grow flowers, which themselves are taxed when sold to consumers.

COMMENTS

Chapter 323, Statutes of 1998 (AB 2798, Machado), extended this sales tax exemption, formerly limited to annual plants, to perennial plants.

Exclusion/Exemption:
QUALIFIED FERTILIZER

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6358 (d).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$48
1997-98	50
1998-99	52

DESCRIPTION

This program exempts from taxation the transfer of fertilizer to be used on land, if the land is used to produce either food for human consumption or other products to be sold in the regular course of business.

RATIONALE

This program provides two basic types of tax relief. First, it provides tax relief to consumers of food products grown with the help of fertilizer, by reducing their prices. As such, this aspect of the program basically is an extension of the sales and use tax exemption for food. The underlying rationale offered for this aspect of the program is that food is a basic necessity of life, and its price, therefore, should not be increased by taxation.

The second type of tax relief provided by the program is to consumers of *non*food products which fertilizer helps produce, to the extent that sales and use taxes on fertilizer ordinarily would be incorporated into these products' prices. The underlying rationale offered here is that the fertilizer is a "component part" of an item which subsequently is, itself, subject to taxation and, therefore, should not be double-taxed. An example is the use of fertilizer by a nursery in growing flowers, which themselves are taxed when sold to consumers.

COMMENTS

For the purposes of this program, the term "fertilizer" includes commercial fertilizers, agricultural minerals, and manures, but does not include soil amendments. The latter are excluded on the basis that they do not constitute a "component part" of the grown products, but rather are capitalized into land values. Such soil amendments include hay, straw, peat, leaf mold, sand, potting mediums, and specified mineral and chemical constituents.

Exclusion/Exemption:
POULTRY LITTER

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6358.2.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from taxation the sale or use in California of certain products that are used as litter in poultry and egg production and that in turn are ultimately resold as, or incorporated in, fertilizer products. This exemption applies to wood shavings, sawdust, rice hulls, or other related products.

RATIONALE

This program provides two types of tax relief. First, it provides tax relief to consumers that purchase fertilizer products. Second, it provides indirect tax relief to consumers of food and nonfood products which fertilizers help to produce, again to the extent that the product prices would reflect the sales and use tax paid on the components incorporated in the fertilizers. Program proponents note that the program is consistent, at least to some extent, with the related program for qualified fertilizer.

Exclusion/Exemption:
FOOD PRODUCTS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Constitution, Article XIII, Section 34, and California Revenue and Taxation Code Sections 6359, 6359.2, and 6359.4.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	$2,480
1997-98	2,609
1998-99	2,698

DESCRIPTION

This program generally exempts from taxation the transfer of food products for home consumption (other than carbonated or alcoholic beverages). The program does not extend to sales of most prepared food, including take-out food items and restaurant meals.

Special rules apply to vending machine sales of otherwise nontaxable food items, such as candy. Generally, 33 percent of the receipts from these sales are taxed as an approximation of the portion of these sales that otherwise would be taxable because they are items consumed on the same premises as the vending machine. Vending sales of any food item costing 15 cents or less, or of any bulk food items (such as nuts) costing 25 cents or less, are fully exempt from taxation. This is accomplished by treating these retailers as the consumers of the items that they sell. Since the food products are exempt when purchased by the vendor (under the general food exemption), this treatment is equivalent to a full tax exemption.

RATIONALE

This program provides tax relief to consumers of food products, by reducing their price. The underlying rationale put forth for the program is that food is a basic necessity of life and, therefore, its price should not be increased through the application of the sales tax.

COMMENTS

Although the basic rationale offered for this program is to exempt food products from taxation because they are a necessity of life, it should be noted that the term "necessity" is somewhat loosely, and even inconsistently, applied. For example, restaurant meals and most take-out foods are taxed. This treatment generally is justified on the grounds that they are luxuries, or at least a convenience, compared with cooking at home. However, some of these taxable foods also appear to be necessities, if purchased by an individual lacking cooking facilities.

In addition, in the case of food products that qualify under this program, there is no attempt to restrict the quality or cost of exempted items. For instance, the program applies to high-grade or expensive products, which do not constitute basic necessities.

In 1991, the Legislature passed legislation that would levy the sales and use tax on snack foods. "Snack foods" were defined to include products that were sold in a condition suitable for immediate consumption, such as cookies, potato chips, and snack cakes. The legislation (Chapter 85, Statutes of 1991, [AB 2181, Vasconcellos] and Chapter 88, Statutes of 1991, [SB 179, Deddeh]) met with some resistance and confusion among taxpayers and retailers, especially with regard to certain apparent inconsistencies. For example, pre-popped popcorn was subject to taxation but unpopped popcorn was not. The so-called "snack tax" was repealed by Proposition 163, approved by the voters in November 1992.

Exclusion/Exemption:
CANDY, GUM, AND CONFECTIONERY PRODUCTS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Constitution, Article XIII, Section 34, and California Revenue and Taxation Code Section 6359(b).*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$199
1997-98	210
1998-99	217

DESCRIPTION

This program generally exempts from taxation the sale or use of candy, gum, and other confectionery products for home consumption. This program is included within the overall food exemption and is subject to the same limitations. Vending machine sales of candy, gum, and other confectionery products may be subject to tax under certain conditions (see discussion under the previous program entitled "Food Products").

RATIONALE

This program provides tax relief to producers of candy and to candy consumers by reducing the prices of such products. The program's rationale is that candy, gum, and confectionery items also constitute food products and as such, deserve the same tax exemption granted for food generally.

This exemption was repealed effective July 15, 1991 as part of a broadening of the sales and use tax base. The exemption was reinstated in November 1992 as part of Proposition 163 and was incorporated into the California Revenue and Taxation Code Section covering food products.

Exclusion/Exemption:

BOTTLED WATER

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Constitution, Article XIII, Section 34, and California Revenue and Taxation Code Section 6359(b).*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	$85
1997-98	90
1998-99	93

DESCRIPTION

This program exempts from taxation the transfer or use of noncarbonated and non-effervescent bottled water.

RATIONALE

This program provides tax relief to the consumers of bottled water. The underlying rationale offered for the program is that water is a basic necessity of life. Many individuals use bottled water because of impurities and other related problems with the quality of their normal water supplies.

COMMENTS

The statute allowing the exemption (California Revenue and Taxation Code Section 6359[b]) was repealed effective July 15, 1991 as part of a broadening of the sales and use tax base. The exemption was reinstated as part of Proposition 163 in November 1992; and was incorporated into the California Revenue and Taxation Code Section covering food products (see previous program entitled "Food Products").

Exclusion/Exemption:

PACKING ICE AND DRY ICE

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6359.7.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the transfer of ice and dry ice, when the ice is used or employed in packing and shipping qualified food products for human consumption by qualified carriers.

RATIONALE

Proponents of this program argue that it is needed to equalize the tax treatment of packing ice and dry ice with that of various other competing cooling processes. These various other means of cooling (such as forced air and chilled water baths) are not directly subject to sales and use taxation because they are "processes" and not tangible personal property (as is ice). The program also has been rationalized on the grounds that coolants are needed to provide consumers with unspoiled food products, many of which are, themselves, exempt from taxation because they are viewed as basic necessities of life.

COMMENTS

This program became operative on January 1, 1986 as provided by Chapter 1045, Statutes of 1985 (AB 1887, Areias). An earlier program had been in effect for ice used in interstate transportation only, until its repeal in 1979 by Chapter 1150, Statutes of 1979 (AB 66, Lockyer).

The rationale that this program is needed to equalize the tax treatment of ice with that of other cooling methods overlooks the fact that the equipment for these alternative coolant systems generally is subject to sales and use taxation at the time it is purchased. A detailed review of this program appeared in Part Two of our *Analysis of the 1988-89 Tax Expenditure Budget*. In our review, we found no evidence that this program was having any significant impacts on the basic economic competitiveness of the affected California industries, or on prices paid by consumers. Accordingly, in the interests of tax equity, we recommended that this program be repealed.

Exclusion/Exemption:

CARBON DIOXIDE USED IN PACKAGING

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6359.8.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the sale or use of carbon dioxide used in packing, shipping, or transporting fruits or vegetables for human consumption, provided that the fruits and vegetables are not sold with the carbon dioxide packaging and any nonreturnable materials containing carbon dioxide. To qualify for the exemption, the fruits or vegetables must be shipped or transported in the carbon dioxide packaging by common carriers, contract carriers, or proprietary carriers.

RATIONALE

This program provides tax relief to consumers of fruits and vegetables that have been packed and shipped. The underlying rationale for the program is that food products such as fruits and vegetables are basic necessities of life, and therefore, their price should not be increased through taxation. This program also attempts to equalize tax treatment of carbon dioxide packaging with other types of packaging (such as dry ice and forced air) that are used to provide consumers with unspoiled food products. These alternative types of packaging also are exempt from taxation as described under separate programs.

COMMENTS

As discussed in the program entitled "Packing Ice and Dry Ice," this program may result in a tax advantage of exempt methods over certain other cooling methods. While cooling methods such as forced air and chilled water are not *directly* taxed, the equipment for these coolant systems *is* generally taxed when purchased.

Exclusion/Exemption:
PRESCRIPTION MEDICINES

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Sections 6369 and 6369.1.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	*$652*
1997-98	*686*
1998-99	*709*

DESCRIPTION

This program exempts from taxation the sale or use of specified medicines and medical-related products used for treating the health problems of human beings. Items which qualify for the program include medicines which are: (1) prescribed by a physician and dispensed by a registered pharmacist; (2) furnished by a licensed physician, dentist, or podiatrist to patients; (3) furnished by a health facility to patients pursuant to the order of a licensed physician; (4) sold to a licensed physician or health facility for treating human beings; (5) sold to the state or other political subdivision for use in treating human beings; and (6) furnished without charge by a pharmaceutical manufacturer or distributor to a licensed physician, health facility, or institution of higher learning for research which will be used to treat human beings. In addition to medicines, qualifying items include such medical products as prosthetic and orthotic devices, hemodialysis products, insulin syringes, sutures, bone screws, and artificial limbs and eyes.

RATIONALE

This program provides tax relief to consumers of certain medicines and medical-related products. The underlying rationale for the program is that the price of medicines should not be increased by taxation because proper medical care and treatment is a basic necessity.

Exclusion/Exemption:

SPECIFIED MEDICAL-RELATED PRODUCTS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Sections 6369.1, 6369.2, and 6369.5.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale and use of the following medical-related products for personal use as directed by a physician: (1) wheelchairs, crutches, canes (including white canes for the blind), and walkers (including their replacement parts); (2) medical oxygen delivery systems; (3) hemodialysis equipment supplied by prescription; and (4) containers used to collect or store human blood.

RATIONALE

This program provides tax relief to consumers of specified medical-related products. The underlying rationale for the program is that such products are items of necessity to individuals who purchase them, and that their cost, therefore, should not be increased by taxation.

COMMENTS

Qualifying "medical oxygen delivery systems" include, but are not limited to, liquid oxygen containers, high pressure cylinders and regulators, when sold, leased, or rented to an individual for personal use under the direction of a physician. This program raises certain issues relating to tax equity and consistent tax-law treatment, since items such as corrective eyewear and auditory devices are *not* exempt from taxation, yet are used to treat medical conditions.

Exclusion/Exemption:

MEDICAL IDENTIFICATION TAGS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6371.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the transfer of medical identification tags furnished by a qualified nonprofit organization. The term "medical identification tags" includes any tag worn by a person for the purpose of identifying the wearer as having a medical disability or allergic reaction to certain medical treatments.

RATIONALE

This program provides tax relief to individuals who need to wear medical information tags because of health-related problems. The rationale for the program is that the prices of such tags should not be increased by taxation, because the tags are a necessity for many individuals with serious health problems.

COMMENTS

This program was originally sponsored by the Medic Alert Foundation, a charitable nonprofit corporation engaged in gathering, storing, and furnishing information regarding the medical problems of members. When an individual subscribes to the Medic Alert Foundation, he or she has the option of purchasing either a bracelet or a necklace on which relevant medical emergency information is engraved. Such products also are available from various other similar types of organizations.

Exclusion/Exemption:
SPECIFIED MEDICAL HEALTH INFORMATION

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6408.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the use of medical health information literature purchased by qualified organizations. Such qualifying organizations must be formed and operated for charitable purposes, be eligible for the welfare exemption (a local property tax exemption available to nonprofit, charitable organizations), and be engaged in the dissemination of medical health information. In addition, the purchase of qualified literature must be made from the organization's national office or another branch of the national office of the same organization. The original purchase of these materials, from a printer for example, is *not* covered by the exemption.

RATIONALE

This program provides tax relief for organizations providing educational health information, and thereby enables these organizations to use their limited resources more effectively for educational purposes. The underlying rationale for the program is that the dissemination of medical health information is socially beneficial.

COMMENTS

The original proponent of this program was the American Heart Association. Prior to the inception of this program, sales and use taxes were levied on the medical information that the association distributed to its regional and local chapter affiliates.

Exclusion/Exemption:

HEALTH AND SAFETY INSIGNIA AND EDUCATIONAL MATERIALS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6409.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the transfer of health and safety insignia and educational materials routinely sold in connection with health, safety, and first aid classes. The program requires the insignia and materials to be sold or purchased by a national charitable organization which qualifies for the welfare exemption (a local property tax exemption available to nonprofit, charitable organizations). In addition, the materials must be purchased from the organization's national office or another branch or chapter of the national office of that organization.

RATIONALE

This program offers tax relief to organizations providing specified health-related and safety-related materials and educational information, and for individuals who might purchase them. Thus, the program encourages the wider dissemination of these materials and information. The rationale for the program is that such materials and information are socially beneficial and worthy of public financial support.

Exclusion/Exemption:

FOOD ANIMAL MEDICINES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6358 (e).

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	Amount
1996-97	$2
1997-98	4
1998-99	4

DESCRIPTION

This program exempts from taxation the sale or use of drugs or medicines for which the primary purpose is the prevention and/or control of disease in animal life that ordinarily constitutes food for human consumption.

RATIONALE

This program provides tax relief to consumers of medical products used on animal life that is used to produce animal food products consumed by humans. This follows the general rationale that food products are a basic necessity of life, and their prices should not be increased by taxation.

Exclusion/Exemption:

MEDICATED FEED AND DRINKING WATER

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6358.4.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the gross receipts from the sale, storage, consumption, or use of drugs or medicines administered to animal life as an additive to feed or drinking water. The primary purpose of the additive must be prevention and control of disease in food animals or nonfood animals which are sold in the regular course of business.

RATIONALE

This program provides two types of tax relief. In the case of food animals, it provides tax relief to consumers of animal-based food products. This may be viewed as an extension of the general sales tax exemption for food products, which is based on the rationale that food is a basic necessity of human life and its price should not be increased by taxation.

The rationale for providing an exemption for medicines and drugs used to treat *non*food animals is that the cost of such treatment is incorporated in the price of these animals, which *is* subject to taxation. Thus, it is argued, taxing it separately would result in double taxation.

Exclusion/Exemption:
PRINTERS' AIDS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6010.3.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the fabrication or transfer of composed type or reproduction proofs, which are made by a typographer for the preparation of printed matter. In addition, this program exempts from taxation the fabrication of reproduction proofs or impressed mats when the materials are transferred to a printer or publisher for use in printing.

RATIONALE

This program provides tax relief to the printing industry assuming sales and use taxes on transfers of qualified printers' aids normally would be borne by printers. Traditionally, printers' aids often became the property of the customer, so that they *were* subject to sales tax. These intermediate products of the printing process, however, were used to make final printing materials, which also were taxed upon their sale. This program thus reduces the degree of this sales tax "pyramiding" for the printing industry. It also tends to equalize tax treatment for printers' aids, regardless of the specific arrangements made regarding the transfer of printers' aids.

COMMENTS

Many other industries are subject to tax pyramiding, but the printing industry has argued that it was particularly hard hit by the multiple application of the sales and use tax. Newer computerized printing and publishing methods produce few, if any, intermediate printer's aids, so that the revenue loss from this program should decrease over time.

Exclusion/Exemption:

PARTNERSHIP PROPERTY USED TO PRODUCE MOTION PICTURES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6010.4.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the use of property rented, leased, or otherwise furnished by a partnership to its members for the production of motion pictures under certain circumstances. In order to qualify for the program, the partnership must be formed by parties engaged in the production or distribution of motion pictures in order to reduce production costs, by sharing equipment, studio facilities, and personnel. The exemption does not apply, however, if the partnership transfers title of any property to its members. In addition, the program does not exempt from taxation the original purchase of property by the partnership.

RATIONALE

This program provides benefits to some segments of the motion picture industry by reducing the costs they incur for using shared movie-making equipment and fabrication labor. It is rationalized on the grounds that it tends to equalize the taxation of equipment and fabrication labor provided "in-house" (say, in a vertically integrated movie company) with the taxation of these items when several studios or independent producers share these resources. The program thus removes a tax advantage that otherwise would benefit integrated studios (firms which are involved in the full range of movie-making activities) versus other motion picture producers.

COMMENTS

The basic structure of the sales and use tax inherently benefits businesses that are vertically integrated. This is because intracompany transfers of equipment and supplies are not considered a sale and, thus, are not taxed. This program extends an equivalent benefit to nonvertically integrated operations in this particular industry.

Exclusion/Exemption:

NEWSPAPERS AND PERIODICALS, DISTRIBUTED FREE OF CHARGE OR BY SUBSCRIPTION

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6362.3, 6362.7, and 6362.8.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$68
1997-98	72
1998-99	74

DESCRIPTION

This program exempts from taxation the sale or use of certain newspapers, periodicals, and any tangible personal property that becomes an ingredient or component of them. The exemption is available provided that a newspaper or periodical is regularly published (at least four times a year). In addition, the item must be: (1) distributed free of charge; or (2) sold by subscription and delivered by mail or common carrier; or (3) purchased or published by an organization that qualifies for tax-exempt status under Internal Revenue Code Section 501(c)(3) and meets certain other requirements. The exemption also applies to any newspaper or periodical that is sold by subscription pursuant to an agreement entered into and for which prepayment was received prior to July 15, 1991.

The term "periodical" is defined as meeting certain stated publication intervals during a year, with each issue bearing some relation to the previous issues. It does not include printed sales messages, shopping guides, or publications where advertising exceeds 90 percent of the printed area of an issue in more than one-half the issues published in a 12-month period.

RATIONALE

This program provides tax relief to the publishers of qualified newspapers and periodicals, and to the consumers of these items. Proponents of this program contend that the contents of a newspaper or periodical are akin to an information service and, thus, the transfer of a newspaper or periodical is equivalent to the sale of a service. Because the transfer of services is generally exempt from sales and use taxation, these proponents thus argue that the transfer of other newspapers and periodicals also should be exempt.

COMMENTS

Generally, paid newspaper subscriptions are subject to taxation, since the publishers of such newspapers have "nexus," or sufficient economic presence in California for tax purposes. Some newspapers published out-of-state, however, have insufficient presence in California to trigger the levying of the sales and use tax.

Exclusion/Exemption:

LEASES OF MOTION PICTURES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6006 (g)(1) and 6010 (e)(1).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$29
1997-98	31
1998-99	32

DESCRIPTION

This program exempts from taxation the qualified lease or rental of motion pictures (including animated motion pictures), television films, and tapes (except video rentals for private use).

RATIONALE

This program provides tax relief to the owners and users of motion pictures and television shows. The apparent rationale for the program is to encourage expansion of the market for motion pictures and tapes in California by reducing the cost of leasing such pictures, and thereby promoting the economic health of the motion picture industry. Proponents of the exemption also argue that it is needed to provide tax equity between exhibitors of motion pictures and tapes versus other forms of entertainment, such as live theater, that are *not* subject to the sales and use tax. There are, however, many forms of entertainment which *are* subject to sales and use taxes, such as videocassette rentals, books, and games.

COMMENTS

The estimated revenue reduction amounts shown above are based only on leases to movie theaters in California, because these transactions involve the transfer of a physical copy of the movie. Television programming, on the other hand, can be and often is transferred via satellite or phone lines. Thus it would *not* be subject to taxation, even in the absence of this program. Consequently, the additional revenues that would be realized from taxing leases of television programming would be relatively small.

Exclusion/Exemption:

MASTER TAPES AND MASTER RECORDS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6362.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation qualifying transfers of master tapes and master records that are used by the recording industry in making sound recordings. The sales tax *does* apply, however, to purchases of the tangible elements of such master tapes and recordings (for example, the cost of the blank tape) when these are acquired from a recording studio by a tape or recording producer.

RATIONALE

This program provides tax relief to the consumers of master tapes and records by reducing the prices of these items. At the time this program was enacted, it was rationalized on the basis that the value of a master tape or record was primarily attributable to the *intangible* element of the music or other information stored on the tangible medium. The proponents of this exemption argued that it was not proper for the state to tax the value of such intangible elements.

COMMENTS

In 1988, the California Court of Appeals held that in certain circumstances the sale or lease of master tapes and records are *not* exempt from taxation. Specifically, in *A&M Records, Inc. v. State Board of Equalization* (1988 [204 Cal. App. 3d 358]), the court determined that the contract to purchase master tapes or records used for producing additional master recordings or copies *was* a taxable transaction. The court held, in this case, that the true object of the contract was for the production of such duplicates and not for the services of the artist.

Exclusion/Exemption:

PRINTED ADVERTISING MATERIALS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6379.5.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale or use of catalogs, letters, circulars, brochures, and pamphlets consisting substantially of printed advertisements for goods and services. To qualify, these materials must be (1) printed to the special order of the purchaser and (2) mailed or delivered by the seller, seller's agent, or a mailing house through the United States Postal Service, or by common carrier to another person, at no cost to the recipient.

RATIONALE

This program provides tax relief to California printers and retailers. The rationale for the program is to provide tax equity for California printers. When a California retailer contracts with an out-of-state printer to print its advertising, the printing job is *not* subject to sales tax. In the absence of this program, a similar contract with a California printer *would* be subject to sales tax. Program proponents argue that the program is necessary to make California printers competitive with out-of-state printers.

COMMENTS

This program was established by Chapter 1515, Statutes of 1986 (SB 2527, Robbins), and took effect on January 1, 1987. An alternative way to provide tax equity for California printers in the absence of this program would be to apply the use tax to printed advertising materials purchased from out-of-state printers by California firms. In cases where the out-of-state printer sends the advertising material directly to California recipients, there had been concern that imposing the use tax would unconstitutionally interfere with interstate commerce. That concern appears to have been erased by a 1988 decision of the U.S. Supreme Court (*D.H. Holmes Co. v. McNamara*, 48 U.S. 24, 100L Ed 2d 21, 108 S Ct 1619). In that case, the court unanimously upheld Louisiana's imposition of use tax on catalogs printed outside the state for a Louisiana retailer and delivered directly to prospective customers in Louisiana.

It is estimated that the total value of all catalog, directory, and printed advertising products generated for use in California is in the billions of dollars. If all such products were subject to taxation, the sales tax liabilities could be several hundred million dollars. However, this figure dramatically overstates the revenue loss to the state due to this program, for two reasons. First, an unknown number of these products are already subject to taxation. For example, catalogs that are sold to consumers are taxed, as are many other advertising materials. Second, an unknown portion of these products would not be subject to taxation, even if this program were repealed. For example, according to the Board of Equalization, advertising inserts in many newspapers would continue to be exempt from taxation under the exemption for newspapers and periodicals.

Exclusion/Exemption:

MOTION PICTURES AND PRODUCTION SERVICES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6010.6.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation charges for qualified production services (so-called "fabrication labor") used in the production of a motion picture (including videos, or any other commercial audiovisual works). These services include the production of special effects, animation, music, sound, editing, and photography, regardless of whether the service is performed under the producer's supervision or done independently. The exemption does not include the production of duplicate tapes for exhibition or broadcast, or release prints.

Additionally, the program exempts transfers of all or part of qualifying motion pictures, or any interest or rights to them (including partially finished work and intermediary materials). To qualify, the motion picture must either be (1) sold before it is first exhibited or broadcast to its general audience, or (2) transferred to any persons holding exploitation rights which they gained prior to the first exhibition.

These exemptions do not apply to (1) the transfer of raw film or videotape stock, (2) the transfer of release prints or tapes for exhibition or broadcast, or (3) rentals or leases of videocassettes, videotapes, or videodiscs for private use. The term "qualified motion picture" does not include motion pictures produced for private noncommercial use, such as weddings or graduations.

RATIONALE

This program has several rationales. First, it provides an incentive for retaining motion picture production activities in California by reducing the industry's tax burden.

A second rationale is that the program simplifies tax administration. Before this program was established, the taxability of charges for special effects and other production services depended on whether these services were performed by studio employees or contractors supervised by the producer (in which case they were *not* taxable) versus by contractors operating independently (in which case they *were* taxable). Taxation was complex because it often was difficult to distinguish among the various contractual relationships involved.

A third program rationale is to create tax equity between studio employees and contractors who perform the *same* kinds of work, as well as tax equity between *integrated* producers that produce a *finished* work and those that *specialize* in one *segment* of the work, such as filming or postproduction editing.

Comments

Fabrication Labor. Although services themselves generally are *not* subject to the sales and use tax, fabrication labor used to make an item of tangible property generally *is* subject to tax. For example, charges by a tailor to make a suit are taxable even if the customer provides the cloth. This treatment provides tax equity between custom-made products and off-the-shelf products. However, there is no tax on fabrication labor if it is provided by employees of the same company that uses the finished product (since no sale or transfer of property occurs), or, in many cases, if the labor is performed under the supervision, and subject to the approval of the customer.

As regards the activities affected by this program, the creation of special effects for motion pictures usually involves the production of tangible property (a film or video product) that is an intermediary product used to incorporate the special effect into the final motion picture. In the absence of this program, the sale of that intermediate product to a producer by a contractor who is not supervised by that producer generally *would* be taxable.

Sales of Motion Pictures. Sales of completed motion pictures prior to their commercial exhibition are considered a sale for resale and would *not* be taxable, even in the absence of this program. In contrast, sales of rough footage or other intermediary products for a motion picture in progress generally *would* be taxable in the absence of this program.

Exclusion/Exemption:

MOBILE TRANSPORTATION EQUIPMENT LEASES

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Sections 6006 (g)(4), 6010 (e)(4), and 6023.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the lease of certain mobile transportation equipment used in the transportation of persons or property. Qualifying equipment includes railroad cars and locomotives, buses, trucks, truck tractors, truck trailers, dollies, bogies, chassis, reusable cargo containers, aircraft, ships, and tangible personal property which is or becomes a component part of such equipment. Equipment which does not qualify for the program includes one-way rental vehicles, passenger vehicles, and trailers and baggage containers designed to be hauled by passenger vehicles. The purchase of mobile transportation equipment by the lessor, however, is generally subject to sales and use tax.

RATIONALE

This program provides tax relief to users of qualifying transportation equipment by reducing its price. According to the Board of Equalization, the program has several rationales. One involves the administrative complexities of determining the portion of leasing payments that is related to interstate commerce activities, which are exempt from taxation. Another relates to the difficulty of separating out the portion of lease payments associated with the provision of related services, such as maintenance, which are non-taxable.

COMMENTS

Existing law allows lessors of mobile transportation equipment to elect to pay tax on lease receipts, rather than on the equipment's cost at the time of purchase. However, this option is available only to lessors who make no use of the equipment other than renting or leasing it.

Exclusion/Exemption:

VESSELS THAT TRANSPORT OVER 1,000 TONS

Program Characteristics	
Tax Type:	*Sales Tax.*
Authorization:	*California Revenue and Taxation Code Section 6356.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the *sales* tax the sale of certain vessels sold by their builder. In order for the program to apply, the vessel involved must be capable of transporting cargoes of more than 1,000 tons. The program does *not*, however, exempt such vessels from the *use* tax.

RATIONALE

The program was originally intended to eliminate a tax "penalty" for purchases of vessels within the state by equalizing their taxation with those purchased outside the state but used within it. At the time this program was enacted, it was thought that the purchase of a vessel from an out-of-state builder for use within the state could not be taxed by the State of California, due to limitations under the U.S. Constitution involving state taxation of interstate commerce.

COMMENTS

The program's original rationale was superseded by a 1942 federal court ruling involving the taxability of vessel purchases. Specifically, in the case of *Los Angeles Lumber Products v. State Board of Equalization* (45 Fed. Supp. 77), the court ruled that the U.S. Constitution does not prohibit a ship purchased out of state for in-state use from being taxed by California. Thus, the use tax applies to ships purchased out-of-state and used in California unless the operators qualify for other use tax exemptions (see program entitled "Qualified Watercraft and Their Component Parts.")

Exclusion/Exemption:

VEHICLES MODIFIED FOR PHYSICALLY HANDICAPPED PERSONS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6369.4.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale and use of items and materials used to modify vehicles for physically handicapped persons. In the event of the sale of such a vehicle to a qualified purchaser, the program also exempts from taxation the portion of the sales price of a vehicle attributable to handicapped modifications. In order to qualify, the vehicle purchaser must be eligible for a disabled license plate or placard for disabled parking.

RATIONALE

This program provides tax relief to physically handicapped persons who must rely on specially modified vehicles, such as those with wheelchair lifts and special steering devices. The underlying rationale for the program is that access to vehicles with special modifications is a necessity for many handicapped persons, and one that can impose financial burdens on them since their income-earning potential often is restricted.

Exclusion/Exemption:

New or Remanufactured Trucks and Trailers For Out-of-State Use

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6388 and 6388.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from taxation the sale or use of new or remanufactured trucks, truck tractors, trailers, semitrailers, trailer coaches (any of which has an unladen weight equal to or exceeding 6,000 pounds), or auxiliary dollies purchased in California for use outside the state or in interstate or foreign commerce.

All of the above types of vehicles and equipment qualify for the tax exemption if the vehicle is: (1) purchased by an out-of-state resident from an out-of-state dealer, (2) delivered by the manufacturer to the purchaser within California, (3) taken out of the state within 30 days, and (4) registered in another state. These qualifications must be furnished in writing to the manufacturer or remanufacturer.

A somewhat broader exemption applies only to trailers and semitrailers. These vehicles may be purchased from either an in-state or out-of-state dealer, and they may be delivered by either the manufacturer, remanufacturer, or dealer within California. The exemption applies if they are (1) purchased for out-of-state use or for interstate or foreign commerce, (2) taken out of the state within a specified time period, and (3) registered in another state. If the trailer or semitrailer is manufactured out-of-state, the purchaser has 30 days to take it out of California. If the vehicle is manufactured in California, the purchaser has 75 days to remove it from the state. The purchaser does not have to be an out-of-state resident.

Rationale

This program benefits California manufacturers of trucks and trailers, and California dealers who sell trailers and semitrailers. In the absence of this program, purchases of qualifying equipment for out-of-state use from California manufacturers or from California dealers (for trailers and semitrailers) could be subject to the sales or use tax if delivery were to be taken at the manufacturer's or dealer's California location. Proponents argue that such a tax would discourage these purchases.

One rationale of the program is that it ensures that purchases for out-of-state use are not taxed. A second rationale for the program is that it stimulates the California trailer-coach manufacturing and remanufacturing industry.

COMMENTS

By making delivery outside California, the manufacturer or dealer could arrange to avoid any California sales or use tax liability on the transaction, even in the absence of this program. This is because the transaction would be classified as an interstate sale, which is not taxable. Given this, the actual revenue loss due to this exemption probably is relatively small. The primary effect of the program is to facilitate sales by California truck and trailer manufacturers and dealers, and to reduce their costs of delivering vehicles.

Exclusion/Exemption:
PROPERTY USED IN SPACE FLIGHTS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6380.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$7
1997-98	8
1998-99	12

DESCRIPTION

This program exempts from taxation the sale or use of qualified property used in space flights originating in the state. Qualified property includes: (1) property that has space flight capabilities including orbital space facilities, satellites, and space vehicles; (2) property used aboard any space facility, vehicle, satellite, system, or station; and (3) fuel sold exclusively for space flight. This program still applies in the event of a failure, postponement, or cancellation of a launch of the qualified space property.

RATIONALE

This program provides a tax incentive for the use of facilities located in California as the origin of space flights versus other similarly equipped facilities in other states. The program also conforms to general sales and use tax policy with respect to purchases of goods used exclusively outside of California.

COMMENTS

Pursuant to Chapter 323, Statutes of 1998 (AB 2798, Machado), this program was expanded to include equipment and property purchases related to *all* space flight activity in the state. Formerly, the program was applicable only to space flights originating at Vandenberg Air Force Base. The sunset date of January 1, 2004 was also eliminated through this legislation, extending the program indefinitely.

Exclusion/Exemption:

AIRCRAFT REPAIR AND RELATED EQUIPMENT

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6366 and 6366.1.

Estimated Revenue Reduction (In Millions)

Fiscal Year	Amount
1996-97	$11
1997-98	16
1998-99	16

DESCRIPTION

This program exempts from taxation the sale or use of tangible personal property purchased after October 1, 1996 that is used as a component part of specified commercial aircraft as a result of maintenance, repair, overhaul, or improvement. Qualifying aircraft must be used for business either as a common carrier or outside of California.

RATIONALE

This program allows California aircraft maintenance and repair businesses to reduce the prices at which their products are provided, thereby making this industry more competitive with those in other states. This program also equalizes tax treatment for this industry with the railroad industry (which also has its own sales and use tax exemption for equipment used in maintaining or repairing railroads). This is important to the extent that the two industries compete as common carriers

COMMENTS

California is one of many states that has a sales and use tax exemption for aircraft repair equipment. The program thus prevents California from being placed at a competitive disadvantage with respect to airline hub activities.

Exclusion/Exemption:

RAILROAD AND RELATED EQUIPMENT

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6368.5 and 6411.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the sale or use of tangible personal property used as a component part of qualified railroad equipment in the course of repairing, cleaning, altering, or improving that equipment outside of California. Qualifying railroad equipment includes locomotives and passenger cars and maintenance equipment used by or leased to a common carrier engaged in interstate or foreign commerce.

RATIONALE

This program allows California railroad maintenance and repair businesses to reduce the prices at which their products are provided, thereby making this industry more competitive with those in other states or countries. Because the equipment involved is installed in railroads engaged in interstate or foreign commerce, it often can be purchased in other states or countries. Exempting the equipment from the California sales and use tax allows businesses to reduce the prices on the equipment sold, thus making it more competitive with other states or countries. This program also attempts to equalize tax treatment between the railroad industry and the airline industry (which also has a sales and use tax exemption for equipment used in maintaining or repairing aircraft). This would be important to the extent that the two industries compete as common carriers.

COMMENTS

Although this program makes an attempt at equalizing tax treatment for competing industries, the most direct competition with railroads in the transportation of goods across state lines is the trucking industry. Since the trucking industry does not benefit from a similar program, this program would appear to grant advantageous tax treatment to the railroad industry.

Exclusion/Exemption:
LEASES OF SPECIFIED LINENS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6006 (g) (2) and 6010 (e) (2).

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	$40
1997-98	42
1998-99	44

DESCRIPTION

This program exempts from taxation the sale and use of linen supplies and similar articles. To qualify for the program, these supplies and articles must be provided under a lease agreement that includes recurring laundering and cleaning services. Linens exempt under this program are taxable at the time of purchase by the lessor.

RATIONALE

This program gives tax relief to providers and consumers of leased linen. Its apparent rationale is that most of the price charged for linen supplies represents the cost of the laundering and cleaning services, which would be exempt if provided separately.

COMMENTS

Generally, lessors have the option of paying sales and use tax on their original purchase price or on their lease receipts. Consequently, this program allows taxation of leased linen on the basis of its original purchase price.

Exclusion/Exemption:

LEASES OF HOUSEHOLD FURNISHINGS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6006 (g) (3) and 6010 (e) (3).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the lease of household furnishings, when the furnishings are leased along with a lease of the living quarters in which they are to be used. The furnishings are taxable, however, at the time of purchase by the lessor.

RATIONALE

According to the Board of Equalization, this program exists to facilitate tax administration. Taxing the rental of furnishings in living quarters would require registering and auditing landlords, who generally are not sellers of any other taxable goods. Also, it would be difficult to determine what portion of the rent is for the furnishings.

COMMENTS

Generally, landlords pay tax when they purchase furniture, and would not be taxed on their furniture rental receipts, even in the absence of this program. This is because of the broader provision that allows lessors to choose whether to pay tax on their original purchase amount or on their lease or rental receipts. The program equalizes tax treatment between landlords that buy furniture to rent, versus furniture leased out by a rental company.

Exclusion/Exemption:

FACTORY-BUILT HOUSING

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6012.7.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation 60 percent of the sales price of qualified factory-built housing. "Factory-built" housing includes such types as modular housing and sectionalized housing. The program does *not* exempt: (1) mobile homes; (2) precut housing packages where more than 50 percent of the package consists of precut lumber only; (3) panelized construction (such as walls or components that may become one or more rooms of a building) that is not a complete housing package; and (4) porches or awnings not purchased with a complete housing package.

RATIONALE

This program attempts to equalize the sales and use tax treatment of factory-built housing with that of conventional housing. When a contractor builds a conventional fixed-foun-dation home, he or she normally pays sales and use taxes on the tangible property that becomes a part of the home, such as lumber, paint, and wallboard. The home sale itself, however, is *not* subject to the sales tax, since the tax is levied on tangible personal property only. Thus, only the value of the home due to the materials embodied in it, is subject to taxation.

This program applies a similar approach to taxing factory-built housing when sold by a manufacturer or dealer. Specifically, data from the industry indicate that about 40 percent of the sales price of modular housing represents the value of materials. Thus, this program excludes from taxation the remaining 60 percent of the sales price not due to materials.

COMMENTS

The Board of Equalization (BOE) Regulation 1521 generally treats the purchase and installation of modular buildings as *construction* contracts for sales and use tax purposes. Consequently, the manufacturer pays tax on materials, and the purchaser pays tax only on the value of fixtures (such as an air conditioner or stove). According to BOE, the total tax liability under this regulation is similar to the assumed tax liability under the sales and use tax. Therefore, while this program gives statutory weight to this type of treatment, it does not significantly affect tax revenues compared with BOE's regulatory interpretation of general sales and use tax law.

Exclusion/Exemption:

NEW MOBILEHOMES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6012.8 and 6012.9.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation 25 percent of the sales price of a new mobilehome charged by the manufacturer to the retailer, provided that the home is sold by the retailer for installation on a foundation for occupancy as a residence. (The sale of the mobilehome by the retailer to the homeowner is fully tax-exempt.)

RATIONALE

The rationale for the program is based on the belief that mobilehomes should be treated like conventional housing for tax purposes. This program provides a measure of tax equity between mobilehomes used on a permanent site versus conventional and factory-built housing. It does this by recognizing that a portion of the retail value of both conventional and factory-built housing is exempt from sales and use taxation. Specifically, in the case of qualified factory-built housing, the exemption is equal to 60 percent of the consumer's purchase price. In the case of conventional housing, the difference between a house's selling price and the cost of taxable materials to the builder is not subject to taxation.

Exclusion/Exemption:

USED MOBILEHOMES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6379.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	$22
1997-98	23
1998-99	24

DESCRIPTION

This program exempts from taxation the sale or use of any used mobilehome that is subject to the property tax.

RATIONALE

This program provides tax relief to the seller of a used mobilehome and to its purchaser to the extent that the reduced tax liability is reflected in lower selling prices. The rationale for the program is to equalize treatment of mobilehomes with that of conventional housing, whose resales are not subject to sales and use taxation.

COMMENTS

Any new mobilehome used as a residence purchased after 1980 is automatically placed on the local property tax roll, and therefore would not be subject to sales tax upon resale.

However, for new mobilehomes purchased prior to 1980, the mobilehome owner may choose whether to treat the mobilehome as property subject to the property tax or as a vehicle. In the latter case, the owner would pay an annual licensing fee, and the buyer would be liable for sales and use tax upon resale of the mobilehome.

Exclusion/Exemption:
Custom Computer Programs

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6010.9.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$253
1997-98	266
1998-99	276

Description

This program exempts from taxation the sale of custom computer programs, other than a basic operational program (including a control program). In addition, a program's documentation manuals and storage media also are exempt from taxation.

Rationale

The rationale for this program is that sales of qualified custom computer programs are primarily service-type transactions and, therefore, not subject to taxation.

Comments

This program was established in 1982 by Chapter 1274, Statutes of 1982 (AB 2932, Vasconcellos). That measure stated it was the Legislature's finding and declaration that the sales of custom programs, other than basic operational programs, are service transactions *not* subject to any sales and use taxes. The measure further stated that the use of any storage media in the transfer of custom computer programs is only incidental to the true objective of the transaction, which is the performance of a service. As such, the Legislature declared that the measure was declaratory of, and not a change in, existing law.

The *resale* of a custom computer program *is* subject to tax, however, because the program was not prepared to the special order of the purchaser (*Touche Ross & Co., v. State Board of Equalization*, 203 Cal. App.3d 1057, review denied).

Exclusion/Exemption:

California Gold Medallions

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6354.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

Description

This program exempts from taxation the sale or use of commemorative "California Gold" medallions.

Rationale

This program provides an incentive for individuals to purchase commemorative California Gold medallions, by lowering their price.

The program also equalizes the tax treatment of these medallions with that of monetized bullion, nonmonetized bullion, and certain coins and medallions which are exempt (in values of $1,000 or more) under Section 6355 of the Revenue and Taxation Code. Proponents of this program argue that California Gold medallions are comparable to these other items (such as South African Krugerrands), because all can be used as metallic stores of wealth and financial investments.

Comments

This program gives California Gold medallions an advantage over bullion coins (see program entitled "Monetized Bullion, Gold and Silver Bullion, and Numismatic Coins") by exempting *all* of their sales, not just those for $1,000 or more.

The Department of General Services was required by Chapter 826, Statutes of 1982 (AB 676, Kelley) to design a series of commemorative California gold medallions to which this program applies.

Exclusion/Exemption:

MONETIZED BULLION, GOLD AND SILVER BULLION, AND NUMISMATIC COINS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6355.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale or use of monetized bullion (coins whose value is essentially the same as that of the metal they contain), nonmonetized gold and silver bullion, and numismatic coins (these have value beyond their metal content due to rarity or aesthetic appeal), including gold medallions struck under the authority of the American Arts Gold Medallion Act. To qualify for the program, individual transactions must have a market value of $1,000 or more.

On or before September 1, 1994, and each year thereafter, the minimum market value used to qualify for the program is to be adjusted for inflation when the sum of the adjustments equals or exceeds $500. The inflation-adjusted amount is to be rounded to the nearest $500.

RATIONALE

This program provides tax relief to purchasers and sellers of qualifying coins and bullion.

The program is rationalized on two basic grounds. First, many buyers of coins or bullion could avoid California sales tax by making purchases from dealers in other states, either in person or by mail. Although they would be liable for use tax on these purchases in the absence of this program, as a practical matter, the use tax is rarely collected on these types of transactions. Thus, program proponents argue that the actual revenue loss from this program is minor, and that the exemption promotes economic activity in California from coin and bullion sales, as well as enabling buyers to deal with local businesses.

Second, proponents argue that the program increases tax equity by equalizing tax treatment of coins and bullion with competing investment vehicles, such as stocks and real estate, which are not subject to the sales or use tax.

COMMENTS

We reviewed this program in detail in our *Report on the 1988-89 Tax Expenditure Budget* (Report 88-20, December 1988), pages 71-76. We concluded that, in the absence of this program, most larger sales of *bullion* (in either monetized or nonmonetized form) would shift to out-of-state dealers, and the state would collect relatively little additional revenue unless changes were made in federal laws that make collection of taxes on these interstate transactions more feasible. However, we recommended repealing the exemption for *numismatic coins,* because this exemption clearly conflicts with the state's general policy of applying sales and use taxes to other collectibles, such as artworks and jewelry.

Exclusion/Exemption:

RETURNABLE CONTAINERS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6364 (c).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the transfer of returnable containers, when sold with their contents, or when resold for refilling. A "returnable container" means a container that customarily may be returned by the buyer of the contents for reuse. All other containers are classified nonreturnable containers for the purpose of this program.

RATIONALE

This program provides tax relief to consumers of products sold in returnable containers by reducing the price of such items. The program's rationale is that the "price" charged for a returnable container often is a deposit, and applying the sales tax on each transaction could result over time in cumulative total sales taxes that eventually might amount to more than the value of the container itself. Thus, the program removes a disincentive to the use of returnable containers, which are viewed as beneficial from a resource conservation and environmental perspective.

Exclusion/Exemption:

CONTAINERS WHOSE CONTENTS ARE TAX-EXEMPT

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6364 (b).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the transfer of filled containers whose contents are not subject to the sales and use tax.

RATIONALE

This program provides tax relief to consumers of tax-exempt goods that are sold in containers (such as most food products). The program also benefits industries producing containerized packaging by encouraging its use. The main rationale for the program appears to be that it lowers the prices at which food and other tax-exempt goods may be sold to consumers. It also simplifies tax administration by eliminating the need to separately state the container prices.

COMMENTS

This program provides an indirect subsidy to consumers who retain empty containers for subsequent use. Examples of this include the use of plastic milk cartons as water jugs, and plastic butter containers as kitchen food-storage bowls.

Exclusion/Exemption:

Original Artworks and Displays For Specified Museums

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6365 and 6366.4.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from taxation the sale or use of original works of art which are purchased (1) by a qualified nonprofit organization, (2) by a state or local government entity, or (3) for donation to a qualified government entity or nonprofit organization. The exemption applies only to art purchased to become a permanent part of the collection of a qualified museum, local government entity, or nonprofit organization.

To qualify, a museum must either: (1) have a significant portion of its space open to the public without charge; (2) be open to the public without charge for not less than six hours per month during any month when the museum is open to the public; or (3) be open to a segment of the student or adult population without charge. For a local government entity to qualify, it must purchase or commission art for public display in buildings, parks, plazas, or other public areas. Such areas must be open to the public at least 20 hours per week for at least 35 weeks of the year. In the case of a nonprofit organization, there are a variety of additional qualifying requirements.

This program also exempts museum pieces purchased for or by the San Diego Aerospace Museum or the California Science Center. The exemption applies only to items which have value as museum pieces. It does not cover display cases, shelving, lamps, or other property used in operation of the museum.

Rationale

This program provides an incentive for individuals or organizations to donate, and for government agencies and nonprofit organizations to acquire, works of art that will be made available to the public to enjoy. It does this to the extent that sales and use taxes on artwork ordinarily would increase the cost of acquiring it. The program's underlying rationale is that art and the displays provided by qualified organizations provide valuable cultural and educational benefits which are worthy of public financial support.

Comments

Separate provisions were established to cover the San Diego Aerospace Museum and the California Science Center, because some of their museum pieces would not necessarily be called "works of art," and thus would not qualify under the artwork exemption. These separate provisions extend the exemption to all of the museum pieces of these two facilities.

Exclusion/Exemption:

SINGLE-USE MAILING LISTS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6379.8.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

DESCRIPTION

This program exempts mailing lists from the sales and use tax where names and addresses or other information are recorded on magnetic tapes or similar devices, and the contract regarding the mailing list restricts the purchaser to a single use.

RATIONALE

This program provides tax relief to individuals and institutions who have one-time access to mailing lists. The program is rationalized on administrative grounds, on the basis that the taxes collected from the one-time use of such mailing lists would likely be exceeded by the administrative costs of collection.

COMMENTS

This exemption would typically not apply to corporations who conduct mail-order campaigns, since such activity requires the reuse of mailing lists.

Exclusion/Exemption:

SALE-LEASEBACKS INVOLVING CERTAIN GOVERNMENTAL ENTITIES

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Sections 6010.10, 6010.11, 6018.8, and 6368.7.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the transfer of certain transportation, pollution control, or alternative energy equipment when these transfers constitute sale-lease-backs or similar arrangements with designated public agencies for financing purposes. The *initial* purchase of the equipment is *not* exempt from sales or use tax, however. In order to qualify, the equipment transfer must fall into one of the following categories:

- Transfers of project property to the California Alternative Energy and Advanced Transportation Source Financing Authority, and leases by the authority back to project-participating parties.
- Transfers of pollution control equipment and facilities to the California Pollution Control Financing Authority, and leases by the authority back to project-participating parties.
- Transfers or leases of mass commuting vehicles (such as buses and rail transit cars) between transit operators and parties providing financing under a "safe harbor" lease arrangement under federal tax laws.
- Transfers of commuter vehicles (including railcars and locomotives, bus and van fleets, and ferryboats) by the California Department of Transportation (Caltrans), and leases of these vehicles back to the department under sale-leaseback arrangements authorized by California Government Code Section 14060 et seq.

RATIONALE

This program provides tax relief to purchasers of alternative energy and pollution control equipment which receive financing assistance from state revenue bond authorities. The program also provides tax relief to transit agencies and Caltrans for transit and commuter vehicles financed through qualifying sale-leaseback arrangements.

The program has two rationales. First, it is argued that alternative energy, pollution control, and transit programs are beneficial to society and, therefore, merit public financial support. The second rationale offered by program supporters is that, because the exempt transactions are not authentic sales or leases but merely "paper" transactions to obtain favorable financing terms, they should not be taxed.

COMMENTS

This program predates enactment of Chapter 558, Statutes of 1990 (AB 3382, Baker), which provides a general exemption from sales and use taxes for property transfers made under qualifying acquisition sale-leaseback arrangements. In the absence of the special programs discussed in this review, many of its specifically exempted transactions probably would qualify for this general exemption (or could be structured to do so). In addition, some transactions exempted under the program might not be deemed by the courts to be taxable sales or leases, even in the absence of both the special and general sale-leaseback exemptions, under the precedent established by *Cedars-Sinai Medical Center v. State Board of Equalization* (162 Cal. App.3d 1182).

Exclusion/Exemption:

Motor Vehicle Fuel Used in Airplanes

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6357.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from taxation the transfer of qualified motor vehicle fuel used to propel aircraft. (This exemption does not apply to aircraft jet fuel.) To qualify, the fuel must be subject to the motor vehicle fuel tax and not be subject to refund.

Rationale

This program provides tax relief to owners and users of certain aircraft. The rationale for the program relates to the reason why motor vehicle fuel became subject to the sales and use tax in 1972. Prior to that time, such fuel was subject only to motor vehicle fuel *excise* taxes. In 1972, however, fuel also became subject to sales and use taxation, a portion of which is levied as a means of raising revenues for transportation-related purposes, including support of highways and mass transit. Because air transportation does not benefit from the use of these revenues, motor vehicle fuel used in airplanes remained exempt from sales and use taxation.

Comments

Motor vehicle fuel is subject to full state and local sales and use taxation, a portion of the revenues from which is dedicated to transportation-related purposes. The remaining portion is largely channeled into the state's General Fund for general purposes. The rationale for not taxing motor vehicle fuel for airplane use would not apply to the General Fund portion of the sales and use tax. This portion is exempt for reasons of administrative convenience and simplicity.

Jet aircraft fuel is not subject to the motor vehicle fuel tax. Rather, it is subject to a special aircraft jet fuel tax of 2 cents per gallon.

Exclusion/Exemption:

FUEL SOLD TO AIR COMMON CARRIERS FOR INTERNATIONAL FLIGHTS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6357.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	$19
1997-98	20
1998-99	20

DESCRIPTION

This program exempts from taxation the sale and use of fuel and petroleum products used by air common carriers for immediate consumption on an international flight. An international flight is defined as a flight whose final destination is a point outside of the United States.

Any fuel sold to a common carrier for use outside the state *after* the first out-of-state destination is exempt from taxation regardless of this program, so that the net effect of this program is to exempt fuel used on the "first leg" of an international flight.

RATIONALE

This program benefits domestic producers of jet fuel, and airlines that have international flights originating in California. It does so by reducing the price of fuel purchased in California for these flights. The program is rationalized on the basis that it equalizes the tax treatment of domestic fuel producers with that of foreign fuel producers. Current federal law prohibits states from taxing imported fuel brought into the state under customs bond and transferred to common carriers for use in foreign commerce. By applying a similar exemption to domestically produced fuel, the program reduces the relative costs of using domestic fuel on flights, making it more competitive with foreign fuel.

COMMENTS

This program was added by Chapter 1227, Statutes of 1988 (SB 1942, Craven), and became operative January 1, 1989, contingent on federal exemption provided in Section 1309 of Title 19 of the United States Code. If the federal prohibition on taxing foreign fuel used in foreign commerce is repealed, this program will also be repealed at the same time.

Opponents of this program argue that, while the federal prohibition on taxing foreign fuel does place domestic fuel producers at a competitive disadvantage, the problem should not be addressed by a California state tax exemption on domestic fuel. Instead, efforts should be made to have the federal prohibition on taxing foreign fuel repealed.

Exclusion/Exemption:
FUEL USED IN WATER COMMON CARRIERS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6385 (c).

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	$16
1997-98	17
1998-99	18

DESCRIPTION

This program exempts from taxation the sale and use of fuel and petroleum products used by a water common carrier (such as a cruise ship or cargo freighter) after it has reached its first out-of-state destination at which passengers or cargo are loaded or discharged. The taxpayer is required to furnish the seller of fuel or petroleum products an exemption certificate in writing, specifying the quantity of fuel or petroleum products exempt from sales and use taxation. This program sunsets on January 1, 2003.

RATIONALE

This program benefits domestic producers of fuel and petroleum products sold to water common carriers and interstate water common carriers. It does so by reducing the price of fuel purchased in California for these carriers. The program is rationalized on the basis that the fuel purchased is being used outside of California. Thus, it equalizes its tax treatment with that of other goods purchased in the state solely for use outside of California. In addition, a portion of the sales tax is meant to raise revenues for transportation-related purposes, including highways and mass transit. Because water common carriers do not benefit from the use of these revenues, it can be rationalized that it should not be subject to at least this portion of the sales and use tax.

Exclusion/Exemption:

MEALS AND FOOD PRODUCTS SERVED IN SCHOOLS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6363.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the transfer of qualified meals and food products that are furnished or served to students in schools (including colleges and universities). In order to qualify for the program, the food must be provided by a public or private school, a school district, a student organization, a parent-teacher organization, or certain blind persons.

RATIONALE

This program provides tax relief to students who consume meals and food products provided by qualified persons and organizations to the extent that taxes levied on such meals and food products ordinarily would increase their prices. The program's rationale is that proper student nutrition should be encouraged and, therefore, the price of the food should not be increased by taxation. The program is also justified on the grounds that students may not have access to cooking facilities, and this type of meal service may be the only option for such individuals.

Exclusion/Exemption:

Hot Food Products Served To Airplane Passengers

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6359.1.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from taxation the transfer of hot prepared food which is either (1) sold by caterers and other vendors to airlines for consumption by passengers, or (2) sold or served to passengers by airlines. The program applies to air carriers engaged in interstate or foreign commerce.

Rationale

This program simplifies tax administration by eliminating the need to allocate meals by state on interstate flights between California and other states. The program also provides tax relief to the consumers of food on airplanes. The program's proponents have argued that the exemption is appropriate because providing food service is incidental to an airline's main service, which is to provide air transportation.

According to this argument, air travelers are "captive eaters," having no choice as to whether food products will be made available to them. Accordingly, the cost of the meal is incorporated in the price of the ticket whether or not they choose to consume the food provided. Thus, it is argued that such meals should not be subject to taxation.

Exclusion/Exemption:

MEALS SERVED TO PATIENTS AND RESIDENTS OF HEALTH CARE FACILITIES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6363.6.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale or use of meals and food products which are served to patients or residents of any of the following (under certain conditions): (1) a health facility, (2) a community care facility, (3) a residential care facility for the elderly, (4) alcohol or drug abuse treatment facilities, or (5) a house or institution providing room and board for the elderly.

RATIONALE

This program provides tax relief to consumers of meals and food products served at qualified health care facilities, to the extent that sales and use taxes levied on such products ordinarily would be incorporated into the prices charged for them. The underlying rationales for the program are that (1) pro-viding proper nutrition for residents of health care facilities should be encouraged and, therefore, the price of food in such facilities should not be increased by taxation, and (2) residents of these facilities generally do not have the alternative of cooking for themselves.

Exclusion/Exemption:

MEALS PROVIDED TO QUALIFIED LOW-INCOME SENIOR CITIZENS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6374.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale or use of meals and food products served to low-income elderly persons by a nonprofit organization or governmental agency under a program funded by the state or the U.S. government. To qualify for the program, a meal must be sold at, or below, cost.

RATIONALE

This program provides tax relief to low-income senior citizens who consume qualified meals. The underlying rationale for the program is that providing proper nutrition to low-income senior citizens should be encouraged and, therefore, the price of food served to qualifying individuals should not be increased by taxation.

COMMENTS

Many meal programs for low-income elderly persons do not charge for the meals, and those meals would not be subject to tax even in the absence of this program.

Exclusion/Exemption:

MEALS DELIVERED TO ELDERLY AND DISABLED INDIVIDUALS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6363.7.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the gross receipts from the sale, storage, use, or consumption of meals that are delivered to homebound elderly or disabled persons by a nonprofit volunteer home-delivery meal provider (such as "Meals on Wheels").

RATIONALE

This program provides tax relief to those individuals that must rely on such services for their meals. Such services provide the proper nutrition to individuals who might otherwise not be able to prepare similar meals for themselves because of their limited mobility. It also encourages nonprofit organizations that may provide such meals at reduced prices to continue doing so.

Exclusion/Exemption:

MEALS PREPARED IN COMMON KITCHEN FACILITIES FOR QUALIFIED SENIOR CITIZENS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6376.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from sales and use taxation meals or food products furnished to and consumed by qualified persons 62 years of age or older. The program applies, for example, to food consumed by senior citizens who reside in a condominium and own equal shares in a common kitchen, and for whom food is served on a regular basis.

RATIONALE

The program provides tax relief to senior citizens living in housing that supplies room and board. The program also equalizes the tax treatment of food served to senior citizens living in independent settings with that of persons living in health care facilities. The underlying rationale for the program is that providing proper nutrition to senior citizens should be encouraged and, therefore, the price of the food served to qualifying individuals should not be increased by taxation.

Exclusion/Exemption:

MEALS AND FOOD PRODUCTS SERVED BY RELIGIOUS ORGANIZATIONS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6363.5.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation qualified meals and food products that are served by a religious organization, or under its auspices. To qualify, the revenue obtained from serving the meal or food must be used in carrying on the functions and activities of the organization. In addition, only those organizations which qualify for the religious property tax exemption may qualify for this program.

RATIONALE

This program provides tax relief for needy persons who are provided meals at nominal costs by religious organizations. Because the program reduces the price and/or cost of providing a meal to a needy person, the program also encourages qualified organizations to provide such meals. The underlying rationale for this aspect of the program is that providing meals to needy persons is a socially beneficial activity.

COMMENTS

A "qualified" religious organization is defined as one which is exempt from property taxes under Article XIII, Section 3(f) of the California State Constitution. This property tax exemption applies to buildings, land on which they are situated, and equipment, provided they are used exclusively for religious worship.

Exclusion/Exemption:
FOOD STAMP PURCHASES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6373.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation all purchases made with food stamps. When both food stamps and cash are used to purchase goods, the amount of the food stamps is applied to the cost of taxable items first.

RATIONALE

California enacted this program to comply with the Federal Food Security Act of 1985, which prohibits any state from participating in the Food Stamp Program if that state taxes food stamp purchases.

California generally exempts food products from the sales and use tax, but some food purchases allowed under the food stamp program are not covered under California's general food exemption (such as carbonated sodas). Thus, a separate provision was needed to exempt such items when purchased with food stamps.

COMMENTS

This program will be repealed automatically if and when the federal government passes legislation which repeals the prohibition on state sales taxation of food stamp purchases.

Exclusion/Exemption:

HEALTH CARE PROFESSIONALS TREATED AS CONSUMERS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6018, 6018.4, 6018.5, 6018.7, and 6020.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program provides a partial tax exemption for qualified health care items by treating various licensed health care professionals as if they were the consumer (rather than the retailer) of items that they provide to their patients and clients as part of their professional services. As such, tax is paid on the price that these professionals *pay*, rather than the price that they *charge*, for these items. Because the latter price typically is greater than the former price, less tax is paid. The program applies to the following professions and items:

- Optometrists, physicians, surgeons, and dispensing opticians with respect to ophthalmic materials, including eyeglasses and contact lenses.

- Chiropractors, with respect to vitamins, minerals, dietary supplements, and orthotic devices.

- Podiatrists, with respect to prosthetic materials and inlays, including arch-supports and special footgear.

- Hearing aid dispensers, with respect to hearing aids.

- X-ray providers, with respect to materials and supplies for medical and dental x-rays, except for purely cosmetic purposes.

RATIONALE

This program provides tax relief to persons who purchase qualified items from health care professionals. This relief occurs to the extent that sales and use taxes levied on the full retail value of such products (versus their cost to health care professionals) ordinarily would increase their prices. The program's rationale is that these products are a component of good health care, which is a basic necessity, and therefore, their prices should not be subject to full taxation.

COMMENTS

This program and others like it, which define the providers of goods as consumers, result in the partial exemption of such products from taxation. The amount of the exemption is tied to the value added to the product's retail price by the provider. The basic cost of the product to the provider, however, *is* subject to sales and use taxation.

Exclusion/Exemption:

VETERINARIANS TREATED AS CONSUMERS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6018.1.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program treats a licensed veterinarian as a consumer (as opposed to as a retailer) of the drugs and medicines used or furnished in the performance of his or her professional services. As a consequence, the program partially exempts the retail value of such items from taxation.

RATIONALE

This program provides tax relief to the clientele of veterinarians. The amount of the tax relief relates to the difference between the price of such items to consumers and the cost of such items to veterinarians. The underlying rationale for the program is that medicines and drugs prescribed for animals are a necessity for these creatures and therefore, the price of the medicines should not be subject to full taxation.

COMMENTS

The term "drugs and medicines" includes substances necessary for the diagnosis, cure, mitigation, treatment, or prevention of animal diseases. It excludes such items as shampoos, pet foods, flea powders and sprays, and vitamins. The largest uses of veterinary drugs are totally exempt from taxation, however. This is because the Board of Equalization's Sales Tax Regulation 1587 (2) (b) and (c) includes medicated feeds and drugs purchased to formulate medicated feeds under the general exemption for animal feeds. Consequently, the revenue loss from this program, though unknown, is probably relatively small.

Exclusion/Exemption:

AIRCRAFT FOR COMMON CARRIERS OR FOR USE BY FOREIGN GOVERNMENTS OR NONRESIDENTS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Sections 6366 and 6366.1.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale or use of aircraft which are to be used either as common carriers or outside of California. The program also exempts from taxation tangible personal property sold to an aircraft manufacturer and incorporated into such aircraft.

In order for aircraft or tangible personal property to qualify for the exemption, the operator's annual gross receipts from common carrier operations must either (1) exceed the lesser of 20 percent of the purchase cost of the aircraft or $50,000 or (2) the operator must provide evidence that the property is used for common carrier purposes. For leased property, the comparable limits are 10 percent and $25,000.

RATIONALE

This program reduces the prices at which the California airplane industry sells airplanes, thereby making the industry more competitive.

COMMENTS

Although billions of dollars of sales are exempted from taxation under this program, little of that forgone tax liability would be realized in the program's absence. This is because aircraft sold to common carriers easily could be delivered to them outside of California. In that case, the transaction would be an interstate or international sale that is not subject to California taxation. There would be a compelling incentive to arrange such out-of-state purchase in most cases because the amount of tax avoided could be several million dollars on a modern commercial jetliner.

Exclusion/Exemption:

TRAILERS AND SEMITRAILERS MOVED TO PLACE OF SALE

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6410, and California Vehicle Code Section 4003.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the use, storage, or other consumption in California of new or used semitrailers that (1) are not currently registered in any state and (2) are operated in the state for not more than five days as part of a continuous trip to a place where the vehicle will be offered for sale. To qualify for the exemption, the trailer or semitrailer must have obtained a one-trip permit issued by the California Department of Motor Vehicles. Under normal conditions, a use tax would be levied on the use of the vehicle for transporting goods in-state.

RATIONALE

This program provides tax relief to the operators of trailers and semitrailers operating under a one-trip permit. When this program first was established in 1986, the proponents offered the rationale that operators should not be charged, in essence, twice for their use of roads. Their view was that double-charging would occur in the absence of the program because operators of laden trailers would be required to pay for both (1) a one-trip permit and (2) use taxes based on the rental or sale value of the trailer.

Another suggested rationale for this program is that it simplifies tax administration, by relieving tax authorities from locating and assessing use taxes on one-trip operators.

COMMENTS

Neither of the two rationales supporting this program is entirely satisfactory. Regarding the double taxation rationale, it fails to recognize that the use tax and the one-trip permit fee are for two separate purposes. In the case of the rationale relating to administrative simplicity, its significance is limited because use taxes could be assessed at the same time operators are issued their one-trip permits.

Despite the weaknesses of the rationales, even if the Legislature chose to eliminate this program, the state probably would realize relatively little revenue gain. This is because simply moving an empty trailer to a place of sale would not constitute a use that would be subject to tax. The effect of this program is to make it economically feasible for these trailers to carry freight when they are moved to a place of sale. In many cases, the earnings from this freight carriage would be less than the use tax, and trailer owners would therefore simply move their vehicles unladen (thus generating no tax liability) if the exemption were not available.

Exclusion/Exemption:

QUALIFIED WATERCRAFT AND THEIR COMPONENT PARTS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Sections 6368 and 6368.1.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from sales and use taxation the sale, lease, or rental of a qualified watercraft and its component parts (including parts used in repairing or maintaining the vessel). In order to qualify for the program, the craft must either be (1) used in interstate or foreign commerce for the transportation of property or persons for hire, (2) used for commercial deep sea fishing operations outside of California's territorial waters, or (3) used 80 percent or more of the time in transporting for hire property or persons to vessels or offshore drilling platforms located outside of California's territorial waters.

In order for a vessel to qualify as a commercial deep sea fishing vessel, the operator's gross receipts from commercial fishing operations must be at least $20,000 per year, or the operator must provide evidence that the vessel is used for commercial deep sea fishing. In order to qualify as a watercraft used in interstate or foreign commerce, the operator's gross receipts must (1) exceed either 10 percent of the cost of the watercraft or $25,000 or (2) provide evidence that the vessel is used for qualifying commercial purposes.

RATIONALE

This program allows California watercraft builders and dealers, and vessel maintenance and repair businesses to reduce the prices at which their products may be provided, thereby making the California industry more competitive.

Exclusion/Exemption:

VEHICLES, VESSELS, AND AIRCRAFT TRANSFERRED WITHIN A FAMILY

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6285.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the transfer of vehicles, vessels, and aircraft when the property is sold by the purchaser's parent, grandparent, child, grandchild, spouse, or brother or sister, (if both are minors).

The exemption also applies when the sale is to a trust in which: (1) the seller has an unrestricted power to revoke the trust; (2) the sale does not result in any change in the beneficial ownership of the property; (3) the trust provides that, upon its revocation, the property will revert wholly to the seller; and (4) the only consideration for the sale is the assumption by the trust of an existing loan for which the tangible personal property being transferred is the sole collateral.

RATIONALE

This program provides tax relief to persons who purchase vehicles, vessels, and aircraft from immediate family members. The program has two rationales. First, it is based on the view that families should be treated as units, so that transactions between family members should not be taxed. Second, it facilitates tax administration because intrafamily transactions are typically not at "arms length," and thus, the price paid could be difficult to determine and may not reflect the true market value of the vehicle, vessel, or aircraft.

Exclusion/Exemption:

NEW VEHICLES SOLD TO FOREIGN RESIDENTS FOR FOREIGN SHIPMENT

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6366.2.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale or use of any new, noncommercial vehicle manufactured in the United States which is purchased by a foreign resident for shipment outside of the United States. The purchaser must (1) be a foreign resident, (2) arrange for purchase through an authorized dealer in the foreign country before arriving in the United States, and (3) obtain an "in-transit" permit from the California Department of Motor Vehicles (DMV) which is valid for up to 30 days. In addition, the retailer must ship or drive the vehicle out of the United States prior to the expiration of the in-transit permit.

RATIONALE

The program's intent is to promote the purchase and export of American-made passenger vehicles, and to increase tourism in the state. The program benefits foreign tourists by reducing the cost of purchasing an American-made car in California. Foreign countries currently provide similar programs for American citizens to purchase and operate vehicles overseas prior to their being shipped here. For California residents, such vehicles would become subject to the use tax upon registration.

COMMENTS

This program was established by Chapter 762, Statutes of 1989 (SB 442, Kopp) and became operative on January 1, 1990.

Exclusion/Exemption:
OCCASIONAL SALES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6006.5 and 6367.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	Major
1997-98	Major
1998-99	Major

DESCRIPTION

This program exempts occasional sales from taxation. An "occasional sale" is defined as either of the following types of transactions:

- The transfer of tangible personal property (except vehicles, vessels, and aircraft, which have their own program) when the seller is not required to hold a seller's permit. (A seller need not hold such a permit if he or she makes fewer than three sales for a substantial amount of money in a 12-month period.)

- Any transfer in which substantially all of the property held by an entity is transferred (except vehicles, vessels, and aircraft, which have their own program), provided that the real or ultimate ownership of such property is substantially similar to that which existed before the transfer. (This type of transfer most commonly involves corporate acquisitions and/or mergers.)

RATIONALE

This program exists in order to simplify tax administration. By exempting sales made by persons with a small number of sales, the program greatly reduces the number of persons and businesses that must register and file tax returns with the State Board of Equalization. Many of these additional sales would generate little additional revenue. For sales of *entire* businesses, the program's rationale is that these transactions are primarily changes in financial arrangements, as opposed to retail-related, even though the transfer of tangible property generally is included.

COMMENTS

This exemption constitutes a major tax expenditure program from a fiscal perspective. It recognizes that enforcing sales tax collections by individuals making small private sales (such as a garage sale) is not realistically feasible. However, there is no limit on the value of any individual occasional sale, so that a seller *can* in fact make large (though infrequent) sales without incurring a tax liability.

Exclusion/Exemption:

Occasional Sales of Vehicles, Vessels, or Aircraft

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6281, 6282, and 6283.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program provides a sales tax exemption for occasional sales of vehicles, vessels, or aircraft. Specifically, any seller who is not required to hold a seller's permit for such sales by reason of the number, scope or character of the sales is exempt from the payment of the tax. For instance, the sale of vehicles by individuals would be exempt from taxation.

This program also exempts from taxation the transfer of certain types of vehicles and other property when, after the transfer, the real or ultimate ownership of the property is substantially similar to that which existed before the transfer. The program applies, among other items, to certain mobilehomes, commercial coaches, vehicles, vessels, and aircraft, when such property is included in the sale of an entire business that includes the transfer of substantially *all* the assets of that business.

The program does not apply to sales of vehicles by a retailer who is licensed under the California Vehicle Code as a manufacturer, remanufacturer, dealer, or dismantler. Further, the exemption does not apply to the rental payments made under a lease of tangible personal property.

Rationale

The rationale for this program is to simplify administration of the sales tax. Sales of vehicles, vessels, and aircraft by individuals or businesses that do not regularly deal in these items would be difficult to identify and tax. This is because the seller may not be registered, or the sale is outside the seller's regular sphere of activities.

The business-related program provides tax relief to owners of businesses that are sold or reorganized. The program's rationale is that the real or ultimate ownership of the assets is unchanged.

Comments

The program does not provide a use tax exemption. The buyer must pay use tax when registering the vehicle, vessel, or aircraft unless some other exemption applies.

The business-related program is identical to the occasional sale exemption provided for the transfer of other property in the sale of an entire business (see program entitled "Occasional Sales"). The occasional sale exemption, however, specifically excludes vehicles, vessels, and aircraft, which are addressed in this exemption.

Exclusion/Exemption:

OCCASIONAL SALES OF OTHER PRODUCTS BY HAY PRODUCERS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6006.5 (c).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts a producer of hay from liability for sales and use taxes on occasional sales of tangible personal property other than hay. To qualify, the sales must not be of such number, scope, and character that they would be taxable if the producer were not also selling hay.

RATIONALE

This program provides tax relief to the consumers of tangible personal property, such as tractors, sold by hay producers. The program is based on the rationale that it equalizes treatment of hay producers and other farmers. In the absence of this program, a farmer who is required to hold a seller's permit because some of his or her hay sales are taxable (for example, sales to private horse owners) *would* also be required to pay taxes when he or she sells on an occasional basis any implements used in producing the hay. (This is because *all* of the sales at retail of a person holding a seller's permit are subject to the sales and use tax.) However, as program proponents point out, other farmers, such as lettuce producers who conduct no taxable retail sales, do *not* have to hold a seller's permit and, consequently, do *not* have to collect sales tax on occasional sales of their farm equipment. This program extends this tax treatment to hay farmers.

COMMENTS

Other businesses (such as manufacturers) which generally hold seller's permits but do not benefit from programs such as this, are subject to the sales tax upon sales of tangible assets of their business.

Exclusion/Exemption:

MEMBERSHIP FEES CHARGED BY CONSUMER COOPERATIVES

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6011.1 and 6012.1.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the membership fees charged by consumer cooperatives. The imputed value of any labor provided to a cooperative by a member in lieu of monthly membership fees also is tax exempt. In the absence of this program, the Board of Equalization could consider cooperative membership fees (both monetary and in-kind payments) as part of the purchase price of goods sold by consumer cooperatives and, therefore, taxable.

RATIONALE

This program provides tax relief to members of consumer cooperatives to the extent that sales and use taxes levied on membership fees ordinarily would increase the costs of belonging to, and buying from, such cooperatives. At the time the program was adopted, proponents argued that the membership fees cooperatives levy are not directly related to the prices they charge for products. Rather, they argued that cooperatives are akin to organizations such as sports clubs, whose membership fees are not directly related to the frequency of facility use. Thus, the program's proponents argue that it provides tax equity between the cooperatives and other organizations such as private clubs.

Exclusion/Exemption:

CLOTHING ALTERATIONS BY CLOTHES CLEANING AND DYEING BUSINESSES

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6018.6.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program defines an operator of a qualified state-licensed clothes cleaning or clothes dyeing business as the consumer (as opposed to the retailer) of the materials and supplies used or furnished in altering clothing. While the operators pay sales taxes on these materials, the value of the alterations are exempt from the sales tax. Such operators thus pay sales tax on the price they *pay* rather than on the price they *charge* for the materials.

To qualify for the program, the business involved may receive no more than 20 percent of its gross receipts from the alteration of garments. Also, the business may operate only as a pick-up and delivery point for garment cleaning, or provide spotting and pressing services (but not garment cleaning), or operate a garment cleaning or dyeing plant on the premises. In addition, 75 percent of the business' total receipts must represent charges for garment cleaning or dyeing services.

RATIONALE

This program provides tax relief to the customers of cleaners that have their clothes altered. According to the State Board of Equalization, the basic rationale for this program is that it simplifies the process of tax administration. This is because, in the absence of the program, many small cleaning establishments would be required to register as retailers, even though clothing alterations are an incidental part of their overall operations.

Exclusion/Exemption:

FLAGS SOLD BY VETERANS' GROUPS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6359.3.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program defines nonprofit veterans' organizations as consumers of the U.S. flags they sell, provided that the proceeds of the sales are used exclusively to further the purposes of the veterans' organization. As defined consumers, such organizations pay sales tax on the price they *pay* rather than on the price they *charge* for the flags they sell, resulting in a partial tax exemption based on this price differential.

RATIONALE

This program provides an incentive for persons to support the activities of nonprofit veterans' organizations by granting tax relief to those who purchase U.S. flags sold by the organizations. The program has the effect of partially exempting the retail value of such flags from taxation, thereby increasing their marketability. The underlying rationale for the program is the view that the purposes and activities of veterans' organizations are worthy of public financial support.

Exclusion/Exemption:

VENDING MACHINE SALES OF NONPROFIT OPERATORS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6359.45(a).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program treats as consumers certain operators of vending machines that dispense items selling for 15 cents or less. As such, the sales and use tax they are subject to is based on the price they *pay* for the items sold rather than based on the *sales* price. In order to qualify for the program, an operator must be a nonprofit, charitable, or educational organization.

RATIONALE

This program provides tax relief to qualifying vending machine operators and their customers, to the extent that sales and use taxes levied on the full retail price of dispensed items (versus their cost to operators) would ordinarily increase their prices and reduce their marketability. One rationale for the program is that the levying of sales and use taxes on individual vending machine products is impractical, since the exact amount of the tax cannot be conveniently incorporated into the coinage charge. A second rationale is that qualifying organizations provide socially beneficial services, and therefore, their fund-raising efforts and other activities are worthy of public financial support.

COMMENTS

The effect of this program is limited to nonfood items. Food items sold in vending machines for no more than 15 cents (or 25 cents for bulk products) are effectively exempt from taxation, regardless of whether the vendor is nonprofit or profitmaking.

Exclusion/Exemption:

PHOTOCOPY SALES BY LIBRARIES

Program Characteristics	
Tax Type:	Sales and Use Tax
Authorization:	California Revenue and Taxation Code Section 6359.45 (b).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program defines certain libraries or their contracted vendors as the consumers of photocopies sold through coin-operated photocopying machines. Consequently, libraries pay sales tax on the purchase of the photocopy machine and supplies, rather than on the sales price of a photocopy. This has the effect of partially exempting the retail value of a photocopy from taxation. This program applies to any library district, municipal library, or county library. The photocopies must be sold from a coin-operated machine located at the library facility in order to qualify for the exemption.

RATIONALE

This program provides tax relief to qualifying libraries and their patrons by reducing the costs of providing photocopying services. The program has several rationales. One is that the levying of sales and use taxes on individual machine-sold photocopies is impractical, since the exact amount of the tax cannot be conveniently incorporated into the coinage charge. Another is that photocopy services serve a worthy public goal of enabling library patrons to make better use of library facilities and information.

Exclusion/Exemption:
Prisoner-of-War Bracelet Sellers

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6360.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

Description

This program defines qualified sellers as consumers of bracelets commemorating American prisoners of war, and thus bases their taxation on the prices the sellers *pay* for the bracelets rather than the sales price. To qualify for the program, a seller must be an organization which (1) is formed and operated for a charitable purpose and (2) qualifies for the welfare (local property tax) exemption. In addition, the organization's profits must be used exclusively to further the purposes for which it has been established.

Rationale

This program provides tax relief to qualifying bracelet-distributing charitable organizations and their patrons. It accomplishes this by reducing the costs or prices at which such bracelets may be provided or sold, thereby increasing the scope of their distribution. The program's underlying rationale is that the distribution of commemorative prisoner-of-war bracelets furthers the effort to locate and identify prisoners of war.

Comments

The California Department of Veterans Affairs indicates that, to its knowledge, only a very limited number of prisoner-of-war bracelets are currently being sold.

Exclusion/Exemption:

VETERANS MEMORIAL LAPEL PINS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6360.1.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the sale, storage, or use of "Buddy Poppies" or any other symbolic impermanent lapel pin that (1) memorializes military veterans killed in foreign wars and (2) is sold by veterans' groups.

RATIONALE

This program provides an incentive for persons to support work done by veterans' organizations by providing tax relief for those who purchase lapel pins sold by these organizations. The Buddy Poppy program, for example, has been used to raise funds to assist disabled veterans. The underlying rationale for this tax exemption program is the view that the purposes and activities of veterans' organizations are worthy of public financial support.

Exclusion/Exemption:

QUALIFIED SALES OF YOUTH GROUPS

Program Characteristics	
Tax Type:	Sales and Use Taxes.
Authorization:	California Revenue and Taxation Code Section 6361.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program treats qualified youth group organizations as consumers of the food products, nonalcoholic beverages, and certain other items that they sell. This has the effect of either *fully* exempting (in the case of most food products, which are not subject to the sales tax when purchased by these groups, but could be subject to sales tax when resold by them) or *partially* exempting (for other items for which the sales tax on their purchase price is less than the sales tax on the resale price) the retail value of these products from taxation. Nonfood items must be made by members of the organization in order to receive this treatment. In order to qualify for the program, a group must (1) use its profits exclusively to further its purpose(s), (2) conduct sales only on an intermittent or irregular basis, and (3) be included in one of the following categories:

- Nonprofit groups that are nondiscriminatory and provide a program of competitive sports or promote good citizenship.
- Groups sponsored or affiliated with a qualifying educational institution.
- Specific named groups, including the Young Men's Christian Association, Boy Scouts, Girl Scouts, Bobby Sox, Future Farmers of America, and Vocational Industrial Clubs of America.

RATIONALE

This program provides tax relief to qualifying youth organizations and to individuals and businesses who purchase products they sell. It accomplishes this by reducing the costs and prices at which these products can be provided and sold, thereby making them more marketable and increasing their sales potential. The program thus has the effect of giving incentives for such organizations to undertake fund-raising activities and for patrons to support them. The program's rationale is that the objectives and activities of the qualifying organizations are socially desirable and worthy of public financial support.

COMMENTS

Youth groups often operate food stands at sports events and fairs, or organize fundraising meals, in order to support their activities. Many of these food sales *would* be taxable in the absence of this program. This is because the food is sold in a hot, prepared form (such as hamburgers or hotdogs), as a meal, or for onsite consumption at an event. Since the food supplies purchased by these organizations are not taxable under the general food exemption, this program results in a full exemption for their sales to consumers (with the exception of carbonated beverages). The program also applies to nonfood items that are made by members of the organization itself, in which case the group pays sales tax on the materials and supplies that it uses, but the finished item is not taxable.

Chapter 116, Statutes of 1990 (AB 520, Klehs), eliminated a previous requirement that youth groups that were not specifically named in statute were required to obtain prior approval from the Board of Equalization in order to qualify for this program.

Exclusion/Exemption:

YEARBOOK AND CATALOG SALES BY STUDENT ORGANIZATIONS

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6361.5.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program defines qualified student organizations as consumers of the yearbooks and catalogues they distribute. Consequently, the organizations pay sales tax on their *purchase* price of such items, rather than on the price at which they *resell* them. This has the effect of partially exempting from taxation the retail value of these items. The program applies to any public or private school, school district, county office of education, or student organization.

RATIONALE

This program provides tax relief to student organizations and students, to the extent that sales and use taxes on the full retail value (versus acquisition cost) of yearbooks and catalogues ordinarily would increase their prices. The rationale for the program is that such catalogues and yearbooks are a fundamental part of the schooling experience, and therefore, the costs of such items should not be increased by fully taxing such purchases.

Exclusion/Exemption:

REPLACEMENTS FOR DESTROYED MUSEUM EXHIBITS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6366.3.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale or use of replacement exhibits for a qualified museum, or for a public art display of the state or a local government. The program requires that the property be acquired to replace property physically destroyed by a calamity within three years after its occurrence, and that it be purchased and used exclusively for display purposes within the museum.

To qualify, a museum must either (1) have a significant portion of its space open to the public without charge, (2) be open to the public without charge for not less than six hours per month during any month when the museum is open to the public, or (3) be open to a segment of the student or adult population without charge. In addition, the museum must be operated by or for a local or state government entity, or by a qualified nonprofit organization.

RATIONALE

This program provides tax relief to qualified museums after they have incurred damage from disasters, including fire, flooding, or earthquakes. The program's rationale is that museums provide a valuable cultural and educational service and, as such, they are worthy of public financial support.

COMMENTS

As described under a separate program, generally, original artwork purchased by a museum is exempt from taxation.

Exclusion/Exemption:

SALES BY PTAS, CO-OP NURSERY SCHOOLS, AND FRIENDS OF THE LIBRARY

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6370.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program treats as consumers nonprofit Parent Teacher Associations (PTAs), Friends of the Library (or equivalent organizations), and nonprofit parent cooperative nursery schools. As consumers, such organizations pay taxes on the prices they *pay* rather than on the prices they *charge* for items they sell to raise funds. This has the effect of partially exempting from taxation the retail value of such items. The program requires that any profits derived from the sales of such property be used for furthering the purposes of the organization.

RATIONALE

This program provides tax relief to qualifying organizations and their patrons, to the extent that taxation of the full retail price of the property these organizations sell would increase their prices and reduce their sales potential. The program thus provides an incentive for organizations to operate, and patrons to support, qualifying activities. The program's underlying rationale is that the goals and activities of these organizations are socially desirable, and thus worthy of public financial support.

Exclusion/Exemption:

RUMMAGE SALES BY QUALIFIED NONPROFIT ORGANIZATIONS

Program Characteristics	
Tax Type:	Sales and Use Tax
Authorization:	California Revenue and Taxation Code Section 6370.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program treats nonprofit organizations that perform auxiliary services to any city or county museum as the consumers of goods sold by those organizations at qualified rummage sales. As consumers, such organizations pay tax on the price they *pay* rather than on the price they *charge* for items they sell to raise funds. The effect of this is to limit the amount of sales and use taxes levied on such property. In order for the program to apply, the property must be sold at an annual rummage sale which must have been held during each of the five consecutively preceding years, and profits from the sale must be used exclusively for furthering the purposes of the organization.

RATIONALE

This program provides tax relief to qualified charitable organizations and their patrons, and (indirectly) to the museums which they support. It does this to the extent that the partial sales and use tax exemption on rummage sales stimulates such sales, and thereby increases the amount of funds which charitable organizations and museums are able to raise from rummage sales. The program's rationale is that museum-related activities are socially beneficial and deserving of public financial support.

COMMENTS

This program results in a full tax exemption for donated items sold at these rummage sales.

Exclusion/Exemption:

HANDCRAFTED ITEMS SOLD BY QUALIFIED ORGANIZATIONS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6361.1.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program treats qualified organizations as consumers of tangible personal property if: (1) such property is handcrafted and designed, created, or made by either individuals with developmental disabilities or children with severe emotional disturbances who are members of or receive services from the organization; (2) the price of such property does not exceed $20; (3) the organization's sales are made on an intermittent basis; and (4) the profits from sales are used exclusively for promotion of the organization.

In order to qualify, an organization must: not discriminate on the basis of race, sex, nationality, or religion; have tax-exempt status as defined under Section 501(c)3 of the Internal Revenue Code; and primarily provide services to either individuals with developmental disabilities or children with severe emotional disturbances.

RATIONALE

There exist several underlying rationales for this program. One is to simplify tax administration in a manner similar to the exemption for occasional sales discussed elsewhere in this report. The program also provides tax relief to charitable organizations and their clientele, to the extent that it reduces the prices of items they sell. The program provides an incentive for individuals to purchase such items because of their reduced prices. To the extent that the lower prices increase sales, this provides additional funds for services to individuals with certain disabilities or emotional disturbances. This program is similar to the sales and use tax exemption provided for sales by qualified charitable organizations.

Exclusion/Exemption:

CHARITABLE ORGANIZATION SALES AND DONATIONS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6375.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

Commonly known as the "welfare exemption," this program exempts from taxation the sale or use of goods made, prepared, assembled, or manufactured by qualified charitable organizations. In order for the program to apply, an organization must qualify for the welfare (local property tax) exemption and be engaged in the relief of poverty and distress. In addition, the organization's sales and donations are exempt only if they are made principally to assist purchasers or donees in poverty or distress.

RATIONALE

This program provides tax relief to charitable organizations and their clientele, to the extent that it reduces the prices and costs of providing property to disadvantaged persons. The program also provides an incentive for individuals to purchase merchandise sold by charitable organizations. It does this by removing the sales tax on such merchandise, thereby reducing the prices at which the merchandise can be sold. To the extent that the organization's sales are increased as a result, the amount of funds available for the relief of poverty and distress is increased.

The program's underlying rationale is that the qualifying organizations provide a socially desirable service in making property available to distressed persons and, therefore, are deserving of public financial support.

COMMENTS

This program provides a tax exemption for sales in stores operated by Goodwill Industries and similar organizations. In practice, the exemption applies to *all* sales in these stores, and no attempt is made to determine whether the purchaser is needy or not.

Donations were included in this program by Chapter 1447, Statutes of 1989 (SB 874, Doolittle). This was done because previously, charities that purchased goods tax-free using their resale permit found that they became liable for tax when they donated these goods, because making a gift constituted a taxable use of the property.

Exclusion/Exemption:

PROPERTY LOANED TO EDUCATIONAL PROGRAMS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6202.7 and 6404.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the loan by retailers of certain tangible personal property to qualified educational institutions.

Specifically, the program exempts:

- Loans of tangible personal property to school districts for educational programs.
- Loans of motor vehicles to the University of California (UC) or the California State University (CSU) system for exclusive use: (1) in an approved driver education teacher preparation certification program or (2) by an employee of the UC or CSU system, so long as the loan is approved by the President or Chancellor of the university and the retailer is not guaranteed automotive-related business from the university.
- Loans of vehicles to an accredited private or parochial secondary school for exclusive use in an approved driver education and training program.
- Loans of motor vehicles to a veterans' hospital or other nonprofit institution, to provide instruction in the operation of specially equipped motor vehicles to disabled veterans.

Under existing law, if a retailer makes use of property that is ostensibly held for sale, he or she ordinarily must pay use tax on the wholesale price of the property. Loans of such property are considered "uses" of the property by the retailer and, therefore, are taxable unless otherwise exempted.

Example. In the absence of this program, an automobile retailer who loans a vehicle at no cost to a high school driver training course would pay use tax on the dealership's cost of the vehicle. This is because most retailers are considered "consumers" of merchandise that they use themselves or loan to others. This program exempts from taxation such loans to qualifying educational institutions.

RATIONALE

This program provides tax relief to qualified educational institutions and the students who use the qualified loaned property. It does this to the extent that exemption of sales and use taxes on such loans enables these educational institutions to service more students because of reduced costs. In addition, students who pay fees for the affected programs may pay less because of the reduced costs. The underlying rationale for the program is that providing equipment and vehicles to educational institutions is a desirable social goal worthy of public financial support.

Exclusion/Exemption:

NEW CLOTHING DONATED TO ELEMENTARY SCHOOL CHILDREN

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6375.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from taxation the sale of children's new clothing when the clothes are sold to a qualified nonprofit organization. In order for the program to apply, the clothes must be sold to a nonprofit organization organized and operated for charitable purposes, possessing tax-exempt status and engaged in poverty and distress relief. The clothes must be distributed, free of charge, to needy elementary school children.

RATIONALE

This program provides tax relief to nonprofit organizations which distribute free clothes to children. The underlying rationale for the program is that such tax relief increases the amount of clothing which nonprofit organizations may acquire with their available resources, and thereby enables them to better meet the needs of the children they service. The program exists in recognition of the view that providing such clothes is a socially beneficial activity worthy of public financial support.

COMMENTS

This program is similar to the general exemption for sales and donations by charitable organizations. However, it does differ in three ways. First, the exemption applies to *purchases* by, rather than sales or use by, the charity. Thus, it is useful to charities that do not have resale permits. Second, there is no requirement that the donating charity qualify for the welfare exemption under the local property tax. Third, there is no requirement that the charitable organization prepare, assemble, or make the donated items.

Exclusion/Exemption:

FIRST $400 OF FOREIGN PURCHASES HAND-CARRIED INTO CALIFORNIA

Program Characteristics	
Tax Type:	Use Tax.
Authorization:	California Revenue and Taxation Code Section 6405.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from the use tax the first $400 of purchases made by state residents in a foreign country and personally hand-carried into California. Only one such exemption can be claimed for any 30-day period, and purchases sent or shipped into California do not qualify for the exemption.

RATIONALE

This program provides tax relief to California residents returning from overseas with purchases that otherwise would be subject to the use tax. The exemption originally was enacted as part of a new state program which seeks to collect use taxes on foreign purchases. Such taxes generally had not been collected prior to 1990 due to administrative difficulties.

The program is largely rationalized on administrative grounds. The exemption recognizes that the state's efforts to collect the use tax on foreign purchases is dependent on the federal government's duty collection procedures. The U.S. Customs Service recently began to provide the state with customs declarations filed by returning Californians. The U.S. Customs Service does not require payment of duties on the first $400 of foreign purchases and keeps no useable records of travelers entering the state with purchases of less than $400. Consequently, the state has no cost-effective means at present to collect use tax from travelers declaring less than $400 of foreign purchases.

Although the state could attempt to collect the use tax on the first $400 of purchases brought into the state by travelers who are subject to customs duties, the administrative costs would be prohibitive.

COMMENTS

The Board of Equalization started collecting customs declarations on October 1, 1990. This program, which was established by Chapter 1533, Statutes of 1990 (SB 2455, Morgan), exempts $400 of the taxable purchases from each billing, for a maximum state revenue loss of $24 per billing.

Exclusion/Exemption:

CHARITABLE DONATIONS MADE BY SELLERS

Program Characteristics	
Tax Type:	*Use Tax.*
Authorization:	*California Revenue and Taxation Code Section 6403.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program provides a use tax exemption for property donated by any seller to specified educational institutions, charitable organizations, and nonprofit museums located in California.

RATIONALE

This program provides tax relief to sellers who donate property to educational and charitable organizations and museums. Generally, the purchase of goods solely for resale does not trigger the payment of sales or use tax on the purchase. Rather, tax is collected only on *retail* sales—that is, sales to someone who will actually make final use of the goods. If, however, property originally bought for resale is instead used by the seller rather than resold, the seller must pay use tax. This includes donations of property, which are considered a "use" of the property by the seller. This program exempts sellers from paying use tax on items donated to qualifying organizations. The program's intent is to give added incentive to donate property to nonprofit organizations and museums, the rationale being that such organizations serve a public purpose and are deserving of public financial support.

COMMENTS

This program was enacted by Chapter 905, Statutes of 1988 (SB 2508, McCorquodale), and originally applied only to persons engaged in retail sales activity who donated property. The program was expanded by Chapter 1387, Statutes of 1989 (SB 1226, Campbell), however, to include *all* sellers (including wholesalers). Chapter 1387 also restricted the program to donations used exclusively for display in the case of nonprofit museums, and required qualifying museums to meet minimum standards for public access.

Exclusion/Exemption:

AUCTIONS INVOLVING NONPROFIT ORGANIZATIONS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6363.2.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the gross receipts from the sale, storage, use, or consumption of tangible personal property sold to a bidder at an auction conducted by, or affiliated with, a nonprofit organization. The purpose of the auction must be to obtain revenue for the funding of a shelter for homeless individuals and families, and those revenues obtained must be expended for that purpose. The exemption does not apply to sales at an auction conducted more than once every 12 months.

RATIONALE

This program provides tax relief to charitable organizations and their clientele by exempting the sales and use tax on merchandise sold at auction. As a result, it increases the amount of funds available to charitable organizations for funding shelters for the homeless. The program also eases the administrative burden since the administrative costs associated with collecting taxes from such infrequent sales could exceed the amount of taxes collected.

Exclusion/Exemption:

SALES BY THRIFT STORES OPERATED BY NONPROFIT ORGANIZATIONS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6363.3.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	Amount
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the sale, storage, consumption, or use of used clothing, household goods, or other items sold by thrift stores operated by nonprofit organizations. It has a sunset date of January 1, 2002. The thrift store involved must be operated for the purpose of raising revenues for funding medical and social services for chronically ill individuals, with at least 75 percent of its net revenues being expended for these purposes.

RATIONALE

This program provides tax relief to nonprofit organizations (such as hospital auxiliary organizations) that raise revenues for the purpose of funding medical and social services for the chronically ill. The program's underlying rationale is that the qualifying organizations are providing a socially desirable service, and therefore deserve public financial support.

Exclusion/Exemption:

Option to Pay Tax on Cost Rather Than Lease Receipts

Program Characteristics	
Tax Type:	Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6006 (g) (5) and 6010 (e) (5).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program provides that owners of property engaged in the business of leasing such property to others may choose to pay *sales* tax based on the *purchase price* that they paid for the property, rather than pay *use* tax on their *lease receipts*. To qualify, property must be leased in substantially the same form as it was acquired by the lessor. This program does not apply, however, to the rental of video cassettes, which are taxed solely on the basis of rental receipts under California Revenue and Taxation Code Section 6006 (g) (7).

Rationale

This program provides tax relief to lessors and lessees of qualified property. The rationale underlying the program is to facilitate the compliance of the lessor with the state sales tax code and to simplify tax administration. The program accomplishes these ends by allowing businesses to pay the sales tax once, upon the purchase of the item, rather than requiring the lessor to pay the tax repeatedly based on the property's rental receipts.

Comments

Under this program, a lessor can choose the most advantageous tax strategy for any specific situation. The State Board of Equalization indicates that lease receipts are chosen as the basis of tax for about 75 percent of all leased property. This approach is preferred by car rental companies, for example. Most rental cars are resold after a year or two, so that rental receipts for these cars are significantly less than their purchase price. Thus, paying tax on the rental receipts results in a smaller total tax liability for the rental company than paying tax based on the purchase price. Paying tax on lease or rental receipts also reduces the amount of capital required for lessors to purchase property initially. In the case of property that is leased for its full economic life, paying sales tax on the purchase price rather than on lease receipts generally would result in a smaller tax liability.

Exclusion/Exemption:

TAX LIABILITY ON "BAD DEBTS"

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Sections 6055 and 6203.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts retailers from paying sales and use taxes due on accounts which have been determined to be uncollectible.

RATIONALE

This program provides tax relief to businesses which have incurred financial losses due to their inability to collect money from customers who have not paid their bills. The underlying rationale for the program is that businesses, especially small firms, can suffer considerable hardships when they are unable to collect money from customers who have purchased goods using credit. Such financial losses can impair a firm's ability to pay taxes, since the funds to pay these taxes normally are collected from its customers.

COMMENTS

The above-cited rationale for this program is strongest when retailers can show that they have executed proper caution when granting credit to consumers. In the absence of such care, however, the rationale loses strength.

Exclusion/Exemption:

ACQUISITION SALE-LEASEBACK ARRANGEMENTS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6010.65.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from sales and use taxation any transfer of the title to, or lease of, property under a qualifying "acquisition sale-leaseback." An acquisition sale-leaseback is a financing arrangement wherein the purchaser of property sells that property to a third party and then leases it back from that third party. These transactions generally are "on paper" only and do not involve any physical transfer of the property. In order to qualify for this program, an acquisition sale-leaseback must be consummated within 90 days of the first functional use of the property, and the sales or use tax must have been paid on the initial purchase of the property.

RATIONALE

This program reduces the cost of acquiring property financed through sale-leaseback arrangements. It does so by eliminating sales tax on the sale to the lessor or, alternatively, the use tax on the lease payments to the lessee. The rationale for the program is that qualifying sale-leasebacks are financing arrangements similar to a mortgage. On that basis, it is argued that taxing the sale-leaseback transaction, in addition to taxing the initial purchase of the property, would amount to double taxation.

COMMENTS

Most sale-leaseback transactions probably would be exempt from sales and use taxes, even in the absence of this program. This is because the courts have ruled (prior to the establishment of this program) that no taxable sale occurs when the sole object of a sale-leaseback is to obtain financing for the purchase of equipment (*Cedars-Sinai Medical Center v. State Board of Equalization*, 162 Cal. App.3d.1182). This program was enacted by Chapter 558, Statutes of 1990 (AB 3382, Baker), in part to simplify tax administration by setting a specific 90-day window in which sale-leasebacks must be completed in order to be tax exempt.

Exclusion/Exemption:
FACTORY-BUILT SCHOOL BUILDINGS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6012.6.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation 60 percent of the sales price of qualified factory-built school buildings. Additionally, it specifies that the place of sale is the retailer's place of business, regardless of whether the sale includes installation or the building is placed on a permanent foundation.

RATIONALE

The intent of this partial exemption is to equalize tax treatment of factory-built school buildings with that of site-built buildings. Generally, the sales and use tax applies only to the building materials used to construct a site-built building, rather than to the full price of the completed building. It was determined that approximately 40 percent of the sales price of a factory-built school building represents the value of the building materials and, thus, the remaining 60 percent of the price of such school buildings should be exempt from taxation.

This program is consistent with the 60 percent exemption which also applies to factory-built housing, described under a separate program discussed earlier (see program entitled, "Factory-Built Housing").

COMMENTS

This program was enacted by Chapter 816, Statutes of 1989 (AB 1051, Leslie) and Chapter 763, Statutes of 1990 (AB 4029, Leslie).

The Board of Equalization (BOE) adopted regulations a few months prior to enactment of this program which classified essentially all installations of modular buildings, including factory-built school buildings, as construction projects so that they would be taxed as if constructed on the site. Under that treatment, a purchaser, such as a school district, pays sales tax only on the value of fixtures and equipment supplied with the building. The manufacturer pays sales or use tax on the materials used to make the building, but no tax is applied to the value added by the manufacturer.

According to BOE, the total tax liability for manufactured buildings under this regulation is similar to the tax liability under this program (that is, about 40 percent of the total value is taxed). Therefore, this program has no significant impact on the amount of tax revenue compared with the board's regulatory interpretation of general sales and use tax law.

Under the board's regulations, however, the local share of sales tax revenues would have been allocated to both the localities where the manufacturer's suppliers were located and to the locality where the building was installed.

The main purpose of enacting this program was to ensure that the city and county in which the building manufacturer is located continue to receive the local portion of the sales tax.

Exclusion/Exemption:

ENDANGERED ANIMAL AND PLANT SPECIES

Program Characteristics	
Tax Type:	*Sales and Use Tax.*
Authorization:	*California Revenue and Taxation Code Sections 6010.50 and 6366.5.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from taxation the sale or use of endangered or threatened animal or plant species, provided that the buyer and seller are both nonprofit zoological societies.

RATIONALE

The intent of this program is to provide tax relief for zoos that breed and exchange animals and plants of endangered species (primarily animals). Some zoos specialize in the development and breeding of certain animal species. Prior to enactment of this program, zoos had been assessed back taxes for making animal exchanges. The program's rationale is that it is a worthy public goal to encourage zoos to breed and exchange endangered species.

COMMENTS

This program does not apply when zoological societies purchase animals or plants from for-profit sources. This program was established by Chapter 937, Statutes of 1989 (AB 804, Peace).

Exclusion/Exemption:

INVESTMENTS BY MANUFACTURERS

Program Characteristics	
Tax Type:	Sales and Use Tax.
Authorization:	California Revenue and Taxation Code Section 6377.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	$5
1997-98	6
1998-99	6

DESCRIPTION

This program provides a partial exemption from sales and use tax for manufacturing, research, and recycling property purchased by "new businesses." The exemption provided under the program is equal to five cents per dollar of the sales and use tax normally owed, which represents the portion of the sales and use tax levied by the state for the General Fund. (The taxpayer still has to pay the additional statewide sales and use tax and any local sales and use taxes.)

To qualify, a business must have (1) commenced business activities in California after 1993, and (2) been in existence for fewer than three years. In addition, the business must be engaged in certain lines of business defined in the U.S. Standard Industrial Classification Manual as "manufacturing" activities.

The program covers property costs that are considered "capital expenditures." (It also includes the value of any capitalized labor costs that are directly related to the construction or modification of these expenditures.) Eligible property is depreciable property (such as machinery and computers) or computer software used primarily in (1) manufacturing, research, pollution control, or recycling activities, or (2) maintaining, repairing, measuring, or testing property used in such activities. In addition eligible property includes, for certain activities, special purpose buildings and foundations that are primarily used in connection with manufacturing, refining, processing, fabricating, or research and storage.

A taxpayer may claim a tax refund under this program if sales and use taxes were paid on qualified costs and if the taxpayer was eligible for this exemption, but did not claim it. The program sunsets January 1, 2001, or earlier under certain conditions.

RATIONALE

This program provides an incentive for qualified taxpayers to expand manufacturing and research property in California. It does this by offsetting a portion of the costs incurred through a partial sales and use tax exemption. It provides tax relief to new businesses that may not be able to claim the Manufacturer's Investment Income Tax Credit (which is available to all businesses) because they do not have positive tax liabilities (which is common among new businesses with large start-up expenses, and thus, similarly large tax deductions for business expenses and losses). Thus, this program tries to equalize tax treatment between new businesses and well established businesses that may be able to readily claim the income tax credit.

COMMENTS

To the extent that this program reduces the cost of capital acquisition to businesses, it results in an unknown expansion in business activity. Also, refer to comments under the PIT and BCT income tax program entitled "Manufacturer's Investment Tax Credit."

Pursuant to Chapter 323, Statutes of 1998 (AB 2798, Machado) this program was expanded to include teleproduction and post-production equipment.

✦ Other State Taxes

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✦ Other State Taxes—Overview

The remaining state tax expenditure programs (TEPs), detailed in the following section, involve state excise taxes (alcoholic beverage taxes, cigarette and tobacco taxes, and various fuel taxes) and the insurance tax. The responsibility for administration of these tax programs lies with the Board of Equalization (BOE) and the Department of Insurance, respectively. Revenues collected from these tax sources may be distributed, depending on the tax, to the state General Fund, designated special funds, or both. (For example, cigarette and tobacco taxes provide revenues to the General Fund *and* three special funds.) Thus, the TEPs that apply to these revenue sources affect revenues that fund a variety of programs. The following provides a brief description of other state taxes.

Alcoholic Beverage Taxes

Current state law levies excise taxes on the sale of alcoholic beverages by manufacturers, distillers, wine growers, certain wholesalers, purifiers, and importers. The point of taxation varies depending upon the alcoholic beverage sold. For example, distilled spirits are taxed when the product is sold by the wholesaler to the retailer; however, taxes on imported beer and wine may occur when these products are first brought into the state. Depending upon market structure, these taxes may be fully or partially passed through to the final consumer in the form of higher prices (the same is true for the other excise taxes discussed below). The state's sales and use tax is applied "on top" of the excise tax.

Alcoholic beverages are taxed by the gallon and state excise tax rates vary by beverage type. The current tax rates are: 20 cents per gallon for beer, hard cider, and most wines; 30 cents per gallon for champagne or sparkling wine; $3.30 per gallon for distilled spirits that are 100 proof or less; and $6.60 per gallon for distilled spirits over 100 proof. All revenues collected from alcoholic beverage taxes go into the state's General Fund.

In addition to state excise taxes, the federal government levies its own excise taxes on alcoholic beverages.

Cigarette and Tobacco Taxes

Current state law levies a tax on distributors for the sale of cigarettes and other tobacco products. As with alcoholic beverage taxes, the state sales and use tax is applied "on top" of the excise tax.

The current state excise tax rate on cigarettes is 87 cents per pack. Of this amount:

- 25 cents is deposited into the Cigarette and Tobacco Products Surtax Fund as required by Proposition 99, which was approved by the voters in November 1988. Revenues from this fund are used for education, natural resources, health services, and research in the areas of tobacco use and tobacco-related diseases.
- 10 cents is deposited into the state General Fund.

- 2 cents is deposited into the Breast Cancer Fund and used for research and administration of programs in this area.
- 50 cents is deposited into the California Children and Families First Trust Fund as required by Proposition 10, which was approved by the voters in November 1998. Revenues from this fund are used for early childhood development, and health education and research programs, primarily at the local level.

Tax rates on other tobacco products such as loose tobacco, cigars, and snuff are adjusted by the BOE each year so that the tax levied is in the same proportion to the wholesale price of these products as the 87-cents-per pack tax levied on cigarette products is of their wholesale price. An additional tax, equivalent to 50 cents per pack, will be levied on these other tobacco products beginning July 1, 1999. Revenues collected from the tax on such other tobacco products are distributed to the Cigarette and Tobacco Products Surtax Fund and the California Children and Families First Trust Fund.

In addition to state excise taxes, the federal government also levies an excise tax on cigarette and tobacco products.

FUEL TAXES

Current law imposes three major categories of fuel taxes: the Motor Vehicle Fuel License Tax (referenced herein as the "Motor Vehicle Fuel Tax"), the Diesel Fuel Tax, and the Use Fuel Tax. Revenues collected from all fuel taxes are deposited into the State Transportation Fund. These revenues provide the state and its localities with a major source of funding for maintaining, replacing, and constructing highways, streets, and other transportation facilities. The following provides a brief description of each type of state tax levied.

Motor Vehicle Fuel Tax. Current state law imposes a tax on distributors for the sale of motor vehicle fuel including gasoline, aviation gasoline, and certain blended gasolines for vehicular use on public streets and highways. The tax does not apply to fuel used for racing motor vehicles at a race track, diesel fuel, liquified petroleum gas, kerosene, methanol, ethanol, or natural gas. The state sales and use tax is applied "on top" of the excise tax.

The current state excise tax is 18 cents per gallon of gasoline, excluding aircraft jet fuel (which is taxed at 2 cents per gallon). As specified in the reviews that follow, certain air common carriers, aircraft manufacturers and repairers, and the U.S. Armed Forces are exempt from the tax on jet fuel.

Diesel Fuel Tax. Current state law imposes a tax on distributors at the wholesale level for the sale of diesel fuel and blended diesel fuel sold for use in propelling vehicles on public streets and highways. Unlike most other state excise taxes, this excise tax is *not* included as part of the base for calculating the sales and use tax.

The current state excise tax is 18 cents per gallon. Prior to July 1, 1995, this tax was collected under the use fuel tax, at which time the diesel fuel tax was established as a separate tax under the California Revenue and Taxation Code. Under the diesel fuel tax, the imposition of the tax was shifted to the first point of distribution (the "rack"), partly in order to ensure greater tax compliance.

Use Fuel Tax. Current state law levies a tax on the sale of alternative fuels such as liquified petroleum gas (LPG), liquified natural gas (LNG), compressed natural gas (CNG), alcohol fuels (ethanol or methanol), and kerosene. These alternative fuels remain untaxed until they are dispensed into a motor vehicle that is operated on California highways, or that is suitable for highway operation.

The current state excise tax rates are 18 cents per gallon for kerosene, 6 cents per gallon for LNG, 7 cents per cubic foot for CNG, 9 cents per gallon for alcohol fuels, and 6 cents per gallon for LPG. As with the diesel fuel tax, this excise tax is *not* included as part of the base for calculating the sales and use tax. An alternative flat tax based on the weight of the vehicle is available for LPG, LNG, and CNG consumers. This rate ranges from $36 for passenger cars to $168 for larger vehicles.

Other Fuel Taxes. A special fuel tax rate of 1 cent per gallon is levied on fuel used by local transit systems, school and community college districts, and certain common carriers. This special tax is in lieu of the other fuel taxes described above.

In addition to the state fuel taxes, the federal government levies an excise tax on fuel products sold.

INSURANCE TAX

In general, insurers conducting business in California are subject to a tax on their gross premiums written in the previous year, less "return" premiums and dividends. ("Return" premiums are refunds paid to policyholders that cancel their policy before its expiration date.) Certain types of insurers and plans, such as title insurers and ocean marine insurers, are taxed slightly differently. Insurers are subject to the gross premiums tax in lieu of all other taxes except real property taxes and business license fees. The basic gross premiums tax rate is 2.35 percent.

In addition, out-of-state insurers operating in California may be subject to an additional "retaliatory tax." This occurs if the effective tax rate imposed by their home state on California insurance companies operating in that state is higher than the tax rate imposed in California on these out-of-state insurers.

There is no comparable gross premiums tax at the federal level. Instead, insurance companies are typically subject to federal corporate income taxation.

Exclusion/Exemption:

ALCOHOL USED IN TRADES, PROFESSIONS, AND INDUSTRIES

Program Characteristics	
Tax Type:	Alcoholic Beverage Tax.
Authorization:	California Revenue and Taxation Code Section 32052.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the alcoholic beverage tax the sale of alcohol, distilled spirits, or wine used in trades, professions, or industry applications. Such uses typically include cases where alcohol is used as part of a production or treatment process of some sort, such as in pickling processes or the production of gasohol. To qualify, the sale must be made by a licensed distilled spirit manufacturer, brandy manufacturer, rectifier, industrial alcohol dealer, or wine grape grower.

RATIONALE

This program provides tax relief to the purchasers of exempted items, to the extent that excise taxes levied on them ordinarily would be incorporated into the price of the product. The underlying rationale for the program is the view that the alcoholic beverage tax is intended to be a tax on alcohol only when it is consumed as a beverage, and that other uses of alcohol should not generally be subject to the tax.

Exclusion/Exemption:

BEER CONSUMED BY BREWERS' EMPLOYEES

Program Characteristics	
Tax Type:	Alcoholic Beverage Tax.
Authorization:	California Revenue and Taxation Code Section 32172.

Estimated Revenue Reduction (In Millions)

Fiscal Year	Amount
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from the alcoholic beverage tax the consumption of beer, when the beer is (1) consumed by the employees of a brewer, and (2) consumed on the premises of the brewer.

RATIONALE

This program provides tax relief to brewers by relieving them of paying taxes on the beer which their employees consume in-house. The underlying rationale for the program appears related to the administrative problems involved with documenting and measuring the volume of in-house beer consumption.

COMMENTS

The Board of Equalization's Regulation 2551 limits the amount of this exemption to the maximum amount allowed by federal alcoholic beverage tax regulations.

Exclusion/Exemption:

DISTILLED SPIRITS USED IN THE MANUFACTURE OF FOOD PRODUCTS

Program Characteristics	
Tax Type:	*Alcoholic Beverage Tax.*
Authorization:	*California Revenue and Taxation Code Section 32214.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program effectively exempts from alcoholic beverage taxation the sale of distilled spirits that are used in the manufacture of food products. Mechanically, it accomplishes this by providing a tax credit equal to the amount of any alcoholic beverage excise taxes paid.

RATIONALE

This program provides tax relief to producers and consumers of food products that incorporate the use of distilled spirits in the manufacturing process. In the absence of the program, excise taxes levied on such distilled spirits ordinarily would be incorporated into the prices of the food products themselves. The underlying rationale for the program is the view that the alcoholic beverage tax is intended to be a tax on alcohol only when it is consumed as a beverage, and that other uses of alcohol should not generally be subject to the tax.

COMMENTS

Some foods use brandy, rum, or other distilled spirits as a flavoring, and little or no alcohol remains in the food after baking or other processing activities. Alcohol also is used as the base for a variety of flavoring extracts. This program specifies that the manufacturer's use of alcohol in food must conform to certain federal regulations.

The tax credit mechanism is used as the means for providing the exemption, as opposed to an outright direct exemption *per se*, due to its relative administrative simplicity.

Exclusion/Exemption:

DISTILLED SPIRITS USED FOR RESEARCH AND MEDICAL-RELATED PURPOSES

Program Characteristics	
Tax Type:	Alcoholic Beverage Tax.
Authorization:	California Revenue and Taxation Code Section 32053.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the alcoholic beverage tax the sale of (1) ethyl alcohol used for scientific research or by any hospital or sanitarium, and (2) alcohol used in medicinal, pharmaceutical, antiseptic, or selected other products. To qualify, packages of distilled spirits must be sold in amounts greater than one gallon.

RATIONALE

This program provides tax relief to the users of alcohol for the above-exempted purposes, including the consumers of products made with such alcohol, by reducing the prices of such products. The underlying rationale for the program is the view that the alcoholic beverage tax is intended to be a tax on alcohol only when it is consumed as a beverage; and that other uses of alcohol should not be subject to the tax. This program also can be rationalized on the grounds that the exempted uses of alcohol are for socially beneficial purposes, and, therefore, their cost should not be increased by taxation.

Exclusion/Exemption:

Distributions of Tobacco Products to U.S. Armed Forces and the U.S. Department of Veterans' Affairs

Program Characteristics	
Tax Type:	Cigarette and Tobacco Tax.
Authorization:	California Revenue and Taxation Code Section 30102.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$23
1997-98	22
1998-99	21

Description

This program exempts from the cigarette and tobacco tax the distribution of cigarettes and tobacco products to the U.S. Armed Forces and to the U.S. Department of Veterans' Affairs.

Rationale

This program provides a tax incentive for the U.S. Armed Forces and the U.S. Department of Veterans' Affairs to purchase cigarettes or tobacco products *in* California, as opposed to *outside* of California. It does this to the extent that the tax, if imposed, would make California cigarette and tobacco product prices sufficiently high to cause these entities to purchase cigarettes outside of California. This, in turn, would reduce economic activity in California related to the distribution and retailing of these products.

The program also has been rationalized on the grounds that it grants tax relief to various members of the U.S. Armed Forces and patrons of the U.S. Department of Veterans' Affairs, by enabling them to acquire their cigarettes and tobacco products at reduced costs. It has been argued that such persons are deserving of this public subsidy because of their present or past service to their country.

Comments

The U.S. Armed Forces and U.S. Department of Veterans' Affairs are such large purchasers of cigarettes that they can cost-effectively purchase cigarettes and tobacco products in a low-cost state for subsequent sale in a higher-cost state, provided that the interstate price differential exceeds the interstate shipment costs.

The courts have held that this program applies to cigarette and tobacco product sales through military commissaries and exchanges, but not sales to U.S. officers' clubs and officers' messes.

The estimated revenue reduction shown above is based on data from the Board of Equalization (BOE). The estimate includes expenditures under the other cigarette tax expenditure programs discussed herein, such as distributions to veterans' institutions and small cigarette and tobacco product shipments. This is because data on these transaction types are not reported separately to the BOE. According to estimates, however, sales to the military comprise the majority of all exempt cigarette sales.

The tobacco industry benefits from this program to the extent that the program increases demand for tobacco products.

Exclusion/Exemption:

DISTRIBUTIONS OF TOBACCO PRODUCTS TO VETERANS' INSTITUTIONS

Program Characteristics	
Tax Type:	*Cigarette and Tobacco Tax.*
Authorization:	*California Revenue and Taxation Code Section 30105.5.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	—
1997-98	—
1998-99	—

DESCRIPTION

This program exempts the sale or gift of federally tax-free cigarettes or other tobacco products, when delivered directly from the manufacturer to either a veterans' home located in California, or a hospital or domiciliary facility of the U.S. Department of Veterans' Affairs. To qualify for the program, the cigarettes and tobacco products must be issued free of charge to veterans receiving hospitalization or domiciliary care.

RATIONALE

This program provides a tax incentive for qualified institutions to provide cigarettes and other tobacco products to their patrons. The underlying rationale for the program is that the provision of free cigarettes and other tobacco products to hospitalized veterans is deserving of public financial support, due to the military services that these individuals have provided to their country.

COMMENTS

As with other exemptions for tobacco products, the tobacco industry benefits from this program to the extent that the program increases demand for tobacco products.

The revenue reduction associated with this program is incorporated within the revenue reduction shown for the immediately preceding program entitled, "Distributions of Tobacco Products to U.S. Armed Forces and the U.S. Department of Veterans' Affairs."

Exclusion/Exemption:

Small Shipments of Cigarettes Transported Into California

Program Characteristics	
Tax Type:	*Cigarette and Tobacco Tax.*
Authorization:	*California Revenue and Taxation Code Section 30106.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	—
1997-98	—
1998-99	—

Description

This program exempts from the cigarette tax the distribution of cigarettes transported into California from out of state, provided that the total shipment does not exceed 400 cigarettes. The program requires that the cigarettes either be (1) intended for consumption by the individual bringing them into the state, or (2) obtained at one time or another from the U.S. Department of Veterans' Affairs, or exchanges or commissaries of branches of the U.S. Armed Forces.

Rationale

This program provides tax relief to consumers of qualifying small-shipment cigarettes. The program's rationale is that the revenues derived from taxing these small shipments are insufficient to justify incurring the administrative costs of collecting the tax.

Comments

There is no similar exemption for other tobacco products. However, Revenue and Taxation Code Sections 30431 and 30432 implicitly allow transportation of individual quantities of other tobacco products valued at $25 or less and on which tax has not been paid, without a transporter's permit or invoices.

The revenue reduction associated with this program is incorporated within the revenue reduction shown for the prior program, "Distributions of Tobacco Products to U.S. Armed Forces and the U.S. Department of Veterans' Affairs."

Exclusion/Exemption:

NATURAL GASOLINE

Program Characteristics	
Tax Type:	*Motor Vehicle Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Section 7401(a)(1).*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the motor vehicle fuel tax the distribution of natural gasoline to a duly licensed distributor.

"Natural gasoline" is not the same as the gasoline that is commonly sold for use in automobiles. Rather, it is a naturally occurring liquid which often is present in crude oil. Generally, natural gasoline cannot be used directly in automobiles. However, natural gasoline may be blended with crude oil distillates during the production of motor vehicle fuel. In this case, the natural gasoline becomes indirectly taxed as a component part of the motor fuel at the retail level. The program therefore, exempts from taxation natural gasoline not used in motor vehicles.

RATIONALE

This program provides tax relief to producers and users of natural gasoline, to the extent that excise taxes levied on such gasoline ordinarily would be incorporated into its production costs and sales price. The program's rationale is that unblended natural gasoline generally cannot be used in vehicles which use the public highways that are supported by the proceeds of the motor vehicle fuel tax.

Exclusion/Exemption:

Ship or Aircraft Fuel Ultimately Distributed to the U.S. Armed Forces

Program Characteristics	
Tax Type:	Motor Vehicle Fuel Tax.
Authorization:	California Revenue and Taxation Code Sections 7041(a)(4) and 7041(a)(5).

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from the motor vehicle fuel tax the qualified distribution of motor fuel to the armed forces. To qualify for this program, the fuel must be (1) used in a ship or aircraft, or (2) used outside of California. The program includes motor fuel that is distributed to a third party prior to its distribution to the armed forces.

Rationale

The basic rationale for this program is that revenues from the motor vehicle fuel tax are directed toward the maintenance of public highways and airports, and these transportation facilities are not used by the vehicles whose fuel use is exempted from taxation under this program. It also has been suggested that the program may increase the purchase of military fuel in California, at least in some circumstances, by reducing its price relative to prices charged in other states.

Exclusion/Exemption:

FUEL FOR OFF-HIGHWAY VEHICLE OPERATIONS

Program Characteristics	
Tax Type:	Motor Vehicle Fuel Tax.
Authorization:	California Revenue and Taxation Code Section 8101(a).

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the motor vehicle fuel tax any motor fuel used for purposes other than operating motor vehicles on public streets and highways.

The program operates via a refund mechanism, whereby the fuel is taxed when purchased and then the purchaser must apply for a refund for qualifying off-road fuel use. Fuel uses that qualify for refunds include use in farm tractors and irrigation pumps, electric generators, and vehicles operated solely on private property (such as within an amusement park). Fuel used by off-road recreational vehicles that are licensed for use on public lands and motor vehicle fuel used in boats are not eligible for this program. Fuel used in construction equipment is addressed in a separate exemption.

RATIONALE

This program provides tax relief to fuel consumers who are not using the fuel to operate vehicles on public streets and highways. The underlying rationale for the program is that the proceeds of the motor vehicle fuel tax are used generally for the construction and maintenance of public streets and highways.

The rationale for *not* exempting fuel used by off-road recreational vehicles licensed for use on public lands is that the estimated amount of revenues collected on that fuel is allocated to special funds that support off-highway recreational activities. Likewise, the estimated amount of tax paid on motor vehicle fuel used in boats is transferred annually to the Harbors and Watercraft Revolving Fund for the support of various boating programs.

COMMENTS

There are many minor fuel uses that qualify for a tax refund but for which refunds are not requested. Fuel used in home lawnmowers is one example.

Exclusion/Exemption:
Fuel Sales to Consulate Officers and Employees

Program Characteristics	
Tax Type:	Motor Vehicle Fuel Tax.
Authorization:	California Revenue and Taxation Code Sections 7401(a)(6), 8101(e), and 8106.1.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from the motor vehicle fuel tax fuel sold to an officer or employee of a foreign consulate, providing specified conditions are met. In order to qualify, the program requires that the sale must be charged to a credit card held by the consulate and certified by the U.S. State Department, and that the fuel must be used in a consular vehicle registered with the State Department. Furthermore, the program only applies to consulates of foreign governments that are exempt from taxes by treaty, or who provide a similar tax exemption to U.S. diplomats on a reciprocal basis. The consulate employee may not use the fuel in connection with a private occupation or for personal gain within the state.

Rationale

This program provides tax relief to foreign governments. According to the Board of Equalization, this program helps fulfill the terms of treaties and reciprocal arrangements between the U.S. and countries with consulate employees stationed in the U.S. Under the terms of such treaties and arrangements, U.S. consulate employees are not subject to tax on fuel consumed in foreign countries, and foreign consulate employees are not subject to taxes on fuel consumed in the U.S.

Exclusion/Exemption:

FUEL FOR RACE CARS

Program Characteristics	
Tax Type:	*Motor Vehicle Fuel Tax and Use Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Sections 7304 and 8604.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

DESCRIPTION

This program exempts from fuel taxation inflammable liquids that are specifically manufactured for racing motor vehicles, and that are distributed and used for racing motor vehicles at a racetrack. In the absence of this exemption, distributors of fuel manufactured specifically for race cars would be required to collect the tax from fuel purchasers. Under this program, distributors are exempted from collecting the tax.

Although this type of program mechanism does not ultimately affect vehicle-related fuel tax revenues, it does result in reduced *sales* tax revenues. This is because the sales tax is imposed on the entire price of the fuel, which ordinarily would include the motor vehicle fuel tax.

RATIONALE

This program provides tax relief to race car owners and operators by reducing the fuel tax they pay on fuel used in operating racing vehicles. The rationale for the exemption from the motor vehicle fuel tax is that such vehicles are operated off-road, and hence do not benefit from the street and highway improvements funded by the tax.

COMMENTS

Other operators of vehicles that are not used on public highways must pay the motor vehicle fuel tax, and then apply for a refund of the tax (if they qualify). California Revenue and Taxation Code Section 7304 applies to the exemption under the motor vehicle fuel tax. The exemption under Section 8604 is a parallel exemption under the use fuel tax.

Exclusion/Exemption:

FUEL FOR COMMON CARRIERS AND THE MILITARY

Program Characteristics	
Tax Type:	*Jet Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Section 7374.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$73
1997-98	77
1998-99	80

DESCRIPTION

This program exempts from the aircraft jet fuel tax all fuel used by common carriers, the military, and persons engaged in the business of constructing or reconstructing aircraft.

RATIONALE

This program provides tax relief to qualified users of jet fuel and their customers, to the extent that taxes on such fuel ordinarily would be incorporated into its price and the prices charged for using planes burning such fuel.

According to the Board of Equalization, the underlying rationale for the program relates to the fact that the tax on jet fuel is used to finance small municipal airports, which are used primarily by private aircraft owners. (Large airports are funded primarily by landing fees and other user charges.) This program exempts common carriers and the military from paying the tax on jet fuel on the grounds that they receive limited benefits from the facilities supported by this tax.

COMMENTS

The aircraft jet fuel tax is imposed upon aircraft jet fuel dealers at the rate of 2 cents per gallon. Recent legislation—Chapter 1027, Statutes of 1998 (AB 66, Baca)—altered the manner in which the local Bradley-Burns *sales* tax revenue on jet fuel is allocated among local jurisdictions. The new allocation formula generally is based on where the fuel is *delivered* as opposed to where negotiations for the fuel contract took place.

Exclusion/Exemption:

FUEL FOR CONSTRUCTION AND AGRICULTURAL MACHINERY

Program Characteristics	
Tax Type:	Use Fuel Tax and Diesel Fuel Tax.
Authorization:	California Revenue and Taxation Code Sections 8652(b), 60100(a)(5)(A), and 60501(a)(4)(C).

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the use fuel tax and diesel fuel tax the fuel used to propel construction equipment operated within the confines of a construction project, and certain machinery used in agricultural operations. For vehicles used in construction, the exemption from the diesel fuel tax is provided in the form of a reimbursement of the tax paid. To qualify, the equipment can be only incidentally operated on the highways, and must be exempt from vehicle registration under the California Vehicle Code.

RATIONALE

This program provides tax relief to the operators of qualified construction equipment and agricultural equipment that only incidentally is used on state highways. The underlying rationale for the program relates to the fact that fuel taxes primarily fund public street and highway construction and maintenance. Since equipment that only intermittently uses the streets and highways does not generally benefit from these improvements, taxing the fuel used to propel such equipment is viewed as inappropriate.

COMMENTS

In theory, it would be possible to impose fuel taxes on that portion of fuel used in moving construction equipment and agricultural machinery on the public streets and highways. However, the revenues collected under such an approach probably would not offset the costs of administering it.

Exclusion/Exemption:

FUEL FOR NONTRANSPORTATION PURPOSES

Program Characteristics	
Tax Type:	*Use Fuel Tax and Diesel Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Sections 8652(c) and 60501 (a)(4)(A).*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the use fuel tax and diesel fuel tax fuel used for a purpose other than to propel a motor vehicle in California. The exemption under the diesel fuel tax is provided in the form of a reimbursement of the tax paid. Typical examples of exempt uses include fuel used in electric generators, to rotate cement mixer drums, or operate garbage compressors.

RATIONALE

This program provides tax relief to the operators of qualified equipment. The underlying rationale for the program relates to the fact that the use fuel tax primarily funds public streets and highway construction and maintenance. Because the qualifying equipment does not directly benefit from the public streets and highways, taxing the fuel used to operate such equipment is viewed as inappropriate.

Exclusion/Exemption:

FUEL FOR OFF-HIGHWAY VEHICLE OPERATIONS

Program Characteristics	
Tax Type:	*Use Fuel Tax and Diesel Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Sections 8653, 60100 (a)(5)(c), and 60501 (a)(4)(A).*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the use fuel and diesel fuel tax, fuel that is used in the operation of a motor vehicle off-highway. For diesel fuel consumed by diesel powered train engines the tax is not paid in the first place. For other off-highway consumption—for example, by trucks—the exemption is in the form of a reimbursement of the tax paid. The exemption for off-highway use by state or local government vehicles could be provided either through an exemption or reimbursement.

RATIONALE

This program provides tax relief to the operators of off-highway vehicles. The rationale underlying the program relates to the fact that the use fuel tax funds public street and highway construction and maintenance. Because vehicles operated off of the public streets and highways do not directly benefit from the use of the tax revenues, levying the use fuel tax on such vehicles is viewed as inappropriate.

Special Tax Rate:

FUEL FOR LOCAL TRANSIT AND SCHOOL BUS OPERATORS

Program Characteristics	
Tax Type:	*Use Fuel Tax and Diesel Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Sections 8655, 60100 (a)(5)(D), 60502, and 60502.2.*

Estimated Revenue Reduction *(In Millions)*	
Fiscal Year	**Amount**
1996-97	$25
1997-98	23
1998-99	22

DESCRIPTION

This program provides operators of local transit services and school buses a special use fuel and diesel fuel tax rate. Specifically, it permits qualified entities to pay a special payment of 1-cent-per-gallon instead of the normal tax rate of 18 cents.

In order to qualify for the program, the entity involved must be either (1) a transit district, (2) a school or community college district, or (3) a private entity providing local public transportation services in an urban or suburban area. These latter entities also must meet certain criteria and either: (1) be a passenger stage corporation subject to the jurisdiction of the Public Utilities Commission; (2) provide transportation services under contract to a public agency, school or community college district; or (3) be a common carrier operating over a route entirely within a single city. The program does not include charter carriers.

RATIONALE

This program provides tax relief to the above-specified local transportation agencies and providers. It also provides relief to public transportation users to the extent that the reduced tax liabilities are reflected in lower transit fares. The rationale underlying this program is that it promotes the establishment, maintenance, and use of public transportation systems, by lowering their operating costs. In the case of school buses, the program's rationale is that it supports the public education system by reducing the portion of budgeted funds needed for student transportation, thereby increasing the amount of funds available for classroom educational activities.

Exclusion/Exemption:

FUEL FOR OUT-OF-STATE TOUR BUSES

Program Characteristics	
Tax Type:	Use Fuel Tax and Diesel Fuel Tax.
Authorization:	California Revenue and Taxation Code Sections 8608(b), 60130, and 60116.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program relieves qualified interstate tour bus operators of the requirement to obtain a use fuel or diesel fuel tax permit from the Board of Equalization (BOE). The effect of this is to exempt such operators from any tax liability associated with their consumption of fuel *within* the state that has been purchased *elsewhere*. To qualify, the fuel must be used by an out-of-state passenger carrier whose operations consist solely of round-trip tours originating and terminating outside of California. In addition, any fuel purchased *within* California must be used solely for propulsion of the vehicle, and tax must be *paid* on *it*.

RATIONALE

This program provides tax relief to the operators of out-of-state tour buses, to the extent that the fuel they bring into the state exceeds that taken out of the state. Before the advent of this program, out-of-state tour bus operators were required to report the actual amount of fuel brought into California, purchased in California, and taken out of California. If the amount brought in exceeded that taken out (indicating net use of out-of-state fuel in California) the operator was required to pay a tax on the difference. Alternatively, the operator could claim a tax refund if the fuel taken out of the state exceeded that brought in.

This program relieves the qualified tour bus operators from having to register with and report to BOE regarding net use of fuel in California that is purchased out of state. Although the user pays tax to the vendor on the fuel purchased in California, there is no tax on any net use of fuel purchased out of the state.

The underlying rationale for the program is two-fold. First, it simplifies state tax administration and saves the state money, to the extent that the costs of collecting the tax would have exceeded the revenues generated. Second, it relieves tour bus operators of burdensome paperwork requirements.

COMMENTS

Prior to this program, failure to register with the BOE could result in a fine of $500 for tour bus operators.

Exclusion/Exemption:

FUEL FOR PUBLIC AGENCY VEHICLES OPERATED ON MILITARY INSTALLATIONS

Program Characteristics	
Tax Type:	*Use Fuel Tax and Diesel Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Sections 8654 and 60501 (a)(4)(E).*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the use fuel tax and diesel fuel tax certain fuel used in a motor vehicle owned by a county, city, district, or other political subdivision. The exemption from the diesel fuel tax is provided in the form of a reimbursement of the tax paid. The program applies to fuel used to operate qualifying vehicles over a highway that is constructed and maintained by the U.S. government, and that is within a military installation. If the motor vehicle is operated on one continuous trip both over such a highway and over a public highway located outside the military installation, only the fuel used to operate the vehicle on the public highway is subject to the tax.

RATIONALE

This program provides tax relief to qualified agencies operating motor vehicles on military bases. The apparent rationale for the program relates to the fact that the roads on military bases are not supported by use fuel tax revenues. This rationale holds that public agencies, which may have to enter military bases to provide certain services, should be relieved of the use fuel tax on the portion of their fuel used on such roads.

Exclusion/Exemption:

FUEL FOR OPERATION OF VEHICLES ON U.S. DEPARTMENT OF AGRICULTURE ROADS

Program Characteristics	
Tax Type:	*Use Fuel Tax and Diesel Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Sections 8653.1 and 60501(a)(4)(D).*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the use fuel tax and the diesel fuel tax fuel used to operate a motor vehicle on any highway that is under the jurisdiction of the U.S. Department of Agriculture (USDA). For diesel fuel, the tax exemption is provided in the form of a reimbursement of the amount of diesel fuel tax paid. In order to qualify for the exemption, the user must pay, or contribute to, the cost of the highway's maintenance or construction under an agreement with the USDA.

RATIONALE

This program provides tax relief to the qualified users of USDA roads, such as logging roads in national forests. The underlying rationale for the program relates to the fact that fuel taxes primarily fund public streets and state highway construction and maintenance. Since these funds do not go to improve USDA roads, taxing the portion of fuel used on such roads is viewed as inappropriate. Limiting the exemption to individuals who contribute to road maintenance serves to confine favorable tax treatment to heavy users of USDA roads, such as logging trucks. A tax expenditure exists since absent the program, fuel consumed for these purposes would be taxed.

Exclusion/Exemption:

Fuel For the U.S. Government And its Instrumentalities

Program Characteristics	
Tax Type:	Diesel Fuel Tax.
Authorization:	California Revenue and Taxation Code Sections 60100 (5)(e) and 60100 (a)(8).

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from the diesel fuel tax, fuel used in vehicles owned by the U.S. government, and its agencies and instrumentalities. Under the program, fuel is sold by the retailer to the U.S. government at the consumer price less the 18 cents per gallon diesel fuel tax incorporated into the price. The retailer then files a claim for reimbursement of the tax paid based on the number of gallons sold to the government consumer.

Rationale

The basic rationale for the program is that federal government agencies are engaged in activities that benefit the public generally, and should not be subject to local taxation. In addition, when the diesel fuel tax was established as separate from the use fuel tax in 1995, an attempt was made to leave unchanged the treatment of fuel consumers. Since U.S. government consumption was not taxed under the more direct use fuel tax, this consumption was also granted an exemption under the diesel fuel tax.

Special Tax Rate:

FUEL USED IN PUBLIC TRANSIT VEHICLES

Program Characteristics	
Tax Type:	*Motor Vehicle Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Section 8101.6.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program provides a special motor vehicle fuel tax rate for motor vehicle fuel used in propelling qualified passenger-carrying vehicles. The special rate is provided in the form of a refund of 6 cents of the 18 cents per gallon general tax rate. To qualify for the program, the vehicles involved must be used in transporting persons for compensation, and must be used by the following:

- A transit district, transit authority, or city owning or operating a transit system.
- A private entity providing specified transportation services.
- Certain passenger stage corporations subject to the jurisdiction of the Public Utilities Commission.
- Any common carrier operating exclusively within the limits of a single city using a regular route and not subject to the jurisdiction of the Public Utilities Commission.

RATIONALE

This program provides a tax incentive to encourage the operation and use of qualified public transit services, to the extent that fuel excise taxes ordinarily increase the costs and prices of such services. The underlying rationale for the program is to expand the state's reliance on public transit, thereby reducing traffic congestion and air pollution, and lessening the need for increased highway vehicle capacity.

Special Tax Rate:
LIQUIFIED PETROLEUM GAS

Program Characteristics	
Tax Type:	Use Fuel Tax.
Authorization:	California Revenue and Taxation Code Section 8651.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$3
1997-98	2
1998-99	2

DESCRIPTION

This program provides a special use fuel tax rate to purchasers of liquified petroleum gas (LPG). The special tax rate is 6 cents per gallon on LPG, compared with the general use fuel tax rate in 1998 of 18 cents per gallon.

RATIONALE

This program provides a tax incentive for the use of LPG, rather than gasoline, in order to encourage the use of alternative fuel sources. Such alternative fuel sources produce lower levels of air pollutants.

In addition, the program has been rationalized on tax equity grounds. Each gallon of LPG has about *75 percent* of the energy content of a gallon of gasoline. At the time that this program was established and prior to August 1990, the general use fuel tax rate on gasoline and diesel fuel was 9 cents per gallon. The 6 cents per gallon rate on LPG (*67 percent* of the general rate) thus approximately equalized the tax on LPG and gasoline in terms of relative energy content (which determines how far a vehicle can travel on a gallon of fuel).

COMMENTS

Since 1994, the tax rate on LPG (6 cents per gallon) has been only *one-third* of the rate of the tax on gasoline (18 cents per gallon). As a consequence, the benefit provided by this program is larger than the amount needed to equalize tax treatment of LPG with gasoline on the basis of relative energy content (see above).

The revenue estimate cited above is based on data from the Board of Equalization (BOE). The estimates include the revenue effect of the special tax rate for liquified *natural* gas. This is because the two types of transactions are not reported separately to the BOE. According to the BOE, however, LPG represents the majority of sales taking place at the reduced tax rate of at 6 cents per gallon.

Special Tax Rate:

ETHANOL AND METHANOL

Program Characteristics	
Tax Type:	*Use Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Section 8651.8*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program provides what is equivalent to a partial exemption from the use fuel tax to purchasers of ethanol and methanol. Specifically, the program provides that the excise tax on such alcohol fuels shall be one-half the rate imposed on gasoline and diesel fuels. In order to qualify for the program, the fuel cannot contain more than 15 percent gasoline or diesel fuels (the remainder of the fuel must be ethanol or methanol).

RATIONALE

Proponents argue that this program provides a tax incentive for the use of ethanol and methanol, in order to make the California economy less dependent on conventional petroleum products and to reduce the level of air pollution. In addition, the program has been rationalized on tax equity grounds. Each gallon of methanol or ethanol fuel has about half the energy content of a gallon of gasoline or diesel fuel. Thus, this program approximately equalizes the tax on alcohol fuels with the tax on diesel and gasoline fuels, based on their relative energy content (which determines how far a vehicle can travel on a gallon of fuel).

COMMENTS

Unlike the special tax rates for liquified petroleum gases, liquified natural gas, and compressed natural gas, the special tax rate for alcohol fuels is set at a percentage of the general tax rate on diesel fuel and gasoline (rather than at a specific number of cents per gallon). Consequently, the tax on alcohol fuels maintains its approximate energy equivalence with the tax on gasoline and diesel fuels regardless of changes in the excise tax rate for gasoline and diesel fuels. The amount of revenue loss per gallon of alcohol fuel due to this program grows, however, as the tax rate on gasoline and diesel fuel increases.

Special Tax Rate:

NATURAL GAS

Program Characteristics	
Tax Type:	Use Fuel Tax.
Authorization:	California Revenue and Taxation Code Section 8651.6.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program provides what amounts to a special use fuel tax rate to purchasers of compressed natural gas (CNG) or liquified natural gas (LNG). The reduced tax rate is 7 cents per 100 cubic feet of CNG and 6 cents per gallon of LNG, compared with the general use fuel tax rate of 18 cents per gallon in 1998.

RATIONALE

This program provides a tax incentive for the use of natural gas rather than gasoline in motor vehicles. The program's rationale is to encourage the use of alternative fuel sources, in order to make the California economy less dependent on conventional petroleum products and to reduce air pollution.

COMMENTS

The energy content of a gallon of LNG or of 100 cubic feet of CNG is similar to that of a gallon of gasoline, so that this program cannot be rationalized on the grounds of equalizing tax treatment on the basis of relative energy content, as can the preceding two programs.

The estimated revenue loss cited above is based on data from the Board of Equalization (BOE). The estimate includes only the revenue loss due to the lower rate on CNG. The revenue loss on LNG is included in the estimate for liquified petroleum gas (LPG) (see the program entitled "Liquified Petroleum Gas"). This is because the LNG and LPG transactions are not reported separately to the BOE.

Special Tax Rate:

FLAT TAX RATE FOR LIQUIFIED PETROLEUM GAS AND NATURAL GAS FUELS

Program Characteristics	
Tax Type:	*Use Fuel Tax.*
Authorization:	*California Revenue and Taxation Code Section 8651.7.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows the owner or operator of a vehicle fueled by liquified petroleum gas (LPG), liquified natural gas (LNG), or compressed natural gas (CNG) (except an interstate user) to pay the use fuel tax at an annual flat rate based on the weight of the vehicle, as opposed to a per gallon rate. The flat rate varies from $36 for passenger cars and any other vehicles weighing 4,000 pounds or less, to a maximum of $168 for vehicles weighing 12,001 pounds or more.

The total amount of tax generated by these flat rates is approximately equivalent to the total amount of tax that would be paid at the per gallon tax rates for these fuels, assuming that vehicles are driven a typical number of miles each year and have typical fuel efficiency. For example, the flat rate of $36 for a passenger car equals the amount of tax at 6 cents per gallon that would be paid if an LPG fueled car were driven 12,000 miles at an average fuel efficiency of 20 miles per gallon.

For these typical assumptions, the flat-rate tax provides what amounts to a partial exemption from taxation to the same extent as is provided by the special per gallon rates for these fuels. The value of the benefit provided by the flat rate tax relative to the value of the benefit from the special per gallon rate, would be greater for vehicles that use more fuel each year than the typical vehicles on which the flat rates are based.

RATIONALE

This program has the same basic rationales as the special tax rates discussed in the immediately preceding reviews—namely, encouraging the use of alternative fuels, and reducing air pollution. It also serves to equalize taxation with gasoline on an energy-content basis. The program's tax savings and simplified reporting procedures also provide an incentive for taxpayers to convert engines to these alternative fuel sources. Furthermore, the program simplifies the administration of the use fuel tax.

COMMENTS

The tax rates under this program have been unchanged in recent years, whereas the general tax rate on gasoline and diesel fuels has increased. Therefore, the revenue loss per vehicle under this program has increased in a manner similar to the revenue losses from the special per gallon (or per 100 cubic feet) rates on LPG, LNG, and CNG.

Special Tax Rate:

EMPLOYEE PENSION AND PROFIT SHARING PLANS

Program Characteristics	
Tax Type:	*Insurance Tax.*
Authorization:	*California Revenue and Taxation Code Section 12202.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program provides a reduced insurance tax rate for employee pension and profit sharing plans. The state's taxes on life insurance, disability insurance, and annuity contracts ordinarily are imposed on dollars of gross premiums written at a rate of 2.35 percent. Under this program, however, qualified insurers pay these taxes at the lower rate of 0.5 percent.

RATIONALE

This program provides tax relief to insurers that serve employee pension and profit sharing plans. It also provides relief to the individuals contributing to such plans, to the extent that the reduced taxes are reflected in lower insurance premium costs. The underlying rationale for the program is to encourage employers to provide insurance coverage under such plans by lowering the cost of the premiums they are charged.

Exclusion/Exemption:

FRATERNAL BENEFIT SOCIETIES

Program Characteristics	
Tax Type:	*Insurance Tax.*
Authorization:	*California Insurance Code Section 10993.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the gross premiums insurance tax any insurance issued by a fraternal benefit society. Fraternal benefit societies include organizations such as Elks and Knights of Columbus.

RATIONALE

This program provides tax relief to fraternal benefit societies. It also provides relief to the individuals who are insured by such organizations, to the extent that the reduced taxes are reflected in lower insurance premiums. The rationale for this program is that fraternal benefit societies are charitable and benevolent institutions engaged in improving social welfare and, as such, they and their members are deserving of public financial support.

✦ Property Tax

✦ TABLE OF CONTENTS—PROPERTY TAXES

✦ Property Taxes—Overview

This section provides information on tax expenditure programs (TEPs) that affect the property tax levies on real property and tangible personal property throughout the state. Virtually all property tax revenues are distributed among the various local government jurisdictions within the county in which the property is located. The property tax is largely administered by local assessors in each of the 58 counties. The Board of Equalization (BOE) provides oversight, is responsible for certain administrative functions, and assesses specific categories of properties.

General Property Taxes

Unlike most other state and local revenue sources, the property tax is a tax on "stock" (or point-in-time value) rather than on "flow" (such as an income flow under the PIT and BCT). Property taxes are levied on the owners of property and are based on the dollar value of the property at a particular point in time. For this reason, the property tax is sometimes referred to as an "ad valorem" (or "according to value") tax. The property tax applies to all classes of property—residential, commercial, industrial, agricultural, open space, timberland, and vacant land. The characteristics of the property tax, as well as certain administrative issues associated with it, are discussed below.

Tax Base. The property tax base consists of *real* property, as well as certain types of tangible *personal* property. Real property includes land, permanently attached improvements (such as buildings and other structures), permanent fixtures (such as installed equipment and machinery), mineral rights, most mobilehomes, and real property located on tax-exempt land. Personal property subject to the property tax includes equipment, portable machinery, office furniture, vessels, and aircraft.

As the following descriptions of property tax expenditure programs illustrate, many types of property are exempt from the property tax, due to a variety of reasons. For example, federal government property is not taxable under federal law. Property owned by other governments or charitable organizations is not generally subject to the tax, nor is household personal property, automobiles and trucks (although vehicles are subject to an "in-lieu" license fee), stocks and bonds, and business inventories. Based on the various exemptions to the property tax, it should not be viewed as a broad-based wealth tax, but rather as a levy on specific types of real and tangible personal property.

Assessment Procedures. The assessment of most property, including personal residences, office buildings, and personal property, is done *locally* by county assessors.

Certain types of properties are assessed by the *state*, since they typically involve activities which cross county boundaries and have value only in combination with their related properties. These properties assessed by the state include utility and railroad property, pipelines, flumes, canals, ditches, and aqueducts.

Prior to the adoption of Proposition 13 in June 1978, properties were assessed based on *market standards*. Using one or a combination of several methodologies, a determination was made as to what the property was currently worth on the open market—that is, its "fair market value." The process of property assessment changed dramatically as a result of Proposition 13's mandated constitutional changes. For locally assessed *real* property, the state changed from an assessment system based on *market value* to one based on *acquisition value*. The most important aspects of the current approach are as follows:

- Property is assessed at an amount equal to fair market value, based on the acquisition cost of the property.
- The acquisition-based, fair market value is allowed to increase by the rate of inflation (but not to exceed 2 percent per year), or decline based on a lower market value.
- Upon resale, the property is reassessed based on the new acquisition cost. New construction, including additions to existing property, is also subject to assessment based on acquisition or construction cost.
- Particular types of construction—such as reconstruction after a disaster, certain transfers of property, and specific new purchases—do not trigger a reassessment.

Most properties are assessed annually on January 1 (the lien date). For properties that change ownership during the calendar year, the supplemental roll is the mechanism used to record the change in assessment immediately. Through the supplemental roll, the new owner pays a prorated tax to reflect the new assessment for the remainder of the year.

Property other than locally assessed real property continues to be assessed based on *market standards* that were used for *all* property prior to the adoption of Proposition 13. This approach applies to both locally assessed *personal* property and *state* assessed property. For locally assessed personal property, the county assessor has the responsibility for determining fair market value. For state assessed property, this assessment responsibility falls upon the BOE. No single appraisal method is used in establishing fair market value; rather, it is dependent upon the type of property, the purpose for which it is used, and its particular market characteristics. Common approaches to property valuation include: purchase price, adjusted sales price of comparable properties, replacement cost, and discounted value of a property's income stream.

Tax Rate. As a result of Proposition 13, the basic county-wide property tax rate is constitutionally limited to 1 percent of assessed value, although lower rates are permitted. Additional levies are possible for the payment of voter approved general obligation debt or for the funding of employee retirement plans adopted prior to July 1, 1978:

Property tax rates can vary within a county due to variation in the debt rates that are levied by local governmental jurisdictions. For 1997-98, average county-wide tax rates ranged from 1 percent (for those counties with no add-on rate), to 1.189 percent (for the City and County of San Francisco). The state average of county-wide rates for 1997-98 was 1.067 percent. The revenue reduction estimates shown in the following individual TEP reviews are based on the 1 percent tax rate.

Tax Levy. The property tax levy is calculated by taking the taxable assessed value and multiplying it by the property tax rate. The growth rate in the taxable assessed value (net of exemptions) was 3.3 percent from 1996-97 through 1997-98, while the change in the total levy for the same period was slightly higher at 3.7 percent. This discrepancy was caused by a slight increase in the average tax rate, due to increased debt assessments. The property tax annually raises more than $20 billion.

Allocation of Revenues. Property tax revenues are allocated among the various local government jurisdictions *within the county* based on a formula determined by the Legislature. The allocation formula is based largely on the distribution of property tax revenues which existed just prior to the adoption of Proposition 13. For state assessed properties, the allocation of property tax revenues among counties is prorated based on the location of the property.

Due to the change in assessment procedures and the limitation on the property tax rate, property tax revenues underwent a dramatic decline after Proposition 13 was approved in 1978. With the reduction in revenues, property tax revenue allocation among local governments has been adjusted on a number of occasions by legislation since Proposition 13 was adopted. In addition, the allocation of property tax revenues varies among counties. On a statewide basis, however, cities currently receive an average of 11 percent of total property tax revenues, counties approximately 19 percent, school districts 52 percent, and other local entities 18 percent.

IN-LIEU PROPERTY TAXES

A number of types of property are exempt from the property tax and are instead subject to an alternative tax. The revenues from these in-lieu property taxes are either returned to local governments or retained by the state.

Private Railroad Car Tax. Owners of private railroad cars must pay the private railroad car tax on cars operated in California. Under the federal Railroad Revitalization and Regulatory Reform Act (4-R Act) adopted in 1976, states are prohibited from taxing railroad property more than other commercial and industrial property. Since railroad property is assessed annually based on fair market value, while commercial and industrial property is assessed based on acquisition value, California modifies its assessment of railroad cars using an adjustment ratio in order to comply with 4-R. For 1997-98, BOE applied an assessment ratio of 86.69. Revenues generated by the Private Railroad Car Tax are deposited in the state's General Fund. Total taxes billed in 1997-98 were $6.2 million.

Timber Yield Tax. Forest trees on private and public lands are subject to a severance tax at the time of their harvest, based on a tax rate which is determined periodically by the BOE. Since 1982, the tax rate has been 2.9 percent of the harvest value. Timber harvest volume from California lands has decreased in the recent past, declining from approximately 4.5 billion board feet in 1988 to approximately 2.4 billion board feet in 1996. Revenues are allocated to the counties where the timber is harvested, and totaled $26.7 million in calendar year 1996.

Racehorses. Qualifying racehorses are exempt from being taxed as personal property and instead are taxed based on their activities and earnings. This tax is administered by the counties, and revenues are treated in the same manner as general property taxes. The taxes are remitted to the assessor of the county in which the horses are quartered.

Vehicle License Fee (VLF). The VLF is an annual fee on the ownership of a registered vehicle in California, levied in place of taxing vehicles as personal property. Beginning January 1, 1999 (as part of a tax relief package enacted in 1998), the fee was lowered by 25 percent, bringing the tax rate to 1.5 percent of the estimated current value of the vehicle. All VLF revenues, as well as replacement revenues to account for the rate reduction, are distributed to cities and counties. The VLF raised about $4 billion in 1997-98.

Exemption (Assessment):
HOMEOWNERS' EXEMPTION

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California State Constitution, Article XIII, Section 3(k), and California Revenue and Taxation Code Section 218.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$356
1997-98	359
1998-99	362

DESCRIPTION

This program provides homeowners a partial exemption from the property tax. The exemption, equivalent to $7,000 of the property's assessed value, is applicable only to a taxpayer's principal place of residence.

RATIONALE

This program provides property tax relief to owner-occupants of residential dwellings by reducing the assessed value of their property, and thereby lowering their property tax bills. The rationale for the program is that it encourages homeownership, and that increased homeownership results in higher levels of economic activity and promotes stability in individual neighborhoods and society generally.

The passage of Proposition 13 in 1978 provided major tax relief to all property owners—including homeowners. By fixing the basic property tax rate at 1 percent, Proposition 13 also had the effect of setting the level of tax relief provided by the homeowners' exemption at about $70 annually.

Exemption (Assessment):

HOUSEHOLD FURNISHINGS

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California State Constitution, Article XIII, Section 3(m), and California Revenue and Taxation Code Section 224.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$500
1997-98	500
1998-99	500

DESCRIPTION

This program exempts from the property tax all personal property owned by individuals, including household furnishings and pets. This exemption does not apply to aircraft, vehicles, or boats, or to personal property held and used in connection with a trade, profession, or business.

RATIONALE

This program provides tax relief to individuals by eliminating the tax on their qualifying personal property. The underlying rationale for the program is to simplify administration of the property tax. The identification and valuation of household items are difficult and often subjective tasks. Moreover, the value of many household property items is so low that the annual tax revenues attributable to them would not offset the costs of collecting these taxes.

Exemption (Reassessment):

TRANSFERS BETWEEN SPOUSES

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California State Constitution, Article XIII A, Section 2(g), and California Revenue and Taxation Code Section 63.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from reappraisal any property transferred between spouses. This exemption includes property transferred between spouses after: (1) a property settlement, (2) a decree of dissolution of a marriage or legal separation, or (3) upon death of a spouse. It also exempts from reappraisal the creation, transfer, or termination between spouses of a co-owned interest in property.

This exemption from reappraisal ensures that the property retains the taxable value ascribed to it prior to the transfer. Because the assessed value of the transferred property would otherwise be increased to reflect its current market value, this exemption reduces the tax assessed on qualifying property.

RATIONALE

This program was added by Proposition 58 in the November 1986 statewide general election. The rationale for the program is that a reappraisal should not be triggered when property is transferred to a spouse upon death of the other spouse, or upon dissolution of a marriage.

Exemption (Reassessment):

TRANSFERS BETWEEN FAMILY MEMBERS

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII A, Section 2(h), and California Revenue and Taxation Code Section 63.1.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from reappraisal a property holder's principal residence, and up to $1 million in other real property, when the property is transferred between (1) parents and children, or (2) grandparents and grandchildren, provided that both parents of the grandchildren are deceased. This exemption from reappraisal provides that the transferred property retains the taxable value that it held prior to the transfer. Since the property would otherwise be reappraised at its current market value (which is generally higher than its taxable value) following the transfer, this program reduces the tax assessment on the specified property.

RATIONALE

This program provides tax relief to property owners by allowing parents and grandparents to transfer the family house and other property to their children or grandchildren without property tax consequences. Proponents of the program argue that transfers within the family deserve special treatment in order to preserve family homes, businesses, and farms.

COMMENTS

This program was added by Proposition 58 in the November 1986 statewide general election, and expanded (to include transfers by grandparents) by Proposition 193 in the March 1996 statewide primary election. This program provides a substantial reduction in property taxes for children or grandchildren who inherit (or otherwise receive) homes, farms, and other real property from their parents or grandparents if the property has been held for several years or more. In these cases, the property's assessed value may be significantly less than its current market value. There is no income limitation or other "needs test" for participants in this program.

Exemption (Reassessment):
Replacement Housing Purchased by Senior Citizens

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII A, Section 2(a), and California Revenue and Taxation Code Section 69.5.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program allows persons 55 years of age or older who sell their principal residence and buy or build another residence of equal or lesser value within two years, to transfer the old residence's assessed value to the new residence, provided that the replacement residence is within the same county as the original residence. In addition, this program allows the transfer of assessed valuation to a replacement dwelling located in a *different* county, provided that the county in which the replacement dwelling is located has adopted an ordinance allowing intercounty transfers of assessed value for elderly homeowners. A homeowner may benefit from this program only once.

Rationale

This program provides tax relief to taxpayers 55 years of age or older who sell their principal dwelling and then buy or build a replacement home. It does so by preventing the reassessment of the replacement home at its current market value. This results in a property tax savings to the extent that the market value of the replacement home is greater than the assessed value of the original home. The rationale for this program is that it removes a disincentive for senior citizens who no longer need family-sized dwellings or dwellings located near schools or places of employment to move to more suitable homes, thereby increasing the availability of suitable housing for younger families.

Comments

This program is available to *all* persons age 55 and older, regardless of income or wealth status. For many seniors, a much more significant impediment to moving in past years was state and federal income tax treatment of capital gains on such home sales. This impediment has largely been eliminated by recent law changes.

This program was originally established when voters approved Proposition 60 at the November 1986 statewide general election. It applied, however, only to moves *within* a county. The approval of Proposition 90 at the November 1988 statewide general election authorized the Legislature to expand the program to allow counties to make this program available to seniors moving in from *another* county.

Exemption (Reassessment):

TRANSFERS WITHIN A JOINT-TENANCY AGREEMENT

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California Revenue and Taxation Code Section 65.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from reassessment any transfer of property among members of a specified joint-tenancy agreement. In order for the program to apply, the original transferor(s) of the property, or their spouses, must remain members of the joint tenancy after the transfer. When an original transferor leaves the joint tenancy, the property must be reassessed unless it vests to a remaining original transferor. If a joint tenant *other than* the original transferor leaves the joint tenancy, there is no reassessment if that tenant's share of the property is either transferred to an original transferor, or is distributed among all remaining joint tenants.

RATIONALE

This program provides tax relief to individuals by reducing the tax liability on property which has been transferred within a joint-tenancy agreement. The underlying rationale for the program is that joint-tenancy agreements essentially represent a single-ownership covenant, and that redistributions of property within the agreement, therefore, should not result in an increased tax liability.

Exemption (Reassessment):

MOBILEHOME PARK PROPERTY TRANSFERS TO TENANT COOPERATIVES

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California Revenue and Taxation Code Sections 62.1 and 62.2.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from reappraisal any mobilehome park property which is transferred to a qualified corporation formed by the tenants of the mobilehome park for the purpose of purchasing the park. To qualify for the exemption, within 270 days of the initial transfer, at least 51 percent of the corporation's stock must be owned by tenants previously renting at least 51 percent of the spaces prior to the transfer. The exemption from reappraisal under this program permits the transferred property to retain the assessed value ascribed to it prior to the transfer.

RATIONALE

This program provides tax relief to mobilehome residents who organize to purchase the mobilehome parks in which they reside. Such purchases may be motivated by the potential loss of long-term, mobilehome-space leases, higher rents for spaces, and other factors. The program's underlying rationale is to promote home ownership among mobilehome residents, many of whom are lower-income or elderly individuals.

COMMENTS

Chapter 139, Statutes of 1998 (AB 2384, Aguiar) extends this exemption indefinitely. It was previously scheduled to sunset January 1, 2000.

Exemption (Assessment):
BUSINESS INVENTORIES

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 219.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$1,600
1997-98	1,760
1998-99	1,940

DESCRIPTION

This program exempts personal property held as inventory by businesses from the property tax.

RATIONALE

This program provides tax relief to businesses that maintain inventories of products for sale in the course of doing business. The rationale for the program is that the application of the property tax to inventories causes extensive administrative problems for retailers and distributors, and may result in the loss of economic activity as businesses take actions to avoid the tax. To the extent that imposing the property tax on inventories would lead businesses to decrease their inventories or locate warehouses outside the state, another rationale for the program is to remove a "disincentive" to efficient inventory management, as well as encouraging inventory-related economic activity in California.

COMMENTS

Inventories were fully taxable prior to 1968, 15 percent exempt from 1968 to 1973, 50 percent exempt from 1974 to 1978, and fully exempt beginning in 1979.

This exemption encompasses a prior exemption for blood and human body parts held for medical purposes (California Revenue and Taxation Code Section 33).

Exemption (Assessment):
FINANCIAL ASSETS

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 212.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

DESCRIPTION

This program exempts from the property tax intangible personal property used by businesses—such as notes, debentures, capital stock, solvent credits, and mortgages. In addition, the program exempts money kept at hand which is used in the regular course of business. In the absence of this exemption, such assets would be considered as business personal property and be taxed as such. Bonds issued by the state or a local government are exempt from the property tax under this exemption as well as a more specific exemption (California State Constitution, Article XIII, Section 3[c], and California Revenue and Taxation Code Section 208).

RATIONALE

This program provides tax relief to businesses that own various intangible financial assets and money kept on hand. According to the Board of Equalization, the rationale for the program is that difficulties in administering the tax on such assets lead to unequal treatment of taxpayers. This is because financial assets can be very difficult to identify, and they easily can be moved outside of the state to avoid taxation. The assets covered under this program have been exempted in order to avoid such administrative difficulties and inequities.

Exemption (Assessment):
BUSINESS RECORDS

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 997.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax business and professional records. The exemption applies to written documents and photographic reproductions, recorded data, research notes, calculations, and indices. However, the value of the media on which the records are stored (such as computer tape) is not exempt. In addition, the program does not apply to books, old newspapers on microfilm, computer programs, and records which are sold in the ordinary course of business.

RATIONALE

This program provides tax relief to persons engaged in a business or profession. The underlying rationale for the program is to simplify tax administration. The assessment of business records is a difficult and often subjective task. In most cases, moreover, these records have no value apart from that to the business itself. There are exceptions, however, such as the records of property transfers found in a title insurance business, or credit records of a credit bureau. Copies of these records might be sold to other parties who want to go into these businesses. In general, however, the value of business records is so low that the annual property tax revenues attributable to them would not offset the costs of assessing and collecting these taxes.

Exemption (Reassessment):

Transfers of Interests in Corporate or Partnership Property

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 64.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	*Amount*
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

Description

This program exempts from reappraisal property owned by a legal entity (such as a corporation or partnership) and transferred pursuant to a corporate reorganization, or when 50 percent or less of the ownership interest in the entity is transferred (providing that control over the entity is not transferred). This exemption from reappraisal generally allows the transferred property to retain the assessed value ascribed to it prior to the transfer. In the absence of this exemption, the property's assessed value would be increased to reflect its current market value pursuant to the change-of-ownership provisions of Proposition 13.

Rationale

This program provides tax relief to the owners of corporations, partnerships, and other legal entities owning real property in California. The rationale for exempting from reappraisal the transfer of property pursuant to a corporate reorganization is that no real transfer of property has taken place. In the case of exempting transfers of 50 percent or less of an entity, program proponents argue that majority interest determines control, and that a transfer of a noncontrolling interest is not a substantive change of ownership.

Comments

This program results from the necessity of defining the term "change in ownership" for properties owned by corporations, partnerships and other legal entities with multiple ownership. It seems reasonable that Proposition 13 did not intend to trigger change-in-ownership reassessments whenever a few shares of a large corporation are traded. The same corporation continues to own the property and there is no change in the control or use of the property due to a minor stock transfer. On the other hand, the outright sale of an entire legal entity to a new owner clearly *is* a real change in ownership even though the name of the corporation holding title to the property may remain the same. The Legislature determined that the appropriate definition of a change in ownership for these properties is a change in the controlling ownership of the legal entity holding title.

Property transfers among farm credit institutions due to reorganizations under federal law were included in this program by Chapter 560, Statutes of 1988 (SB 569, Garamendi).

Exemption (Reassessment):

TRANSFERS TO EMPLOYEE BENEFIT PLANS

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California Revenue and Taxation Code Section 66.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from reappraisal property transferred to an employee benefit plan. Transfers of property that are exempt under this program include: (1) the vesting of a participant's or beneficiary's interest in an employee benefit plan, (2) any contribution of real property to an employee benefit plan, and (3) any acquisition by an employee benefit plan of the stock of the employer's corporation for the purpose of control. An employee benefit plan is defined for the purposes of this program as either an employee pension plan, or as a plan or fund which provides employee welfare benefits (such as medical or hospital care, disability or unemployment benefits, daycare, job-related training, or legal services).

This exemption from reappraisal permits the property to retain the assessed value ascribed to it prior to the transfer. Because the assessed value would otherwise be increased following the transfer to reflect the market value of the property, this exemption reduces the property's tax assessment and, therefore, its property tax liability.

RATIONALE

This program provides a tax incentive for firms to improve the funding of, and the benefits provided by, their employee benefit plans. To the extent that the lower property tax liability promotes use of a greater variety of financing mechanisms for plans, the program may lead employers to contribute more to the plans and, hence, provide improved benefits to their employees.

In addition, the program provides tax relief to employees having a vested interest in employee benefit plans. It also provides relief to participants when an employee benefit plan acquires controlling interest in a company in order to prevent a corporate takeover.

One rationale underlying this program is to encourage employee participation in, and ownership of, businesses in the State of California.

Exemption (Assessment):
COMPUTER PROGRAMS

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 995.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	*$100*
1997-98	*100*
1998-99	*100*

DESCRIPTION

This program exempts from the property tax *all* computer programs, except basic operational (including control) programs. The storage media for the programs are, however, taxable. Such storage media are defined under this program to include punch cards, tapes, discs, or drums.

RATIONALE

This program provides tax relief to the owners of computer programs. The underlying rationale for the program is to stimulate technological innovation in California by promoting the development and use of computers. The program's proponents also argue that the taxation of computer programs would be detrimental to the computer science industry because it would discourage the use of computer programs by other California industries. In addition, proponents argue that the valuation of custom software is a highly subjective and potentially arbitrary process.

COMMENTS

Custom computer programs also are exempt from the sales and use tax under California Revenue and Taxation Code Section 6010.9.

While valuing custom software may be difficult, standard software has well-established prices. Software purchases often comprise a significant portion of the total cost of a mainframe or personal computer installation, so that this exemption probably results in a revenue loss of more than $100 million annually.

Exemption (Assessment):
MOTION PICTURES

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 988.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program provides that the value of motion pictures for property tax purposes is the full value of the *tangible materials* upon which the motion picture is recorded. As such, this program exempts intangible rights, such as the copyright, or right to reproduce, copy, and exhibit the motion picture, as well as the value added to the motion picture in the production process.

RATIONALE

This program provides an incentive for the motion picture industry to locate in California by reducing the operating costs associated with doing business in the state. According to program proponents, many motion picture companies have migrated to other states. This program is rationalized on the grounds that a healthy motion picture industry is important to the economic health of California.

COMMENTS

Intangible property, such as a copyright, never is taxable in and of itself because the property tax is levied only on real property or *tangible* personal property. However, the courts have ruled that, in valuing tangible property, assessors may take into consideration earnings from intangible rights that are associated with that property (*Michael Todd Co. v. Los Angeles County*, 57 Cal. 2nd 684, and *ITT World Communications v. Santa Clara County*, 101 Cal. App. 3d 246).

Exemption (Assessment):
HAND TOOLS

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 241.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from taxation the first $20,000 in personal property that consists of hand tools owned and supplied by an employee that are required as a condition of employment, such as for some mechanics or construction workers. Hand tools consist of hand-held implements and equipment (including hand-held power tools) which may be transported to and from the workplace, and which are necessary for the ordinary and regular performance of the employee's work.

RATIONALE

These hand tools would be exempt if owned for personal use. In addition, as small objects, they would be difficult to assess accurately. As a result, this exemption helps to provide administrative simplicity to the property tax system.

Exemption (Assessment):
Returnable Containers for Soft Drink Beverages

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 996.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from the property tax returnable beverage containers held on the property tax lien date by persons who are under a legally enforceable duty to return the containers for reuse. The program also exempts from taxation the containers that are not in the physical possession of the bottler on the lien date.

Rationale

This program provides tax relief to retailers who collect containers for return to a bottling company. In addition, it provides tax relief to bottling companies by exempting them from taxes on beverage containers held by retailers and consumers on the lien date. The program does not apply to bottles physically in possession of bottling companies on the lien date.

Proponents of this program defend its provisions on equity grounds. They argue that retailers should not be responsible for taxes on containers to which they do not hold title. They likewise argue that the bottling company should not bear the tax liability for bottles not in their possession, because many of these bottles will be broken or otherwise not returned to their bottling facilities.

Prior to 1973, county assessors generally assessed bottling companies for *all* of the containers they owned, including those held by retailers and consumers. Industry members complained, however, that certain assessors assessed both the bottling company *and* the retailers for the same containers. In 1973, the courts decided that bottlers were not liable for bottles outside their control on the lien date. This program codifies the relief granted to bottlers by the courts, and extends the relief to the retailers handling the bottles.

Comments

Nonbusiness consumers of soft drinks generally are exempt from taxation of beverage containers under the constitutional exemption for household furnishings and personal effects.

Nonreturnable containers are business inventory and are exempt from property taxation under California Revenue and Taxation Code Section 219.

Exemption (Assessment):
State and Local Governments

Program Characteristics	
Tax Type:	*Real and Personal Property Tax.*
Authorization:	*California State Constitution, Article XIII, Sections 3(a) and 3(b), and California Revenue and Taxation Code Section 202(a)(4).*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from the property tax real property owned by the state or a local government (including special districts). Property owned by a city or county, but located outside of its boundaries, may be taxable, however, under Article XIII, Section 11 of the California Constitution. Property owned by the State Compensation Insurance Fund (SCIF) does not qualify for this exemption.

Rationale

In the absence of this exemption, local governments would be required, in essence, to pay property taxes to themselves. In addition, the exemption avoids situations when one level of government assesses the property of another level of government.

Comments

Special provisions apply to the tax treatment of possessory interests, extraterritorial property, and property owned by the SCIF.

Possessory Interests. Use of tax-exempt government property for a private purpose generally results in a taxable possessory interest. For example, a lessee would have a taxable possessory interest for leased space that is used for a shop or public restaurant in a government building, and would be required to pay property taxes based upon the value of the possessory interest.

Extraterritorial Property. Any property (including water rights) located in Inyo or Mono counties and owned by a local government outside those counties is taxable if it was assessed in 1966 (for Inyo County) or 1967 (for Mono County). This provision primarily applies to property owned by the Los Angeles City Department of Water and Power in the Owens Valley. In other counties, real property located outside the boundaries of the owning local government is taxable if it was taxable when acquired by the local government or, for new construction, if it replaces a previously taxable improvement. Special formulas apply to the assessment of these properties.

State Compensation Insurance Fund. The SCIF is a semi-independent nonprofit agency, which was created by the state in 1919. The SCIF provides workers' compensation insurance to local public agencies, to state agencies requiring excess coverage, and to private companies. The SCIF also is required by law to be the insurer of last resort for high-risk companies. The SCIF is fully supported out of its premium structure. The SCIF maintains a headquarters office building in San Francisco and has district offices statewide. The exclusion of the SCIF from the general exemption appears to reflect the Legislature's desire to ensure that all of the SCIF's costs are reflected in its premium structure, in order to ensure parity between the SCIF and private insurance providers.

Exemption (Assessment):

LEASES BY A NONPROFIT CORPORATION TO A GOVERNMENT

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 231.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax real property which is owned by a nonprofit corporation and leased to a government entity. The property must be used exclusively by the government for specified governmental purposes, and must be located within the boundary of the leasing government. The lease arrangement also must ultimately transfer ownership of the property to the government. Property leased by the State Compensation Insurance Fund does not qualify for this program.

RATIONALE

This program essentially extends the property tax exemption generally available to government-owned property, to property owned by nonprofit corporations that governments have created as capital-outlay financing vehicles. For example, a government may create a "dummy" nonprofit corporation to issue tax-exempt securities to finance acquisition of a capital facility which the government entity then lease-purchases. The underlying rationale for the program is that such nonprofit corporations are, for all practical purposes, an "arm" of the government. Therefore, these corporations should share the tax-exempt status granted to regular government entities.

COMMENTS

Technically, this program is based on the exemption granted for charitable property in the California Constitution. Nonprofit corporations are deemed to be charities operating for the benefit of general governmental purposes.

Chapter 489, Statutes of 1990 (SB 2309, Greene), expanded this program to include golf courses leased to governmental entities.

Exemption (Assessment):
VOLUNTEER FIRE DEPARTMENTS

Program Characteristics	
Tax Type:	*Real and Personal Property Tax.*
Authorization:	*California State Constitution, Article XIII, Section 4(b), and California Revenue and Taxation Code Section 213.7.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax real property which is both owned by a volunteer fire department and used exclusively for the department's purposes. For property to qualify, the fire department must have official recognition and at least partial financial support from a local government agency in whose jurisdiction the department is located. Qualifying property is deemed by this program to be used for charitable purposes and, therefore, is granted tax-exempt status under the welfare exemption in the California Constitution.

RATIONALE

This program provides tax relief to volunteer fire departments. The underlying rationale for the program is that volunteer fire departments render government-like services to the public.

Special Assessment:
RESTRICTED HISTORICAL PROPERTY

Program Characteristics	
Tax Type:	*Real and Personal Property Tax.*
Authorization:	*California State Constitution, Article XIII, Section 8, and California Revenue and Taxation Code Sections 439 through 439.4.*

Estimated Revenue Reduction *(In Millions)*	
Fiscal Year	***Amount***
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

DESCRIPTION

This program provides a partial exemption for restricted historical property. Eligible properties must be included on an official list of historical properties, and the property owner must enter into a contract with the city or county in which it is located that prohibits any alteration or use of the property that is not consistent with its historic designation. These contracts run for 10 years and are automatically extended each year so that 10 years always remain on the contract, unless the property owner or the local government objects.

In return for this restriction, the property is assessed in a special manner that generally reduces the amount of tax levied on it. Specifically, the assessment is based only on the income that the property can generate in its restricted use, and the assessed value is derived from this anticipated income stream using a special "historical risk component" that further reduces the computed amount of assessed value.

RATIONALE

This program provides an incentive to preserve and restore historical property in California by reducing the tax liability on such property. It is similar to the partial exemption for open-space lands.

COMMENTS

Prior to the adoption of Article XIII A of the California Constitution (Proposition 13); properties could be reassessed annually based on their "highest and best" use. For example, the assessed value of an historic house in an intensively developed downtown area could be based on the development potential of the property for an office building. The resulting property tax burden could have increased the cost of maintaining the historic property to the point that development of the property—in a way incompatible with its historical nature—became an economic necessity. An original argument for this program was that it removed this disincentive for historic preservation.

Under Proposition 13, however, reassessments occur only when a change in ownership or new construction takes place. Consequently, for existing property owners, an increase in the development potential of their property no longer increases their taxes.

Exemption (Assessment):

AIRCRAFT OWNED BY A GOVERNMENT AGENCY

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Sections 5331 and 5332.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax any aircraft owned by the United States, a foreign government, or any local government agency.

RATIONALE

This program has two rationales. First, it simply recognizes that aircraft owned by the United States or a foreign government generally are immune from taxation under federal law and treaties. Second, the program extends the general exemption for property owned by a local government within its own boundaries to include aircraft based at airports outside the owning jurisdiction. This eliminates tax inequities that otherwise would occur because some local agencies do not have suitable airport facilities available within their own jurisdiction.

Exemption (Assessment):

FEDERAL PROPERTY USED FOR MIGRATORY FOWL

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 254.2.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	*Minor*
1997-98	*Minor*
1998-99	*Minor*

DESCRIPTION

This program exempts from the property tax federal property used exclusively for any of the following: (1) refuges for migratory water fowl, (2) promotion or protection of migratory water fowl, or (3) migratory water fowl public shooting grounds.

Federal property is generally exempt from the property tax, but property leased to a private party may involve a possessory interest. A possessory interest is the right to use the property and, under California law, is subject to the property tax. For example, if a private contractor operated a water fowl shooting ground on property leased from the federal government, the contractor ordinarily would be required to pay property tax on his or her possessory interest in the property. This program exempts the contractor from paying property taxes on such property.

RATIONALE

This program provides tax relief to the operators and users of public water fowl shooting grounds that are located on federal property.

Exemption (Assessment):

HOSPITAL, EDUCATIONAL, MUSEUM, SCIENTIFIC, OR CHARITABLE PURPOSES ("WELFARE EXEMPTION")

Program Characteristics	
Tax Type:	Real and Personal Property Tax.
Authorization:	California State Constitution, Article XIII, Sections 4(b) and 5, and California Revenue and Taxation Code Sections 214 through 214.14, 215.2, 215.5, and 236.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$337
1997-98	374
1998-99	415

DESCRIPTION

This program exempts from the property tax specified real and personal property used *exclusively* for religious, hospital, educational, museum, scientific, or charitable purposes. (Charitable purposes, as defined by statute, now include a wide range of activities performed by nonprofit organizations for public benefit.) This program is commonly referred to as the "welfare exemption." The property must be owned (or leased for a term of 35 years or more) and operated by nonprofit corporations that meet specified requirements. The program also applies to real property that is under development and that ultimately will be used for the exempt purposes. Any possessory interest in government property held by a qualifying organization for qualifying purposes also is tax exempt.

Hospital property represents the single largest category of property qualifying for this program. Other examples of qualifying property include the following:

- Property used exclusively for purposes associated with a nursery school, or K-12 school.
- Property of a nonprofit educational radio or television station that does not sell advertising time.
- Real property used exclusively for the preservation of native plants or animals, biotic communities, or geological formations of scientific or educational interest.
- Museum property, including museum restaurants, gift shops, and items to be sold at a rummage sale.
- Property of nonprofit educational organizations generally.
- Specified property used exclusively for housing and related facilities for low-income, elderly, or disabled families.

RATIONALE

This program provides tax relief to the qualifying organizations. The rationale for the program is that these organizations fulfill a socially valuable function in providing property and services to the public and, therefore, are deserving of governmental financial assistance.

COMMENTS

The estimated revenue loss cited above *excludes* losses due to the "religious exemption," which we have included under the program that exempts church and religious property.

Exemption (Assessment):

RELIGIOUS WORSHIP OR RELIGIOUS PURPOSES ("CHURCH EXEMPTION")

Program Characteristics	
Tax Type:	*Real and Personal Property Tax.*
Authorization:	*California State Constitution, Article XIII, Sections 3(f), 4(b), and 4(d), and California Revenue and Taxation Code Sections 206, 206.1, 206.2, and 207.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$82
1997-98	86
1998-99	89

DESCRIPTION

The California Constitution, Article XIII, Section 3(f) directly exempts from taxation property used for religious worship. This is known as the "church exemption," and covers facilities used for religious instruction.

In addition, Article XIII, Sections 4(b) and 4(d) of the Constitution, authorizes the Legislature to exempt property used for religious purposes generally and for church parking. Under this broader "religious exemption," the Legislature has exempted from the property tax real property owned or leased exclusively for religious worship or other specified religious purposes. Under this program, church parking lots, social halls and community centers, retreats, nurseries and preschools, and parochial K-12 schools are exempt from the property tax.

RATIONALE

This program provides tax relief to religious organizations by exempting from taxation property used for religious purposes, church parking lots, and parochial schools. The purpose of the program is to promote the establishment and maintenance of houses of worship and related activities, by reducing their operating costs. The rationale offered is that religious institutions should be free from financial burdens imposed by government to the maximum possible extent.

COMMENTS

The religious exemption is included within the broader "welfare exemption" that covers property owned by qualifying nonprofit organizations and used for charitable, religious, or hospital purposes. Property owned by religious organizations and used primarily for charitable, rather than religious, purposes usually qualifies for a property tax exemption under the welfare exemption. The religious exemption generally does not apply to homes provided to religious leaders.

Exemption (Reassessment):

TRANSFERS WITHIN THE SAME RELIGIOUS DENOMINATION

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California Revenue and Taxation Code Section 62(k).

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from reappraisal taxable property (for example, property which is not used for religious purposes) transferred between specified corporations belonging to the same religious denomination. The transferring and receiving corporations must be a "corporation sole" (that is, a corporation represented by an individual who has independent legal decision-making authority), religious corporation, or public-benefit corporation, and the same denomination's laws, rules, regulations, or canons must regulate the transferor and transferee.

In an hierarchical church, such as the Roman Catholic Church, each diocese is a corporation sole. Thus, in the absence of this program, a transfer of property from one diocese to another could trigger a property tax reassessment. This program provides that the transferred property retains the value ascribed to the property prior to the transfer.

Religious property owned by a religious organization is not affected by this program, because such property is exempt under the welfare exemption. However, many religious organizations own residences or income properties which are affected by this program.

RATIONALE

This program was sponsored by the California Catholic Conference to clarify that transfers of property between dioceses are exempt from reappraisal. The rationale behind the program is that the larger religious denomination, not the corporation sole, should be considered the owner of the property for tax purposes.

Exemption (Assessment):

Leases by a Charitable Organization to a Government for Charitable Purposes

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California Revenue and Taxation Code Section 214.6.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from the property tax real property which is owned by an organization qualifying for the welfare exemption, but which is leased by a government agency. The welfare exemption provides that property which is used by a qualified charitable organization exclusively for its own charitable purposes is exempt from the property tax. This program extends this tax exemption to property which is leased by such organizations to a government entity.

Rationale

This program provides an incentive to qualified charitable organizations to enter into leases of property to a governmental agency.

The purpose of the program is to facilitate sale-leaseback arrangements between otherwise tax-exempt charitable organizations and government agencies. Such sale-leaseback arrangements are often undertaken by local governments as an alternative to borrowing funds for capital improvements.

The tax exemption gives the charitable organization an incentive to raise funds for its charitable purposes through leases with government agencies, since the organization will thereby incur no property tax. It also makes the government a more attractive lessor than other lessors in the eyes of the organization, since property leased to these other lessors *would* generally be taxable.

Exemption (Assessment):
Private Property Used by a Public Library or Free Museum

Program Characteristics	
Tax Type:	Real and Personal Property Tax.
Authorization:	California State Constitution, Article XIII, Section 3(d), and California Revenue and Taxation Code Section 202(a)(2).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$1
1997-98	1
1998-99	1

Description

This program exempts from the property tax privately owned property used by a public library or a free museum.

Rationale

This program provides tax relief to public libraries and free museums by reducing their property tax liabilities. The program also provides an incentive for the establishment and maintenance of such institutions to the extent that it reduces their operating costs.

According to the Board of Equalization (BOE), in the case of public libraries, the exemption primarily applies to land or structures leased by a government for the operation of a public library. This is a common arrangement for the establishment of smaller branch libraries. In the absence of the exemption, the owner of the land would be liable for the property tax. This liability would be passed on to government in the form of higher rents. The exemption for public libraries exists to facilitate the leasing of land for the government operation of such facilities.

In the case of museums, the rationale behind the program is that museums that charge no admission are providing a public service.

Comments

According to the BOE, the exemption for free museums is not widely used, as most private museums in California charge an admission fee.

Exemption (Assessment):
PUBLIC SCHOOLS, COLLEGES, AND UNIVERSITIES

Program Characteristics	
Tax Type:	Real and Personal Property Tax.
Authorization:	California State Constitution, Article XIII, Section 3(d), and California Revenue and Taxation Code Sections 202(a)(3) and 203.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from the property tax property used exclusively for public schools, community colleges, state colleges, and state universities (including the University of California). The exemption also applies to off-campus facilities owned or leased by an apprenticeship program sponsor, provided that these facilities are used exclusively by the public schools for specified classes.

RATIONALE

This program provides tax relief to public educational institutions by eliminating the tax on their properties. Thus, the exemption reduces the annual operating costs of public schools.

Exemption (Assessment):

PRIVATE COLLEGES AND SEMINARIES

Program Characteristics	
Tax Type:	*Real and Personal Property Tax.*
Authorization:	*California State Constitution, Article XIII, Section 3(e), and California Revenue and Taxation Code Section 203.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	$66
1997-98	69
1998-99	72

DESCRIPTION

This program exempts from the property tax buildings, land, equipment, and securities used exclusively for educational purposes by private nonprofit colleges and seminaries. Qualifying institutions must meet specified admission requirements, and must confer upon their graduates at least one academic or professional degree based on a program of at least two years of liberal arts studies, or three years of professional studies.

RATIONALE

This program provides tax relief to private colleges and seminaries and to their students. It does so by annually reducing operating costs which are, in turn, passed on in the form of lower tuition and student fees. The rationale behind the program is that lower costs promote greater college participation.

Exemption (Assessment):
STATE COLLEGE MANAGEMENT

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 202.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax personal property used in the management of state colleges, but *owned* by an auxiliary non-profit corporation or student body organization. In order to qualify, the state must have entered into a contract with the corporation or organization under which services are provided or equipment is leased.

RATIONALE

This program essentially extends the tax relief provided under the college exemption to student body organizations and other non-profit entities that provide services or lease equipment to state colleges. It also provides tax relief to the state colleges, to the extent that any property tax savings are passed on to the colleges in the form of lower costs. The rationale behind the program is to promote the establishment and maintenance of such organizations by lowering their operating costs.

Exemption (Assessment):
STUDENT BOOKSTORES

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Sections 202.7 and 203.1.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from the property tax personal property used or owned by a nonprofit corporation which operates a student bookstore affiliated with a nonprofit college or seminary, or with the University of California.

RATIONALE

This program provides tax relief to nonprofit corporations, such as student body organizations, which operate bookstores for nonprofit colleges or seminaries. It also provides tax relief to bookstore customers, to the extent that lower operating costs are reflected in lower prices for books and student supplies. The rationale behind the program is that it promotes the establishment and maintenance of nonprofit bookstores by reducing their operating costs, which in turn can help to lower the costs to students of obtaining a college education.

Exemption (Assessment):
STUDENT BODY ORGANIZATIONS

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 202.6.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax personal property owned or used exclusively by a qualified student body organization, as specified in the California Education Code. To qualify, the student body organization must be organized within a community college or K-12 public school.

RATIONALE

This program provides tax relief to specified student body organizations. The underlying rationale for the program is that these organizations play a supportive role in educational institutions through their fund-raising and social activities and, as such, are deserving of public financial support.

Exemption (Assessment):

NONPROFIT ENTITIES USING PROPERTY FOR SELECTED PUBLIC PURPOSES

Program Characteristics	
Tax Type:	Real and Personal Property Tax.
Authorization:	California State Constitution, Article XIII, Section 4(b), and California Revenue and Taxation Code Sections 201.1 through 201.4, and 201.6.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax real property which is owned by a qualified nonprofit entity and is used for a specified public purpose. Such qualifying purposes include property owned by a transit development board and property used exclusively for agricultural fair use pursuant to a contract with a county board of supervisors.

RATIONALE

This program provides tax relief to qualified nonprofit entities engaged in valid public purposes. As such, this exemption can be viewed as an extension of the exemption for government property. These nonprofit entities, however, would not be fully exempt from property taxation absent this exemption.

COMMENTS

This program initially was implemented to provide tax relief to the San Diego and Arizona Eastern Railroad. This company was created in the 1970s by the San Diego Metropolitan Transit Development Board, which was interested in acquiring the right-of-way for urban rail mass transit.

The manner in which the railroad was purchased ceded ownership to the nonprofit corporation. The transit authority made the purchase in this manner in order to avoid a laborious and expensive title search, and to comply with certain restrictions imposed by the federal Interstate Commerce Commission.

In 1980, the Board of Equalization (BOE) determined that the railroad was subject to property taxes because it was not owned by a government agency. Thus, without this program, the BOE would require taxation of the railroad's property.

Exemption (Assessment):

DESIGNATED INSTITUTIONS

Program Characteristics	
Tax Type:	*Real and Personal Property.*
Authorization:	*California State Constitution, Article XIII, Section 4(c), and California Revenue and Taxation Code Section 203.5.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax real property owned by the California School of Mechanical Arts, California Academy of Sciences, and Cogswell Polytechnical College. It also exempts property held in trust for the Huntington Library and Art Gallery.

RATIONALE

This program provides direct tax relief to the above-cited institutions. It also provides relief to their students, to the extent that the lower property taxes are reflected in lower tuition and student fees. The rationale behind the program is to encourage the development and operation of the specified institutions, and reflects the view that these institutions are deserving of public financial support.

COMMENTS

The above constitutional provision authorizes the Legislature to implement this program, which it has done. Most property held by these institutions would be exempt under the welfare exemption. This program extends the exemption to *all* of their property, including property used for income production.

Exemption (Assessment):
CEMETERY PROPERTY

Program Characteristics	
Tax Type:	*Real and Personal Property Tax.*
Authorization:	*California State Constitution, Article XIII, Section 3(g), and California Revenue and Taxation Code Section 204.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	$4
1997-98	5
1998-99	5

DESCRIPTION

This program exempts from the property tax qualified property owned by a nonprofit corporation which is (1) used or held for storing human remains or (2) used for the care and maintenance of such property. The program does not, however, apply to undeveloped property held for future use.

RATIONALE

This program provides tax relief to nonprofit corporations that sell and maintain cemetery plots, and to the individuals who purchase the plots.

One rationale for the program is that it simplifies administration of the property tax. Once in use, individual plots have little market value and, therefore, would generate minimal property tax revenues. Moreover, there are potentially significant problems involved with tax collection, particularly for older plots where an heir may no longer exist. The revenues generated from a property tax on individual plots probably would not, therefore, offset the costs of assessing and collecting the tax.

Exemption (Assessment):
San Diego Supercomputer Center

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 226.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from taxation all of the computer equipment of the San Diego Supercomputer Center, located on the campus of the University of California, San Diego. Although the computer center is owned by the university and is exempt from direct taxation under the general exemption for university property, it is leased to a private operator. This lease creates a possessory interest in the computer center, which would be taxable in the absence of this program.

Rationale

The program reduces the operating costs of the San Diego Supercomputer Center by eliminating annual property tax payments. The rationale for the program is that most of the funding for operating the center comes from the federal government and the university, and the center serves public policy objectives established by the National Science Foundation. Consequently, it is argued that the center serves a worthy public purpose; and exempting it from taxation reduces the level of federal and university funds that must be raised each year to support its operating costs.

Comments

This program was established by Chapter 1559, Statutes of 1988 (SB 2584, Ellis).

Exemption (Reassessment):

DISASTER-DAMAGED PROPERTY

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California State Constitution, Article XIII A, Sections 2(a), (2e), and 2(f), and California Revenue and Taxation Code Sections 69, 69.3, and 5825(c).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program provides that property which is either rebuilt or acquired as a replacement for disaster-damaged property shall be assessed at the same value as the original property prior to the disaster.

In the case of real property, qualifying property must have been damaged on or after July 1, 1985, and: (1) the Governor must have declared that a disaster occurred, (2) the disaster must have reduced the market value of the property by more than one-half, and (3) the replacement property must be comparable to, and located in the same county as the property damaged by the disaster. Property owners may transfer the base year value of qualifying disaster-damaged properties to *another* county, provided that the board of supervisors in that county has adopted an ordinance authorizing such transfers. In cases where the market value of the replacement property exceeds 120 percent of the market value of the original property, the original assessment is adjusted upward by the amount of the excess.

For mobilehomes that are taxed as personal property, this exemption provides that assessed value will not increase for any mobilehome that has been reconstructed or replaced by a comparable mobilehome due to damage or destruction by any misfortune or calamity.

RATIONALE

This program provides tax relief to disaster victims by reducing their tax liability on rebuilt or replacement property. The rationale for the program is that persons who are forced to replace their residences on account of a natural disaster should not have to face an increased tax liability as an additional consequence of the disaster.

COMMENTS

The constitutional provisions of this exemption were approved by the voters as Proposition 8 (November 1978), Proposition 50 (June 1986), and Proposition 171 (November 1993). The provisions authorizing intercounty transfers were added by Chapter 72, Statutes of 1994 (AB 382, Lee).

Special Assessment:

PROPERTY DAMAGED BY MISFORTUNE OR CALAMITY

Program Characteristics	
Tax Type:	Real Property Tax
Authorization:	California State Constitution, Article XIII A, Sections 2(e) and 2(f), and California Revenue and Taxation Code Section 170.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program reduces the *assessed* value of qualified damaged property in proportion to the reduction in the *market* value of the property caused by the damage. Because the assessed value of most properties is significantly less than their current market value, this program can provide a tax reduction for properties whose market value after the damage still exceeds their pre-damage assessed value. In the absence of this program, the assessed value of damaged property is reduced only if its market value after the damage is less than its assessed value. In order to qualify under the program, the damage must have been caused by a disaster, or by misfortune or calamity, and the damage must be at least $5,000. The program is available only if adopted by a county ordinance.

Example. A supermarket with a market value of $1 million and an assessed value of $700,000 sustains $200,000 of damage in an earthquake. The damage reduces the market value of the property by 20 percent and, therefore, the assessed value also is reduced by 20 percent—to $560,000. In the absence of this program, there would not be any reduction in assessed value, because the damage has not reduced the property's market value below its existing assessed value.

RATIONALE

The program provides tax relief to owners of property damaged in a disaster or in calamities, such as fires. The program is rationalized on the basis that property owners who suffer disasters or calamities should receive tax relief in order to mitigate their losses.

COMMENTS

Not all counties have ordinances implementing this program. Some counties have adopted an implementing ordinance only for a limited period of time following major disasters.

Exemption (Reassessment):
ENVIRONMENTAL CONTAMINATION

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII A, Section 2(i).*

Estimated Revenue Reduction *(In Millions)*	
Fiscal Year	***Amount***
1996-97	—
1997-98	—
1998-99	*$1*

DESCRIPTION

This exemption allows property owners to transfer their current assessed value to a replacement property within their county if the original property was environmentally contaminated. This contamination could be caused, for example, by the presence of toxic or hazardous materials. The replacement property could involve either (1) the repair or reconstruction of a damaged structure *on* the contaminated site or (2) purchase of a similar structure on a *different* site.

In order to qualify for this special treatment, *all* of the following conditions need to be met:

- A residential property (for example, a house or condominium) is made uninhabitable or a nonresidential property (for example, a store or business) is made unusable by an environmental problem.
- The current owner did not know of the environmental problem when the property was purchased or built.
- A state or federal government agency designates the property as a toxic hazard, environmental hazard, or environmental clean-up site.
- A property is substantially damaged or destroyed by the environmental clean-up efforts.
- A lead government agency stipulates that the property was not made uninhabitable or unusable by an act or omission of the current owner.

The exemption applies only to replacement property acquired, constructed, or repaired (1) after January 1, 1995 and (2) within five years after ownership of the contaminated property is sold or transferred. A county is given the authority to extend this exemption to property owners moving from *other* counties and replacing environmentally contaminated property.

RATIONALE

This program is similar to the existing exemption for owners of property damaged by natural disasters. Since the property owner must not have caused the environmental contamination in order to qualify for the exemption, tax relief is given to property owners who are suffering from an environmental problem outside of their control.

Comments

This exemption was added to the Constitution by the voters as Proposition 1 in November 1998. As result, it has not yet been used and it is unclear how many properties will be eligible under its provisions.

Exemption (Reassessment):
PROPERTY CONDEMNED PURSUANT TO EMINENT DOMAIN PROCEEDINGS

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII A, Section 2(d), and California Revenue and Taxation Code Sections 68 and 5825(d).*

Estimated Revenue Reduction *(In Millions)*	
Fiscal Year	**Amount**
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

DESCRIPTION

This program allows the owner of real property or a mobile home acquired by a government entity through eminent domain proceedings or inverse condemnation, to carry over his or her original assessed value to a comparable replacement property. In cases where the market value of the replacement property exceeds 120 percent of the market value of the original property, the original assessment is adjusted upward by the amount of this excess.

This program seeks to ensure that taxes on a similar new property are equivalent to those that were levied on the old property prior to its acquisition by a government. To the extent that the market value of the replacement property exceeds the assessed value of the original property, this program effectively reduces the tax assessment on the replacement property. Moreover, this program excludes from the assessed value a portion of the market value of a more expensive replacement property.

RATIONALE

This program provides tax relief to property owners who are displaced from their property as a result of eminent domain proceedings. The rationale for this program is that property owners who must move because the government has taken their property should not also be required to pay higher taxes simply because they acquire replacement property.

Exemption (Assessment):
EARTHQUAKE SAFETY IMPROVEMENTS

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII A, Section 2(a), 2(c), and California Revenue and Taxation Code Sections 70(d) and 74.5.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from reassessment as new construction any qualifying reconstruction or improvements made to existing buildings after November 5, 1990 that have been identified by local governments as being hazardous to life in the event of an earthquake. In order to qualify, the reconstruction or improvements must be required by a local earthquake safety ordinance or employ earthquake hazard mitigation technologies approved by the State Architect. In the case of required improvements to buildings with unreinforced masonry-bearing walls, the exemption is limited to 15 years, but it includes improvements made after June 4, 1984.

RATIONALE

This program provides tax relief to property owners who add qualifying earthquake safety improvements to their buildings. It does this by eliminating any increase in assessed value that otherwise would take place because of the value added to such buildings by these improvements. The primary rationale for the program is to protect life and property by promoting the rehabilitation of buildings that would be unsafe in an earthquake. Program proponents also argue that providing an incentive for earthquake safety improvements will protect the tax base and reduce future disaster mitigation costs.

COMMENTS

The 15-year exemption for improvements to buildings with unreinforced masonry-bearing walls was authorized by Proposition 23, adopted at the June 1984 statewide primary election. The authority for the unlimited exemption for earthquake safety improvements to other types of buildings was added by Proposition 127, approved at the November 1990 statewide general election.

Exemption (Reassessment):
FIRE SAFETY IMPROVEMENTS

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California State Constitution, Article XIII A, Section 2(c)(2), and California Revenue and Taxation Code Section 74.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from reappraisal as new construction the construction or installation in an existing building of fire sprinkler systems, other fire extinguishing systems, fire detection systems, or fire-related egress improvements. The exemption applies to systems completed on or after November 7, 1984.

RATIONALE

This program provides tax relief to building owners who add fire safety improvements to their buildings. It does so by exempting such systems from reappraisal as new construction, thus reducing the cost to the property owner of providing for the fire equipment. Upon a change in ownership, however, the value of the fire equipment would be reflected in the new assessed value of the property to the extent that it increases the property's market value.

COMMENTS

Fire safety improvements often are required by local building codes when older buildings are renovated. This exemption was approved by the voters in November 1984 as Proposition 31.

Exemption (Reassessment):

IMPROVEMENTS FOR DISABLED ACCESSIBILITY

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII A, Section 2(c), and California Revenue and Taxation Code Section 74.6.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	$10
1997-98	10
1998-99	10

DESCRIPTION

This program exempts from reassessment as new construction any qualifying improvements or modifications made to existing buildings on or after June 7, 1994 that have been made to improve accessibility by disabled persons. Such improvements include access ramps, widening of doorways and hallways, barrier removal, access modifications to restroom facilities and elevators, and any other modification that would cause it to meet or exceed the accessibility standards of the 1990 Americans With Disabilities Act and the most recent California Building Standards Code that is in effect on the date of the application for a building permit.

RATIONALE

This program provides tax relief to property owners who make modifications to their buildings to improve accessibility for disabled persons. It does this by eliminating any increase in assessed value that otherwise would take place because of the value added to such buildings by these modifications. The primary rationale for the program is to encourage property owners to make modifications to improve accessibility for disabled persons.

COMMENTS

This program was added by Proposition 110 of the June 1990 statewide primary election.

Exemption (Reassessment):

HOMES AND IMPROVEMENTS FOR DISABLED PERSONS

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California State Constitution, Article XIII A, Sections 2(c) and 3, and California Revenue and Taxation Code Sections 69.5 and 74.3.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows severely and permanently disabled persons, regardless of their age, to transfer the assessed value of their existing home to a replacement home in the same manner as provided for homeowners over the age of 55. In order to qualify, the disability must necessitate the move for either physical or financial reasons. The replacement residence generally must be in the same county as the original residence, and it must be bought or built within two years of the sale of the original dwelling. Further, the value of the replacement home cannot exceed the value of the original residence. In addition, this program allows the transfer of assessed valuation to a replacement dwelling located in a different county, provided that the county in which the replacement dwelling is located has adopted an ordinance allowing intercounty transfers of assessed value.

This program also excludes from reappraisal any building improvements that make an owner-occupied home more accessible to, and usable by, a permanently and severely disabled person who is a permanent resident of the dwelling.

RATIONALE

This program provides tax relief to disabled persons who must move because of their disability. It does so by preventing the reassessment of the replacement home at its current market value. This results in a property tax savings to the disabled person to the extent that the market value of the replacement home is greater than the assessed value of the original home. The program also prevents any increase in property taxes that otherwise would result from improvements made to a home to accommodate a disabled person. Program proponents argue that disabilities reduce or eliminate income, so that disabled persons who must move or modify their dwellings often cannot afford higher property taxes.

COMMENTS

Although the program's rationale is based on the need to provide tax relief to disabled persons, specific evidence of need is generally not required to qualify.

This program was authorized by Proposition 110, which was approved at the June 1990 statewide primary election, and was implemented by Chapter 1494, Statutes of 1990 (AB 3843, Cannella). It applies to replacement homes acquired and improvements completed after June 5, 1990.

Exemption (Assessment):
ACTIVE SOLAR ENERGY SYSTEMS

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII A, Section 2(c)(1), and California Revenue and Taxation Code Section 73.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

DESCRIPTION

This program exempts from assessment as new construction certain active solar energy systems. To qualify, a system must produce heat, electricity, or mechanical energy, and its collection and storage devices must be thermally isolated from the space where the energy is used. Wind energy systems do not qualify. The exemption applies to systems constructed or added after March 1, 1981. The law also specifies that the exemption does not apply to that portion of the construction or addition associated with solar swimming pool heaters which is in excess of the cost of a comparable conventional fossil fuel heating system. Because they are not assessed when they are built, qualifying solar energy systems remain exempt from property taxation until a change of ownership occurs and triggers an assessment.

RATIONALE

This program provides a tax incentive for the expanded use of solar energy technology. It accomplishes this by reducing the relative cost of such installations compared to conventional systems. This reduction in the relative cost of active solar energy systems may; in combination with the net energy cost savings provided by such systems, result in lower total installation, operating, and maintenance costs over the system's life than the total costs for comparable conventional systems. The program's underlying rationale is the view that promoting solar energy technologies is desirable and, therefore, worthy of public financial support.

COMMENTS

This program is scheduled to sunset on January 1, 2006.

Exemption (Assessment):

VETERANS' EXEMPTION

Program Characteristics	
Tax Type:	*Real and Personal Property Tax.*
Authorization:	*California State Constitution, Article XIII, Sections 3(o), 3(p), 3(q), and 3(r), and California Revenue and Taxation Code Sections 205 and 205.1.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program exempts from the property tax up to the first $4,000 of assessed value of property owned by a veteran. Veterans may not claim both this exemption and the homeowners' exemption on the same piece of property. Most U.S. veterans qualify for the program. In addition, property owned by a veteran's widow or widower may qualify for the exemption as long as he or she remains unmarried. A deceased veteran's parents also may qualify.

RATIONALE

This program is intended to provide tax relief to qualified veterans and their families. The rationale for the program is that veterans have served their country and, therefore, are deserving of certain governmental benefits.

COMMENTS

According to the Board of Equalization (BOE), this exemption has not been claimed frequently since the homeowners' exemption became available. This is because the homeowners' exemption has the greater value to the taxpayer. The BOE also points out that, when this exemption is claimed, it most commonly is claimed on boats and airplanes.

Previous requirements that veterans must have resided in California when they were inducted into the armed services were deleted by Proposition 93, approved in the November 1988 statewide general election. Similar residency requirements in other states have been judged unconstitutional by the federal courts.

Exemption (Assessment):
DISABLED VETERANS' PRINCIPAL RESIDENCE

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California State Constitution, Article XIII, Section 4(a), and California Revenue and Taxation Code Section 205.5.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	$10
1997-98	11
1998-99	12

DESCRIPTION

This program exempts from the property tax a portion of the assessed value of the principal residence owned by a disabled veteran, or by the disabled veterans' unmarried surviving spouse. The value of the exemption varies with the disability and the claimant's income. The program generally exempts up to $40,000 of assessed value for veterans who have lost two or more limbs or are blind in both eyes. Totally disabled veterans (as determined by the U.S. Department of Veterans' Affairs) receive exemptions of up to $100,000 of assessed value. The maximum exemption amounts above increase to $60,000 (in the case of blindness or loss of two limbs) and $150,000 (for total disability), for low-income disabled veterans or surviving spouses.

Program participants cannot also claim the general veterans' property tax exemption or the homeowners' exemption. The larger exemption for totally disabled veterans and surviving spouses terminates on January 1, 2001, a change which will affect property taxes due in 2001-02 and thereafter.

RATIONALE

This program initially was designed to provide tax relief to disabled veterans who must install special ramps and fixtures. The program was intended to eliminate the tax on such specially installed improvements. In 1974, however, the program was extended to apply to a portion of the assessed value of a disabled veterans' principal residence, regardless of whether the home has special features.

The rationale for the program is two-fold. First, it is thought to be inequitable for veterans to pay property tax on residential improvements required by a service-related injury. Second, disabled veterans, by virtue of their service to their country, are thought to be entitled to certain publicly provided benefits.

COMMENTS

The higher exemption amounts for totally disabled veterans would have sunsetted on January 1, 1991, but were extended until 1996 by Chapter 1077, Statutes of 1989 (SB 320, Royce) and extended again until 2001 by Chapter 536, Statutes of 1995 (AB 3, Baca). This measure also increased the totally disabled exemption from $100,000 to $150,000 for low-income veterans or surviving spouses. According to the Board of Equalization, most veterans who claim this exemption do so on the basis of total disability.

Proposition 110, adopted at the June 1990 statewide primary election and implemented by Chapter 1494, Statutes of 1990 (AB 3843, Cannella), provides an exemption from assessment as new construction for disability-related modifications made to the home of any severely and permanently disabled person. A veteran may benefit from this assessment exemption in addition to this program.

Exemption (Assessment):

REAL PROPERTY OF SPECIFIED VETERANS' ORGANIZATIONS

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII, Section 4(b), and California Revenue and Taxation Code Section 215.1.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***Amount***
1996-97	*Minor*
1997-98	*Minor*
1998-99	*Minor*

DESCRIPTION

This program exempts from the property tax real property owned by a qualified nonprofit veterans' organization. To qualify, the organization must have been chartered by the United States Congress, and organized and operated for charitable purposes. The exempt property must be used *exclusively* for *charitable* purposes. For example, property used *primarily* for veterans' social activities would not qualify.

RATIONALE

This program provides tax relief to qualified veterans' groups by relieving them of taxes on their real property. The rationale behind this program is to promote charitable activities by qualifying veterans' organizations.

Exemption (Assessment):

Personal Property of Specified Veterans' Organizations

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 215.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	*Minor*
1997-98	*Minor*
1998-99	*Minor*

Description

This program exempts from the property tax qualified personal property owned and used by a nonprofit veterans' organization, provided that the organization has been chartered by the U.S. Congress. To qualify, the property must be used exclusively to further the goals of the veterans' organization.

Personal property used by veterans' organizations *exclusively for charitable purposes* would be exempt under Revenue and Taxation Code Section 214. This program extends the exemption to property used to further the goals of a veterans' organization, which may not be exclusively charitable in nature.

Rationale

The rationale for the program is that veterans, by virtue of their military service, deserve to have their veterans' organizations receive certain publicly provided benefits.

Special Assessment:

Open-Space Contracts (The "Williamson Act")

Program Characteristics	
Tax Type:	Real Property Tax:
Authorization:	California State Constitution, Article XIII, Section 8, and California Revenue and Taxation Code Sections 421 through 430.5.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	$97
1997-98	97
1998-99	97

Description

This program provides a partial exemption for restricted open-space lands. Owners of eligible properties must enter into a contract with the city or county in which the land is located that prohibits any development or use of the property that is not consistent with its use as farmland, open space, or wildlife habitat. These contracts run for 10 years and are automatically extended each year so that 10 years always remains on the contract, unless the property owner or the local government objects. In return for this restriction, the property is assessed in a special manner that generally reduces the amount of tax levied on it. Specifically, the assessment is based only on the income that the property can generate in its restricted use, and the assessed value is derived from this anticipated income stream using a statutory formula. The program applies to land and living improvements (such as vines and orchards), but not to other improvements (such as farmhouses and barns).

Chapter 353, Statutes of 1998 (SB 1182, Costa) provides another similar program for open space. Land owners can enter their land into 20-year contracts as farm land security zones. Under this program, property tax savings potentially could be greater than under the Williamson Act.

The annual budget act provides an appropriation to reimburse cities and counties for their approximate revenue losses associated with these contracts. The *1989-99 Budget Act* provides $36 million for these subventions in 1998-99.

Rationale

This program is intended to provide a tax incentive for the conservation of farmlands, open space, and wildlife habitat lands by reducing the property tax on land that is restricted for these purposes.

Comments

Prior to the adoption of Article XIII A of the California Constitution (Proposition 13), properties could be reassessed annually based on their highest and best use. For example, the assessed value of a farm in an urbanizing area could be based on the land's development potential for a shopping center or housing tract. The resulting property tax burden could have increased the cost of maintaining the farming operation to the point that alternative types of development became an economic necessity.

An original argument for this program was that it removed this incentive to develop farmland and other types of open space. Under Proposition 13, however, reassessments occur only when a change in ownership or new construction takes place. In the absence of either of these events, a property's assessed value remains constant, except for an annual inflation adjustment of up to 2 percent. Consequently, for existing property owners, an increase in the development potential of their property no longer increases their taxes. Furthermore, Proposition 13 generally limits the property tax rate to 1 percent of assessed value so that, in most cases, property taxes have a small financial impact and only marginally affect decisions to buy or develop real estate. For these reasons, a property tax reduction, such as this program provides, is unlikely to change current or future decisions regarding the development or preservation of open-space lands, and the program now functions essentially as a subsidy to owners of restricted open-space lands.

The new farmland security zone program aims to increase the property tax savings available and therefore increase the incentive to preserve open space.

Exemption (Assessment):
GROWING CROPS

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII, Section 3(h), and California Revenue and Taxation Code Section 202(a)(1).*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from the property tax any agricultural crops growing on property on the lien date (January 1 of each year). The program does not apply to mature vineyards or orchards.

RATIONALE

This program provides tax relief to farmers by eliminating any tax liability for growing crops. In the absence of the program, such crops would be included in the value of land under Property Tax Rule 121 of the Board of Equalization. The program is rationalized on equity grounds. In the absence of the exemption, farmers with crops that mature early in the calendar year, such as asparagus, would have a higher tax liability than farmers with later-maturing crops, such as wheat or corn. This is because the crops which are more mature on the lien date (January 1 of each year) would be of higher value than crops which were less mature on that date.

COMMENTS

Harvested crops are not subject to the property tax because they are exempt as business inventory under California Revenue and Taxation Code Section 219.

Exemption (Assessment):
FRUIT TREES, NUT TREES, AND GRAPEVINES

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California State Constitution, Article XIII, Section 3(i), and California Revenue and Taxation Code Sections 211 and 223.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from the property tax fruit trees and nut trees for the first four years after they have been planted, and grapevines for the first three years after they have been planted. It also exempts nursery stock held by the grower from taxation as personal property, provided that the nursery stock is planted within the following year.

RATIONALE

This program provides a tax incentive for growers to plant orchards or vineyards by not levying the property tax on trees and vines until the approximate time when the trees and vines begin to bear produce.

One rationale for the program is that no income is available from orchards and vineyards to pay taxes and other carrying costs in the initial years after their planting. Under these circumstances, the planting of fruit trees, nut trees, and grapevines cannot provide the same level of cash flow and return on investment in the near term as can various alternative land uses.

Exemption (Reassessment):

DISEASED GRAPEVINES

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 53.*

Estimated Revenue Reduction *(In Millions)*	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program authorizes county boards of supervisors to allow special assessments for grapevines planted to replace certain diseased grapevines. The assessed value of the diseased grapevines can be transferred to their replacements. The grapevines must have been younger than 15 years old and have been destroyed by either phylloxera or Pierce's Disease. These two diseases have been particularly damaging to California vineyards in recent years.

As noted previously, grapevines also receive an exemption from property tax assessment for the first three years after planting. As a result, this provision only affects the assessment of replacement grapevines once the three year exemption has expired.

RATIONALE

The program extends tax relief to vineyard owners already facing high costs to replace their grapevines. The rationale is that vineyard owners should not experience higher property tax payments as a result of a disease outside of their control.

Special Assessment:

RESTRICTED TIMBERLANDS

Program Characteristics	
Tax Type:	*Real Property Tax.*
Authorization:	*California State Constitution, Article XIII, Section 3(j), and California Revenue and Taxation Code Sections 434.5 and 436.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program provides a partial property tax exemption for restricted timberlands. Restricted timberlands are assessed in a special way to reflect only the value of the land for timber production, exclusive of its development potential or aesthetic value. The Legislature has established per-acre values for various classes of timberlands. Each year, the Board of Equalization adjusts these values in proportion to the annual change in the unit prices of the different types of timber. In order to qualify for this program, land must be designated by the county as a timber production zone, which prohibits any use of the land that is not compatible with timber production. This restriction runs for 10 years, and is automatically renewed each year (resulting in a continuously rolling 10-year commitment). If either the property owner or the county wants to terminate this commitment, then the contract is not renewed in the following year, and the 10-year time period is allowed to "run down."

RATIONALE

This program provides tax relief to owners of timberlands. The program's rationale is that the reduced tax burden on lands maintained as forests reduces economic pressure for incompatible development and facilitates long-term forest management by limiting the annual ownership costs of timberlands. As a result, it is argued that these lands continue to serve public purposes by providing recreation, open space, and wildlife habitat, which merits public financial support.

COMMENTS

This program for timberlands is similar in principle to the program that limits the assessed value of lands which are under open-space contracts. As with the open-space program, the benefit of this program has diminished since the adoption of Proposition 13 in 1978, which eliminated reassessments due to property appreciation in the absence of new construction or of a sale or other transfer of the property.

Standing commercial timber (as opposed to the underlying land) is not taxed under the property tax. Instead, standing timber is subject to a separate state tax—the timber yield tax—when it is cut (California Revenue and Taxation Code Section 38115). The state allocates the revenue from the timber yield tax back to the counties in which the timber was produced.

Exemption (Administrative):
LOW HARVEST VALUE TIMBER

Program Characteristics	
Tax Type:	Timber Yield Tax.
Authorization:	California Revenue and Taxation Code Section 38116.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program authorizes the Board of Equalization (BOE) to exempt timber harvest yields of up to $3,000 in value from the timber yield tax. The BOE must determine that, if not exempted, these harvests would cost more in tax administration costs than they would provide in revenues.

RATIONALE

This exemption is intended to provide administrative savings in those cases where collecting taxes on a small timber harvest would be more costly than the amount of collected revenues.

Exemption (Assssment):

SEED POTATOES

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 234.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from taxation as personal property seed potatoes which are held on the lien date (January 1 of each year) and are to be planted during the assessment year. The program does not apply to those potatoes owned by plant nurseries.

RATIONALE

This program provides tax relief to potato farmers. The rationale for the program is that seed potatoes essentially reflect business inventory that is incorporated into the potato crop and, therefore, should be exempt from taxation. This is similar to the treatment for property tax purposes of seeds, which are exempt as business inventory under Property Tax Rule 133 of the Board of Equalization (BOE). According to the BOE, this program applies to a small number of farmers in northeastern California.

Exemption (Assessment):
VESSELS

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California State Constitution Article XIII, Section 3(l), and California Revenue and Taxation Code Section 209.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax vessels which (1) have a carrying capacity in excess of 50 tons and (2) transport freight or passengers.

RATIONALE

According to the Board of Equalization, the rationale for this program is based on tax equity grounds. In the absence of the exemption, a vessel would be taxed only if it were in port on the property tax lien date (January 1 of each year). As a result, shipping schedules would determine which vessels were taxable each year, and some vessels might pay no property tax, even though they might spend as many days per year in California ports as other vessels on which taxes would be levied.

Proponents of the program also argue that it removes a tax disincentive for maritime shippers to use California ports. This is because both Washington and Oregon have similar exemptions, and these states have ports which compete, to some extent, for business with California's ports. Thus, the program's proponents argue that, in its absence, some maritime shipping through California ports would be diverted to other northwestern ports, such as Seattle.

COMMENTS

This program was first implemented in California in 1914 and the exemption is provided for directly by the State Constitution. An alternative way to approach the tax-equity issue regarding mobile vessels would be to tax them based on the average number of days per year that they are docked in California ports. Such treatment would be analogous to the way that railroad cars and airplanes are taxed, which is based on the percentage of time that they are in the state.

Special Assessment:
DOCUMENTED VESSELS

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 227.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	$2
1997-98	3
1998-99	3

DESCRIPTION

This program allows a "documented vessel" to be assessed for property taxation at 4 percent of its full cash value, provided that it is employed *exclusively* for any of the following purposes: (1) taking fish or other living resources from the sea for commercial purposes, (2) providing instruction or conducting research, or (3) transporting at least seven people as a commercial passenger fishing ship. A "documented vessel" is defined under the program as a vessel which has a valid marine document issued by the U.S. Bureau of Customs, or that is registered by the California Department of Motor Vehicles.

RATIONALE

This program provides tax relief to the owners of qualifying documented vessels. It does this by authorizing their assessment at 4 percent of value, instead of the normal 100 percent, which results in a much lower effective rate of tax on them. The rational for this program is that the economic viability of the commercial fishing industry is susceptible to significant fluctuations on a year-to-year basis, and the tax relief provided by this program helps to maintain the health of the industry. It does this by reducing annual costs to vessel owners. Implicit in this argument is the notion that maintaining the health of the commercial fishing industry is important to the state, and that the cost of this program is offset by the benefits of the increased stability of the industry.

COMMENTS

The economic viability of the California fishing industry depends on a great many different factors, including weather, the availability of fish, and various other determinants of fishing-related costs and revenues. In a prior review of this program, we concluded that the property tax exemption had only a minor impact on the viability of the fishing industry, relative to these other factors (see *The Economic and Fiscal Impacts of California's Property Tax Assessment of Sportfishing Vessels,* Legislative Analyst's Office, April 1979, Report No. 79-9).

Exemption (Assessment):
VESSELS UNDER CONSTRUCTION

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 209.5.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax any vessels of at least 50 tons carrying capacity or 100 tons displacement during the time they are being constructed. The program also exempts from taxation property which will be incorporated into such vessels. The program applies only to vessels which are built by their ultimate users. Vessels which are built for resale are exempt under another provision of the law, because they are classified as "business inventory."

RATIONALE

This program provides tax relief to the shipping and shipbuilding industry. In addition, proponents argue that this program provides a tax incentive for shipping companies to undertake vessel construction projects in California ports, especially since both Washington and Oregon provide a similar tax exemption for vessels under construction. These proponents argue that, in the absence of the program, the California shipping industry, and related port activities, might be at a competitive disadvantage relative to their counterparts located elsewhere on the West Coast.

Exemption (Administrative):

VESSELS WITH A MARKET VALUE OF $400 OR LESS

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 228.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax vessels with a market value of $400 or less. The program applies only to vessels used or held for noncommercial purposes, and does not apply to lifeboats. In addition, each property owner may have only one such vessel exempted in any given year.

RATIONALE

This program provides tax relief to owners of low-value vessels. Its underlying rationale is to simplify tax administration. The value of the qualified boats is so low that the annual tax revenues attributable to them would not offset the cost of collecting the taxes.

COMMENTS

California Revenue and Taxation Code Section 155.20 allows counties to also provide, by ordinance, a general exemption for low-valued property (defined as property not assessed at more than $5,000). In those counties having passed such an ordinance, the general exemption for low-valued property supersedes this program.

Exemption (Assessment):
AIR CARRIER GROUND TIME

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 1152(c).*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax a portion of the time during which aircraft are located in California, but are out of service. Ordinarily, the taxation of aircraft is based on the percentage of time an aircraft is physically located in the state, either on the ground or flying above it, and the proportion of its total arrivals and departures that take place in the state. However, this program permits out-of-service days to be excluded from this calculation. Specifically, for out-of-service periods exceeding 30 consecutive days, the amount of time after the first seven days is excluded.

RATIONALE

This program provides a tax incentive for airlines to have their airplanes serviced within the state. Because routine servicing can be done on airplanes at or near many different airports, including those located outside of California, it is argued that the absence of this program could cause some airlines to have these services performed elsewhere, particularly in states that do not include servicing time in determining property taxes. On the West Coast, for example, both Washington and Oregon exclude time spent within the state for servicing when computing property taxes on airplanes.

Exemption (Assessment):
Aircraft Being Repaired

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 220.*

Estimated Revenue Reduction *(In Millions)*	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from the property tax any aircraft which is in California on the property tax lien date (each January 1) solely for the purpose of being overhauled, modified, serviced, or repaired. Aircraft normally based in California, or which service California airports, *do not* qualify for the program.

Rationale

This program provides tax relief to aircraft owners who bring their craft into California to be overhauled, modified, serviced, or repaired. According to the Board of Equalization, this program effectively applies primarily to aircraft which *must* be serviced or repaired by a California manufacturer. The program is justified on the grounds that it would be inequitable to tax aircraft which ordinarily are not operated in California, and which happen to be in California on the lien date solely for servicing or modification.

Proponents of the program also argue that it provides an incentive for airlines to repair their craft in California and, as such, promotes the California aircraft repair industry. To the extent that aircraft repairs need to be made by an aircraft's manufacturer, this program also could promote California's aircraft manufacturing industry.

Exemption (Assessment):
PRIVATE RAILROAD CAR REPAIR DAYS

Program Characteristics	
Tax Type:	*Private Railroad Car Tax.*
Authorization:	*California Revenue and Taxation Code Section 11294.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program provides a partial property tax exemption for private railroad cars, based on the number of days such cars are in the state but are undergoing repairs. For the purposes of this program, a private railroad car is any passenger or freight car which is not owned by a railroad company. Such cars ordinarily are owned by leasing companies, or by railroad car manufacturers who lease the cars to railroad companies. The state assesses and collects the property tax on private railroad cars from the lessor in lieu of the local property tax. The revenue from this tax is deposited in the state General Fund.

The state computes the tax liability of the railroad car company by estimating the average number of each class of car physically present in the state in any year, based on the number of days railroad cars actually spend in the state. For example, if six flat cars spent 120 days each in the state, the Board of Equalization would assess the tax on the average value of two flat cars.

This program provides that the number of days spent within the state for repair purposes in any year does not count as time-in-state for purposes of the property tax assessment formula. The number of servicing days excluded from the computation cannot exceed 90 days per car per year, unless the claimant provides substantiation of the necessity of the additional days.

RATIONALE

This program provides a tax incentive for the repair and servicing of private railroad cars in California. The proponents of the program argue that, if this repair and servicing time were taxable, certain railroad cars would be taken out of the state to be serviced. It is argued that, by exempting the repair and servicing time, California's railroad car service industry is not at an economic disadvantage relative to the out-of-state service industry.

Exemption (Assessment):

CARGO CONTAINERS USED IN OCEAN COMMERCE

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 232.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax qualified cargo containers principally used in transporting cargo in ocean commerce. A cargo container is defined as a specially designed receptacle which facilitates the carriage of goods by vessels and other means, and has a displacement of more than 1,000 cubic feet. This program does not apply to any cargo-carrying vehicle subject to registration under the California Motor Vehicle Code.

RATIONALE

This program provides tax relief to the owners of cargo containers, which it has been argued, gives an incentive for shippers to use California ports instead of other ports in the Pacific Northwest (such as Portland and Seattle). The program encourages the use of California ports to the extent that the exemption of cargo containers lowers the cost of using California ports relative to other ports, and to the extent that this cost savings is not offset by other factors. The actual volume of trade that would be diverted to non-California ports in the absence of this program would depend on such factors as (1) the sensitivity of shippers' demands for California port use to changes in the cost of using such facilities, and (2) the actual magnitude of the increase in such costs attributable to the property taxation of cargo containers.

COMMENTS

The economic and fiscal impacts of this program were reviewed in 1978 by our office (see *The Economic and Fiscal Impacts of California's Cargo Container Property Tax Exemption*, Legislative Analyst's Office, Report 78-5, March 1978, 35 pages). This study concluded that, while it was impossible to measure accurately the amount of trade diversion or changes in shipping rates attributable to this program, elimination of the program at that time would most likely have resulted in a positive net fiscal impact on California state and local governments.

Exemption (Assessment):

EXHIBITION EXEMPTION

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 213.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax qualified personal property brought into the state temporarily for use in a public exhibit. To qualify, the property must be subject to property tax in another state or country, and any taxes due must have been paid prior to claiming the exemption in California.

RATIONALE

This program provides a tax incentive for nonresidents to exhibit property in California, such as automobiles, artwork, crafts, and other such items. In the absence of the program, such property owners would be required, in effect, to pay "double taxes" on any property being exhibited on the property tax lien date (January 1 of each year). This tax treatment might discourage nonresidents from exhibiting property of public interest within California.

Exemption (Assessment):

WORKS OF ART AVAILABLE FOR DISPLAY

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 217.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax privately owned works of art made available for display in: (1) a publicly owned art gallery, (2) a publicly owned museum, or (3) a museum which is both regularly open to the public and operated by a nonprofit organization. To qualify, the art must have been made available for display within a certain period of time prior to the property tax lien date, and must meet certain artistic criteria. The exemption does not apply to art loaned by any person who holds works of art primarily for purposes of sale.

RATIONALE

This program provides a tax incentive for individuals to loan art works to qualified museums, by exempting such works from the property tax. The underlying rationale for the program is to promote the public display of artwork in California.

Exemption (Assessment):
WORKS OF ART OWNED BY THE ARTIST

Program Characteristics	
Tax Type:	*Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 986.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program provides a special property tax valuation for qualified works of art owned by the artist who produced them. Art that is held by a person engaged in the business of selling or producing art is considered personal property and, as such, may be subject to the property tax (see below).

This program provides that the taxable value of art which is held by its creator shall equal the value of the materials used to create the artwork. Artwork may qualify for this program only if it has never been sold or exhibited.

RATIONALE

This program provides tax relief to artists by reducing the cost to them of maintaining a collection of their own artwork. The rationale for the program is that absent an actual sale of a piece of artwork, its taxable value can be difficult to determine. By valuing such artwork solely in terms of its materials, this program is intended to ease tax administration by reducing the number of appealed assessments.

COMMENTS

In the absence of this program, some artwork owned by artists potentially would be exempt either as business inventory or as personal property used as household furnishings. In addition, certain materials used to create the artwork could be exempt from taxation as business inventory.

Exemption (Assessment):

AEROSPACE MUSEUM DISPLAYS

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 217.1.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program exempts from the property tax aircraft loaned or donated for display in either (1) a publicly owned aerospace museum or (2) an aerospace museum which is both regularly open to the public and operated by a nonprofit organization. The property must either have been made available for display for a period of 90 days during the 12-month period immediately prior to the property tax lien date, or the person claiming the exemption must certify in writing that the property will be made available for display for at least 90 days following the first day the property was on public display. The exemption does not apply to aircraft loaned by any person who holds aircraft primarily for purposes of sale.

RATIONALE

This program provides an incentive for aircraft owners to lend or donate specified aircraft to qualifying aerospace museums. The rationale for the program is that aircraft used for display purposes are functionally similar to works of art and, therefore, deserve comparable treatment under the property tax.

COMMENTS

This program was sponsored by the San Diego Aerospace Museum. The museum also qualifies for a sales and use tax program which exempts from taxation the transfer of certain tangible personal property to aerospace museums. According to the Board of Equalization, the San Diego Aerospace Museum is the only museum in California that currently qualifies for these programs.

Exemption (Assessment):
AIRCRAFT OF HISTORICAL SIGNIFICANCE

Program Characteristics	
Tax Type:	Personal Property Tax.
Authorization:	California Revenue and Taxation Code Section 220.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program exempts from taxation aircraft of historical significance. To qualify for this exemption, aircraft must be 35 years or older or be a model of which there are fewer than five in existence worldwide. In addition, aircraft must be held primarily for purposes other than sale and must be on public display at least 12 days each year.

RATIONALE

This program provides tax relief to owners of aircraft of historical significance. The underlying rationale for this program is to promote the preservation and public display of aircraft of historical significance.

Exemption (Administrative):

ASSESSMENTS OF $5,000 OR LESS

Program Characteristics	
Tax Type:	*Real and Personal Property Tax.*
Authorization:	*California State Constitution, Article XIII, Section 7, and California Revenue and Taxation Code Section 155.20.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows county boards of supervisors to exempt from the property tax those properties on which the total net tax liability is lower than the cost of assessing and collecting the tax. Under this authority, county boards may not exempt property with an assessed value in excess of $5,000. For temporary possessory interest in convention, cultural, or fairground facilities, the exemption limit is $50,000.

RATIONALE

This program provides tax relief to the owners of low-valued property. The rationale for the program is to simplify administration of the property tax. The value of certain properties is so low that the annual tax revenues attributable to them would not offset the costs of collecting the tax. This program allows counties to forego incurring these net administrative losses.

Exemption (Administrative):

Supplemental Roll Tax Assessments Of $20 or Less

Program Characteristics	
Tax Type:	*Real and Personal Property Tax.*
Authorization:	*California Revenue and Taxation Code Section 75.41(d).*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	Amount
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program permits county auditors to cancel supplemental property taxes due on a property if the amount of these taxes is $20 or less.

Rationale

This program provides tax relief to taxpayers who transfer or construct low-valued property. The rationale for the program is to simplify administration of the supplemental property tax. The revenues generated by collecting supplemental roll assessments of $20 or less may not offset the costs of collection.

Comments

Several county assessors have pointed out that most of the costs associated with supplemental property taxes involve the *assessment* rather than the *collection* of the tax. These assessors claim that, once the assessment is made, it *is* cost-effective to collect the tax. To the extent that this is the case, the above program rationale may not be valid for certain properties.

Exemption (Administrative):

FIXTURES EXCLUDED FROM THE SUPPLEMENTAL ROLL

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California Revenue and Taxation Code Section 75.5.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	$41
1997-98	45
1998-99	49

DESCRIPTION

This program exempts qualifying fixtures from supplemental property tax assessment. In order to qualify, the fixtures must be valued as a separate appraisal unit from the structure on the property. Fixtures are real property that originally had the character of personal property, such as equipment, but have been affixed to and incorporated into real (primarily business) property.

Prior to the exemption, the assessed value of qualifying fixtures was placed on the supplemental tax roll for the year in which it was installed. The property owner then received a supplemental tax bill for the tax on the additional assessed value, prorated to reflect the remaining portion of the tax year.

Under this program, qualifying new fixtures added to a property are exempt from supplemental assessment, so that they are not taxed until the fiscal year following the one in which they are installed. Fixtures that qualify for this program include manufacturing machinery or store fixtures, which are appraised separately from any building. The program does not include fixtures such as elevators or air conditioners which are appraised as part of a building.

RATIONALE

This program provides tax relief to businesses that add qualifying fixtures. It does so by eliminating any property tax on these fixtures during the remainder of the tax year in which they are installed. The program's rationale relates to considerations of administrative efficiency and cost-effectiveness. Counties argue that compiling information on fixture changes and determining the proper supplemental tax amounts on fixture additions and removals made throughout the year is administratively burdensome, and that the additional revenue does not justify the expense of assessing and collecting these taxes.

Exemption (Administrative):

Interests That Represent Less Than Five Percent of the Property's Total Value

Program Characteristics	
Tax Type:	Real Property Tax.
Authorization:	California Revenue and Taxation Code Section 65.1.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	NA
1997-98	NA
1998-99	NA

Description

This program exempts from reappraisals transfers of ownership interests in any property which represent less than 5 percent of the entire property's full market value. The qualifying transfers must have a market value of less than $10,000. When several interests are transferred in any given assessment year, they are accumulated. If the total transfer exceeds 5 percent or $10,000, then all of the transferred interests are reappraised.

Property exempted from reappraisal under this program retains the value ascribed to it prior to the transfer. To the extent that the market value of the property has increased and would otherwise be reflected in the reassessment of the property, this program reduces the tax liability on such property.

Rationale

This program provides property tax relief to the owners of the qualifying property. The underlying rationale for the program is to simplify administration of the property tax. The tax revenues from reassessing incremental transfers of property valued under $10,000 may not offset the county costs for assessing, billing, and collecting the taxes due.

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✦ MAJOR SUBJECT INDEX

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