January 6, 2011

Hon. Kevin de León
Senator, 22nd District
Room 5108, State Capitol
Sacramento, California 95814

Dear Senator de León:

As you know, the February 2009 state budget agreement changed the rules used to determine California taxable income for companies that operate both in California and outside of California, effective for taxable years beginning on or after January 1, 2011. While the state's historical apportionment formula considers the concentration in California of firms' sales, property, and payroll, the February 2009 budget agreement provides that multistate firms will have the option each year to choose an alternate apportionment formula that considers only their sales. This is known as the "optional single sales factor" apportionment method.

Structure of This Letter. This letter responds to your request for additional information on single sales factor apportionment. Specifically, this letter discusses:

- The fiscal effects for the state's General Fund if California moved from elective optional to mandatory single sales factor apportionment, effective January 1, 2012.
- The effects of such a change on California's competitiveness with other states.
- Examples of the tax impacts for a hypothetical company considering expanding in California or another state with a mandatory single sales factor apportionment method.
- The California job gain estimate included in our May 2010 report that recommended the state move to the mandatory single sales factor.
- Our current recommendation to the Legislature concerning this issue.

Fiscal Effects of Mandatory Single Sales Factor Apportionment

About $1 Billion Revenue Increase by 2013-14. The Franchise Tax Board (FTB) estimates that moving to a mandatory single sales factor effective January 1, 2012 would increase General Fund revenues by $250 million in 2011-12, $850 million in 2012-13, and $1 billion in 2013-14, compared to existing law.

Estimate Assumes Current "Cost of Performance" Rules. As requested by your staff, these estimates assume that, under a mandatory single sales factor, companies follow cost of performance rules (now allowed in law only for companies who do *not* elect to use the existing optional single sales factor). These rules allow a company to attribute *no* revenues from sales of other than tangible personal property to California in sales factor calculations if a plurality of the costs associated with these products or services were incurred in another state. For example, a company that performs a service, such as software testing, for a client based in California may spend $300,000 in California and $310,000 in Oregon in performing that service. For the purposes of determining the company's California taxes, none of this company's revenues from the California client count in tax apportionment calculations because a plurality of the costs of performing the service occurred outside of California.

Revenue estimates would be higher if, as an alternative, the current cost of performance rules were *not assumed* in the mandatory single sales factor fiscal estimate. If the cost of performance rules were eliminated from the estimate, FTB reports that the annual General Fund revenue increase for mandatory single sales effective in 2012 would increase somewhat. In this alternative scenario, FTB estimates a total General Fund revenue increase of $300 million in 2011-12, $1 billion in 2012-13, and $1.1 billion in 2013-14, compared to existing law. In this alternate scenario, the companies currently under cost of performance would attribute some intangible sales to California to the extent related products or services were received, used, or located here.

Effects of Mandatory Single Sales on Competitiveness

As we discussed in our May 2010 report, *Reconsidering the Optional Single Sales Factor*, there is a case to be made that the single sales factor formula promotes job growth to some extent and puts California producers on a more level playing field with producers based in other states. Broadly speaking, a switch to a mandatory single sales factor would tend to increase taxes for companies that have lower property and payroll factors than their sales factor. In other words, these companies have a greater share of their national sales in California than the California share of their national property and payroll. These are often companies that use property and labor to produce goods in other states and import them into California for sale. Companies, therefore, that make products in other states and ship them here for sale would tend to pay more taxes under mandatory single sales. While it is very difficult or impossible to project the precise overall effect of switching from optional to mandatory single sales for the state's economy, it is clear that different companies would be affected differently depending on their circumstances. We discuss some examples below.

Mandatory Single Sales Could Hurt Companies When They Lose Money. Mandatory single sales would hurt California-based companies, among others, in years when they lose money. (For purposes of this analysis, we consider California-based companies to be those with substantially higher concentrations of property and payroll in California relative to the concentration of their sales here.) This is because, under mandatory single sales, these companies would be unable to switch back to the double-weighted sales factor in the existing apportionment in order to claim more losses and, therefore, would have fewer losses to deduct against future profits. This would tend to increase these companies' state taxes over a typical business cycle.

Mandatory Single Sales Would Help Companies in Other Cases. While California-based companies would be able to deduct fewer losses under mandatory single sales, these companies would benefit to the extent that they compete mostly with out-of-state companies who also have nexus in California and whose state taxes will rise proportionately more.

Examples of Corporate Expansion Under Elective and Mandatory Single Sales

You asked us to describe scenarios for a hypothetical California company considering expansion either in California or another state. Consistent with your request, the examples below assume that the hypothetical company operates in two states—Oregon (which has a mandatory single sales factor apportionment method) and California—and expands by doubling its property and payroll. The company's sales and pretax profits are held constant, but varying them would not affect the relative tax burden in the two states as long as sales increased proportionately in both states. Initially, as shown in Figure 1, the company has 90 percent of its property and payroll and 75 percent of its sales in California. As such, with a lower sales factor than property and payroll factors, this particular company elects to use the optional single sales factor apportionment method available to companies under existing California law beginning in 2011. (Note that companies with different characteristics would experience different expansion incentives than this hypothetical company. This discussion also does not consider all of the various factors, such as credits and deductions and non-tax factors, that affect companies' expansion decisions.)

Figure 1

Hypothetical California Firm With Some Operations in Oregon

(Dollars in Millions)

	California				Oregon			
	Existing Optional Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	100%	75%	$50	25%	100%	25%
Payroll	180	90	—	—	20	10	—	—
Property	900	90	—	—	100	10	—	—
	California apportionment ratio			**75%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$150	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$13**	**Oregon Tax Payment**			**$4**

Mandatory Single Sales: No Tax Change if Company Expands in California. We then assume that the company expands its operations in California, doubling its payroll and property commitments. Assuming that California changes to a mandatory single sales factor, the hypothetical company would see no effect on its tax bill, as shown in Figure 2. The company's tax payment in each state remains the same as they were in Figure 1. This is because of the assumption that sales are held constant.

Figure 2

Mandatory Single Sales: No California Tax Impact if Hypothetical Company Expands Here

(Dollars in Millions)

	California				Oregon			
	Mandatory Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	100%	75%	$50	25%	100%	25%
Payroll	380	95	—	—	20	5	—	—
Property	1,900	95	—	—	100	5	—	—
	California apportionment ratio			**75%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$150	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$13**	**Oregon Tax Payment**			**$4**

Mandatory Single Sales: No Tax Change if Company Expands in Oregon. Similarly, as shown in Figure 3, if the company expanded into Oregon its tax bills in the two states would not change. The tax payments in both states would remain the same as they were in Figure 1.

Figure 3

Mandatory Single Sales: No Tax Impact if Hypothetical Company Expands in Oregon Either

(Dollars in Millions)

	California				Oregon			
	Mandatory Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	100%	75%	$50	25%	100%	25%
Payroll	180	45	—	—	220	55	—	—
Property	900	45	—	—	1,100	55	—	—
	California apportionment ratio			**75%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$150	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$13**	**Oregon Tax Payment**			**$4**

Optional Single Sales: No Tax Change if Company Expands in California. Now assume that California continues to use an optional single sales factor. As shown in Figure 4, if the hypothetical company expands in California, it would continue to elect to use the single sales factor (because its sales factor for California would be less than its property and payroll factors), and as such its tax bill would not change.

Figure 4

Optional Single Sales: No Tax Impact for a California Expansion

(Dollars in Millions)

	California				Oregon			
	Existing Optional Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	100%	75%	$50	25%	100%	25%
Payroll	380	95	—	—	20	5	—	—
Property	1,900	95	—	—	100	5	—	—
	California apportionment ratio			**75%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$150	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$13**	**Oregon Tax Payment**			**$4**

Optional Single Sales: Lower California Taxes if Company Expands in Oregon. By contrast, if the company expands in Oregon, its sales factor in California would then be higher than its property and payroll factors (see Figure 5). It presumably would then *not* elect to use California's optional single sales factor. As a result, the company's California tax bill would fall—from $13 million in the prior figures to $11 million in Figure 5—as a result of the Oregon expansion.

Figure 5

Optional Single Sales: Less California Taxes if Company Expands in Oregon

(Dollars in Millions)

	California				Oregon			
	Existing Optional Single Sales Apportionment Formula				Mandatory Single Sales Apportionment Formula			
	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula	Amount In State	State's Share Of National Amount	Weight In Tax Formula	Share Times Weight in Tax Formula
Sales	$150	75%	50%	38%	$50	25%	100%	25%
Payroll	180	45	25	11	220	55	—	—
Property	900	45	25	11	1,100	55	—	—
	California apportionment ratio			**60%**	Oregon apportionment ratio			**25%**
	x Total national profits			$200	x Total national profits			$200
	California taxable profits			$120	Oregon taxable profits			$50
	x California corporate tax rate			8.84%	x Oregon corporate tax rate			7.90%
	California Tax Payment			**$11**	**Oregon Tax Payment**			**$4**

This is one example of how the optional single sales factor in current law could give some California-based companies an incentive to expand into other states as opposed to expanding here in California. As such, the existing optional single sales factor appears to be counterproductive in some respects with regard to promoting job growth and corporate expansion in California.

Evidence on Job Growth

As we discussed in our May 2010 report, evidence suggests that increasing the weight of the sales factor produces a small but noticeable increase in economic activity. For example (see page 8 of that report), results of a 2005 simulation using the California-specific Dynamic Revenue Analysis Model (DRAM) suggest that a mandatory single sales factor could produce an eventual net gain of about 40,000 jobs relative to the three-part apportionment formula that California had in place as of 2001. (This analysis was based on data concerning California's economy as of that date.) These specific job-gain estimates should be interpreted with caution, as discussed in the report.

LAO Comments

Legislature Could Eliminate Optional Single Sales Factor, Effective in 2011. Earlier, we provided fiscal estimates assuming that the state eliminated the optional single sales factor and replaced it with a mandatory single sales factor effective in 2012. Alternatively, the Legislature could make this change to the mandatory single sales factor retroactively to the beginning of 2011. If it were to do so, the Legislature might want to take action in the early weeks of 2011 in order to give companies as much notice as possible of the change for their 2011 tax planning. Assuming companies use the cost of performance rules, FTB estimates that a change to mandatory single sales effective in January 2011 would increase General Fund revenues by $240 million in 2010-11, $850 million in 2011-12, and $1 billion in 2012-13.

LAO Recommendation. As discussed in our May 2010 report, we recommend that the state adopt a mandatory single sales factor of apportionment for companies that also operate outside of California.

If you have additional questions, please feel free to contact James Nachbaur of my staff at (916) 319-8365 or by e-mail at james.nachbaur@lao.ca.gov.

Sincerely,

Mac Taylor
Legislative Analyst