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November 24, 2009

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed initiative on corporate taxes (A.G. File No. 09-0058, Amdt. #1-NS).

Proposal

The measure repeals three corporate income tax provisions passed by the Legislature and approved by the Governor as part of the September 2008 and February 2009 budget agreements. Under current law, the provisions will take effect starting in tax years 2010 or 2011.

- ***Optional Single Sales Factor.*** If a business operates in California and at least one other state, its California taxable income is defined as its national income multiplied by a weighted average of the fractions of its national property, payroll, and sales that are attributable to California. Currently, the weights on the property and payroll factors are 0.25 and the weight on the sales factor is 0.5. Starting in 2011, a business will be allowed to decide each year whether to use this formula or an alternate formula that uses only the sales factor. Under this option, its California taxable income would be equal to its national income multiplied by the ratio of its California sales to its national sales. This measure repeals a business's option to use the sales-only formula.
- ***Credit Sharing Among Member Businesses of a Unitary Group.*** The credit-sharing provision will allow a business whose available credits exceed its total tax bill to transfer its unused credits to another business in the same unitary (or combined) group. Currently, credits are restricted to the business that earns them. The credit-sharing provision takes effect starting in tax year 2010. This measure repeals the ability to share credits within a unitary group.

- ***Net Operating Loss (NOL) Changes.*** Recent legislation allows businesses, beginning in 2011, to deduct net operating losses against profits reported in either of the two *previous* years. For example, a business that turned a profit (and paid taxes) in 2009 but lost money in 2011 will be able to deduct its 2011 losses against its 2009 profit and file an amended return for 2009 to get a refund. This measure repeals this provision, which is known as a carryback. In addition, existing law limits to 20 years the amount of time that NOLs attributable to a tax year beginning on or after January 1, 2008 may be deducted from future taxable income. This measure reduces this time limit to ten years.

Fiscal Effects

By repealing the three provisions, this measure would increase the taxes paid by businesses. The Franchise Tax Board (FTB) estimates that the combined net impact of repealing the above three provisions would increase business tax revenues by $80 million in 2009-10, $600 million in 2010-11, $1.7 billion in 2011-12 (first full-year effect), and increasing amounts thereafter.

Although the FTB's net estimate takes into account interactions between the three provisions involved, it does not incorporate various behavioral effects that might take place in response to the measure. For example, some businesses that would expect to benefit from the optional single sales factor may cut back their planned California operations in the absence of this option. Research evidence suggests that a higher sales factor can promote job growth. Similarly, the loss of the credit-sharing provision may make it harder for businesses with actual or expected excess credits to raise capital, so such businesses may experience a reduction in their taxable activity. The effect on behavior from removing these provisions is difficult to estimate. Any potential adverse effects on the economy and state and local tax revenues might be offset by the benefits of the public services or reductions in other taxes that would be funded by the revenue from repealing these provisions.

Summary of Fiscal Effect

The measure would have the following major fiscal effect:

- Annual state revenue increase from business taxes of about $1.7 billion when fully phased in, beginning in 2011-12.

Sincerely,

Mac Taylor
Legislative Analyst

Michael C. Genest
Director of Finance