



California Chamber of Commerce
 Building Owners and Managers Association
 California Aerospace Technology Association
 California Bankers Association
 California Grocers Association
 California Independent Grocers Association
 California Manufacturers and Technology Association
 California Retailers Association
 California Taxpayers Association
 California Broadcasters Association
 California Business Properties Association
 Council on State Taxation
 International Council of Shopping

Employers Hit with Over \$10 Billion in Tax Increases and Accelerations in 2008 and 2009 Budget Deals

As a result of the September 2008 and February 2009 budget agreements, our organizations believe it is important for decision-makers to have an understanding and appreciation of the impact of recently-enacted budgetary tax law changes on the California business community.

Because of tax changes adopted as part of the 2008-09 Budget in AB 1452 (Ch. 763, 2008) and SBX1 28 (Ch. 1, 2007-08), as well as ABX3 3 (Ch. 18, 2009-10) for the 2009-10 Budget, California employers will pay over \$10 billion more in taxes during the next 2 budget years. These increases were done through a combination of tax increases, borrowing, and acceleration of tax revenues from employers in the next 2 years and beyond.

While some important economic recovery reforms were also adopted in the budget process, many companies investing in jobs and operations in California – or attempting to recover from the economic downturn – will suffer permanent harm from these tax increases.

September 2008 Tax Increases and Accelerations

1. Strict Liability Penalty that Punishes Reasonable Tax Disputes (SBX1 28) Estimated to have raised over \$2.5 billion from employers as of June 1, 2009

This imposed a new, 20% strict liability penalty in addition to all existing penalties, which applies to “understatements” of tax liability of \$1 million or more. It applied retroactively to tax year 2003, with a May 31, 2009 deadline, and, prospectively, is permanent. No other state has this penalty. It applies even to reasonable taxpayer behavior where there is no culpability, forcing companies to overpay their taxes every year, to take into account amounts reasonably in dispute or outside of their control, in order to ensure no 20% penalty is imposed. Overpayments will eventually be partially refunded, but the state will have received a low-interest loan from employers, with no deadline for refunds.

2. Limit on Research & Development Tax Credit and Enterprise Zone Program Credits (AB 1452) Estimated to raise \$900 million from employers

This bill imposed a two-year limit on the use of all business tax credits, including research and development and enterprise zone credits, California’s only remaining statewide investment incentive tax credits. For tax years 2008 and 2009, these credits are capped at one-half of the taxpayer’s liability, with only very small employers exempted. This limitation will result in a mid-stream change and tax increase for companies who made investment decisions and plans in reliance upon them. Credits that could have been used during the limitation period are permitted to be carried over, but the lost time-value of

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money to companies is permanent.

Offsetting Improvement: Effective January 2010, tax credits (but not enterprise zone credits per SBX1 28) may be shared among a related group of affiliate or subsidiary companies, referred to as “unitary utilization.” This will help some but not all companies, due to individual circumstances.

3. Suspension of Net Operating Loss (AB 1452) **Estimated to raise \$1.6 billion over two years**

This bill suspends for two years, tax years 2008 and 2009, the ability of employers and individuals to deduct net operating losses (NOL). Very small businesses are exempted. The NOL deduction gives employers more flexibility to manage losses they experience within timeframes and cycles that differ from the arbitrary and rigid government tax filing deadlines. The suspension will directly impact marginally profitable employers attempting to emerge from losses due to increased tax liability and reduced cash flow.

Offsetting improvement: After the 2-year suspension period, treatment of losses will partially conform to federal carryover and carryback, which benefits some but not all companies, due to individual circumstances.

4. Accelerated Estimated Tax Payments (SBX1 28) **Estimated to raise \$2.3 billion over two years**

Beginning January 2009 and ongoing, business and individual taxpayers must pay more of their estimated taxes earlier in the year and imposes a new 100% accuracy requirement on taxpayers with incomes over \$1 million. Instead of 4 payments of 25%, the first two payments will be 30% and the last two 20%. This will reduce cash flow for independent contractors and other employers small and large.

5. Accelerated Limited Liability Company Fee (AB 1452) **Estimated to raise \$360 million from employers**

Limited liability companies (LLCs) must pay their annual fees during the first six months of the current tax year, beginning January 2009 and permanently thereafter. A 10% penalty will be assessed if employers underestimate. The new fee deadline will result in a double payment of the fee in the early part of 2009 – the prior year’s LLC fee and the current year’s fee are due. This will pose a hardship for small companies with limited cash flow. Also, LLCs must accurately estimate the following year’s fee liability, or be subject to a 10% penalty.

February 2009 Tax Increases

The February 19, 2009 State Budget included \$12.5 billion in tax increases in ABX3 3 (Ch. 18, 2009-10), including over \$3.5 billion impacting the California business community.

1. Sales and Use Tax Rate Increase (ABX3 3) **Estimated to raise over \$2.4 billion from employers**

Employers in this state pay over 40% of the sales tax. The budget accord

increased the sales tax rate starting April 1 by a full one cent in order to raise almost \$6 billion over the next two years, of which employers will pay roughly \$2.4 billion.

2. Vehicle License Fee Increase (ABX3 3)

Estimated to raise \$425 million from employers

Employers in this state pay approximately twenty-five percent of the VLF. The budget agreement increased the VLF rate to 1.15% starting May 19 in order to raise about \$1.7 billion on an annual basis, of which employers will pay about \$425 million annually.

3. Personal Income Tax Rate Increase (ABX3 3)

Estimated to raise \$1 billion from employers

Many employers in this state are organized as limited liability companies, Subchapter S corporations, and partnerships, among others, all of which pay under the Personal Income Tax Law. As such, these employers will also pay the increases in the PIT rates of .25%. Almost all will now pay the highest marginal rate of 9.55% for the 2009 and 2010 tax years (which does not include the 1% surcharge for mental health funding). As such, the business community will pay over \$1 billion during this two-year tax increase.



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Employer Economic Recovery, Development Crucial to Ensuring Sufficient Revenues and Future of Needed State Programs

Much has been written in recent weeks about "corporate tax breaks" and the need to repeal them, as well as to close alleged "tax loopholes." These are highly inaccurate misrepresentations of important investment incentives adopted to facilitate economic recovery in the wake of the severe recession and \$10+ billion in tax increases and accelerations imposed on the employer community.

Eliminating any investment incentives, as proposed by some groups, will adversely impact California's employers, cause continued job losses, further erode the business climate, and prolong the state's ability to economically recover from the recession in which it finds itself. By limiting this recovery, our state will continue to suffer financially.

Moreover, the very groups urging repeal of investment incentives spent millions opposing the May 2009 ballot measures, the defeat of which contributed \$6 billion towards the current \$24 billion deficit. The measures' defeat also results in significantly less tax revenues being collected by the state.

The major investment incentives being criticized, including positive tax changes involving single sales factor, research and development, and net operating losses, have only minor fiscal impact to the state until 2011. As such, repealing these important tax law changes will provide nominal fiscal relief to the state.

Investment Incentives Adopted in Recent Budgets Are Crucial to State Recovery from the Recession and \$10+ Billion in Employer Tax Increases/Accelerations

We urge the Legislature to leave intact the important tax law changes enacted in the February 2009 and September 2008 budgets, including elective single sales factor, research and development tax credits sharing, and net operating losses carryback. Any repeal of these reforms will hamper our state's fiscal recovery.

1. Elective Single Sales Factor Apportionment: Encourages Jobs and Investment in California

- **Current tax structure penalizes investment.** The current 4-factor apportionment formula (the method the state uses to determine taxes owed by a multistate company in relation to the other states) discourages job creation and capital investment in this state because the more a company invests in jobs, buildings, and equipment in California, the more corporate income taxes the business pays to this state. Effective January 1, 2011, some employers will have the option to elect a single sales factor apportionment formula.

- **Single sales factor will encourage jobs and investment we don't currently have.** Investment decisions are being made in reliance on the 2011 effective date of the single sales factor apportionment formula. However, the delayed implementation date means that, if the state were to repeal single sales factor, it would only lose that additional investment with no current-year revenue gains. Since the provision does not take effect until January 1, 2011, any repeal would not help the current budget year and will adversely impact valuable investment decisions.
- **Positive revenue return on investment.** A 2003 study by the Associated Industries of Massachusetts, which reviewed the effectiveness of Massachusetts' single sales factor formula, found "Massachusetts gains over \$7 of additional net personal income for each dollar of reduced state corporate excise tax revenues." The study concluded, "This is a significant long-run return in terms of new jobs and higher incomes as a result of the state's investment."

2. Research & Development Tax Credit Sharing: Improves Ability for Some to Use the Important Tax Credit

- **Allows companies to fully utilize tax credits promised to them.** Effective January 1, 2010, the research and development (R&D) tax credit may be shared among a related group of affiliate or subsidiary companies. This change will help some employers who are not currently able to fully utilize their promised tax credits, despite having engaged in the desired R&D activities.
- **Improves taxpayer equity.** FTB has been able to have it both ways – businesses are "unitary" for the purpose of taxation, but separate entities for the purpose of applying tax credits. There should be consistent tax treatment of the members of a unitary group.

3. Net Operating Loss Carryback: Improves Taxpayer Equity in Tax Treatment of Losses

- **NOL deduction resolves inequity in the tax structure.** The NOL deduction is meant to resolve an inequity in our tax structure, which comes from businesses experiencing losses or profits at different times, yet all being subject to the same government deadlines for income tax reporting. To resolve this, the net operating loss (NOL) deduction allows taxpayers to offset or deduct one tax year's losses from another tax year's profits.
- **NOL carryback change improves equity in tax treatment of employer losses.** Effective January 1, 2011, employers and individuals will be able to carryback losses two years, as well as being able to carry them forward. Under current law, only carryforwards are available. Carryback and expanded carryforwards will provide added flexibility and partial federal conformity for companies that use the NOL deduction.

Economic Recovery, Development Needs to Be a Top Priority for the State

- **The state should take a long view of tax policy, similar to any investment strategy.** While the costs of existing and recent investment changes seem high, the long-term benefits of job retention, creation and investment are tremendous. The state's strongest revenue-generating years have occurred when the economy is strong. Higher employment rates and capital investment result in bountiful personal and corporate income tax revenues that will stabilize the economy going forward.
- **Higher taxes are no guarantee of additional net revenues, while harming the economy.** Proposals such as split roll property taxes, various ways to tax high-income investors in the California economy, and other punitive tax proposals that target job creators and the employers in this state are extremely high-risk. The resulting harm to the economy and decline in revenues may far outweigh any static revenue "gains" scored from a particular proposal.
- **California's tax climate already chills investment.** California has the highest corporate tax rate among the western states, and one of the highest in the country. California's personal income tax and sales tax rates also consistently rank in the top 10 highest in the nation. Repeal of these investment incentive proposals will only exacerbate those unfortunate rankings.
- **California has lost more manufacturing jobs than any other state.** Most states have lost manufacturing jobs since 2000. As a percentage of gross state product (GSP) though, no competing state has lost as many as California since 2000. According to a soon-to-be-released report on California manufacturing, the industry's share of the state's GSP has declined 9.8 percent. Comparatively, Texas manufacturing gained 24 percent of its GSP and Oregon gained 66 percent. California has lost 30 percent of its industrial base since December, 2000, more than any other state.
- **Federal government is improving NOL and R&D.** Ironically, the federal government is exploring ways to provide incentives to employers to stimulate the economy. For example, it has expanded to 5 years the carryback of the net operating loss deduction and created a new R&D tax credit. Repealing any of these important incentives would have the opposite effect and discourage growth.