Proposition 39 – Targeted Tax Increase by Mandating Single Sales Factor; Earmarks Funds for Green Projects

CALTAX POSITION

CalTax is opposed to Proposition 39. This measure would lock in spending for green projects, thereby limiting options for addressing the state's budget deficit. By earmarking funds to green projects, the initiative would restrict lawmakers from being able to choose what programs are important for their constituents. CalTax also opposes this measure because it targets many businesses that would have to pay higher taxes at a time when the state’s economy is still in recovery.

SUBJECT

Requires specified businesses to estimate California business income by using the single sales factor apportionment formula. Increases state tax revenue by an estimated (but unverified) $1 billion annually to fund energy efficiency projects for public and private buildings, job training programs, and K-12 schools and community colleges. The initiative is sponsored by the California League of Conservation Voters and Thomas Steyer, billionaire investor and owner of Farallon Capital Management.

MAJOR PROVISIONS

- **Mandates Single Sales Factor Apportionment for Specified Taxpayers.** Repeals the option for specified taxpayers to elect the single sales factor apportionment, and instead requires specified taxpayers, unless specifically exempted, to apportion their income to California using only the sales factor of the unitary apportionment formula, beginning January 1, 2013. Taxpayers exempted from mandatory single sales factor apportionment include qualified entities engaged in either agricultural, extractive, savings and loan, or banking or financial business activities – essentially the same entities that are required to apportion income under the current three-factor formula. However, with California’s repeal of the Multistate Tax Compact in budget trailer bill SB 1015 (Ch.37, St. 2012), it is unclear whether banking and financial institutions still would be able to apportion under the three-factor formula, as specified in Revenue and Taxation Code 25128(c)(7).

- **Applies Market Sourcing Rules for Assignment of Sales.** For all taxpayers, including those apportioning under the three-factor formula, sales other than sales of tangible
personal property are to be assigned to California beginning January 1, 2013 as follows:

- Sales from services are assigned to California if the purchaser received the benefit of the service in the state.
- Sales from intangible property are assigned to California if the property is used in the state. Marketable securities sales are assigned to the state if the customer is in the state.
- Sales from the rental, lease, or licensing of real property are assigned to California if the real property is located in the state.
- Sales from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in the state.

However, taxpayers meeting certain conditions may assign 50 percent of their qualified sales to this state, and exclude the remaining 50 percent.

**Earmarks Half of the Revenue for Clean Energy Programs.** Redirects $550 million or half of the revenue generated by this proposal (if actual revenue is less than anticipated), from the general fund to a newly created Clean Energy Job Creation Fund, for five years, 2013-14 through 2017-18. Proceeds will be used to support programs that:

- Improve energy efficiency and clean energy at public and private schools and colleges, and other public facilities.
- Train and employ disadvantaged youth, veterans and others on energy efficiency and clean energy projects.
- Assist local governments in establishing and implementing Property Assessed Clean Energy (PACE) programs, or similar financial and technical assistance programs that provide loans to private property owners for energy efficient retrofits, as specified.

**Creates Another Government Entity.** Establishes the Citizens Oversight Board, composed of nine political appointees, to annually review and audit expenditures from the Clean Energy Job Creation Fund, publish a complete annual accounting of expenditures on a public website, and submit an evaluation report to the Legislature. The board is not slated to be abolished after revenue transfers to the Clean Energy Job Creation Fund are complete, and it is unclear what the ongoing responsibilities of the board will be, and how those activities would be funded.

**FISCAL IMPACT**

Unknown. The Legislative Analyst's Office and the state's Department of Finance estimate total revenue increases of $500 million in 2012-13 and $1 billion (rounded) annually thereafter as a result of mandating single sales factor apportionment. The initiative transfers $550 million, or half of the anticipated $1.1 billion revenue increase, to the Clean Energy Job Creation Fund from 2013-14 through 2017-18. If revenue is less than anticipated, half of the actual revenue increase would be transferred.
Assuming the fiscal estimate is correct, K-14 schools would receive $225 million of the increase for five years under Proposition 98 funding requirements. This amount would increase to $500 million upon expiration of the fund transfer to the Clean Energy Job Creation Fund.

Note: This is a static revenue estimate that does not take into account changes in taxpayer behavior. It is unverifiable, because the Franchise Tax Board has no way of calculating the incremental revenue increase between the four-factor formula and mandatory single sales factor, and the estimate is likely incorrect.

BACKGROUND

The goal of a unitary method of taxation is to fairly apportion income among the various states in which a business (and its affiliates) has operations, and to prevent manipulation of how a business reports income for tax purposes. To do this, a multistate business must use an apportionment formula, which can consist of a percentage of the value of a business’ property, payroll and sales within a particular state.

California adopted portions of the Uniform Division of Income for Tax Purposes Act (UDITPA) to apportion income based on a formula that determines the percentage of a taxpayer’s (worldwide or U.S.) business income that should be attributable to California. The formula measures the taxpayer’s property, payroll and sales in California as a percentage of total property, payroll and sales. This approach helps avoid double taxation of business income that is earned outside the state.

While the UDITPA formula uses an equally weighted three-factor formula, California modified this formula in 1993 to provide for a double-weighted sales factor, with some exceptions. In 2008-09, further changes allowed taxpayers to apportion their income to California by using just the sales factor of unitary apportionment formula, for taxable years beginning on or after January 1, 2011. Under this approach, taxpayers (excluding industries that are not permitted to double-weight the sales factor) may elect to apportion income using the multi-factor formula or by multiplying the percentage of California sales by total business income, without consideration of property and payroll.

Since the enactment of elective single sales factor in 2008-09, there have been several attempts to repeal the law or to impose a mandatory single sales factor:

- Proposition 24, on the November 2010 ballot, sought to repeal the election, but failed on a 42 percent to 58 percent vote.
- AB 1935 (de León, 2009/10) would have mandated the use of the single sales formula for all companies except for financial institutions and oil companies, which would continue to use the three-factor formula – this bill was held in the Assembly Appropriations Committee.
- ABX1 40 (Fuentes and Fletcher, 2011/12), a last minute gut-and-amend, would have mandated the use of the single sales factor formula for all companies except for certain qualified business activities (extractive, agricultural, banks and financials, and savings and loan), which would continue to use the three-factor formula. The bill also included “offsetting” tax decreases. The bill failed to get a rule waiver, and was not taken up for a vote.
• SB 116 (de León, 2011/12), identical to ABX1 40, failed passage on a 22-15 Senate floor vote.

• SB 1505 (DeSaulnier, 2011/12) would have mandated the use of the single sales factor formula for all companies except for certain qualified business activities (extractive, agricultural, banks and financials, and savings and loan), which would continue to use the three-factor formula. It would have required all taxpayers to use the "market rule" for assigning sales other than the sales of tangible personal property, and would have redirected funding for veterans homes. This bill was held in the Senate Committee on Veterans Affairs.

• AB 1500 (Pérez, 2011/12) would have mandated the use of the single sales factor formula for all companies except for certain qualified business activities (extractive, agricultural, banks and financials, and savings and loan), which would continue to use the three-factor formula. It would have required all taxpayers to use the "market rule" for assigning sales other than the sales of tangible personal property, and would have redirected funding for college scholarships. The bill passed the Assembly by a 54-25 vote, but failed passage in the Senate on the last day of the legislative session. The final Senate vote was 22-15 – five votes shy of the necessary two-thirds needed for passage.

• SB 1015 (Senate Budget and Fiscal Review Committee), a budget trailer bill enacted as part of the 2012 budget, prospectively repealed the Multistate Tax Compact (MTC) for California purposes in an attempt to pre-empt the court's decision in *The Gillette Company, et al. v. Franchise Tax Board* case. In its decision, the First District Court of Appeal ruled that taxpayers may elect to use the three-factor apportionment formula instead of California's four-factor formula, which double-weights the sales factor. The court also ruled that California must be explicitly withdrawn from the MTC to disallow the three-factor election that is allowed under the compact. Since the ruling, the court has vacated its own decision and ordered a rehearing of the case, because both the FTB and the taxpayer asked for clarification on several points. On October 2, the court reaffirmed its decision in favor of the taxpayer, but also acknowledged that SB 1015 was signed into law. The FTB indicates it will appeal this decision. Given the continuing court proceedings, it is likely that the three-factor formula apportionment issue will not be resolved until appeals are finalized.

CALTAX ANALYSIS AND POLICY CONSIDERATIONS

• May Not Accurately Reflect Income Earned in California. In many situations, a mandatory single sales factor approach would incorrectly apportion income that is earned in other states to California.

To account for different business models operating in California, the single sales factor method was authorized as an alternative method for taxing business income. The law maintained the option for businesses to use the multi-factor method for entities whose business income is more fairly apportioned by that taxation formula. This ensured that different types of businesses with varying business models would be able to more accurately determine their portion of taxable income in California, rather than using a one-size-fits-all approach. Since income earned in another state might be taxed by the other state and then also by California under a mandatory single sales factor apportionment approach, it could result in double-taxation of the same income.
• **Apportionment Formula Change Results in a Tax Increase for Some.** Implementation of a mandatory single sales factor would result in a tax increase on some companies doing business in the state, including manufacturers that have large California investments and employ large numbers of Californians. The legislative analyst and the Department of Finance estimate that a mandatory single sales factor would increase tax liabilities for some multistate companies by an aggregate $1 billion annually. This estimate is unverifiable, and likely incorrect, but taxes would increase by some degree.

• **Ballot-Box Budgeting Restricts Budget Options.** The use of ballot initiatives to lock in specified levels of funding for various programs, also known as ballot-box budgeting, has severely limited the state's ability to reduce spending or redirect resources in hard economic times. Proposition 98, for example, requires that the state provide a minimum level of funding for K-14 education each year, and essentially eliminates discretion on how the state spends approximately 40 percent of the state's general fund revenue. Notwithstanding the potential importance of some of these programs, mandating funding levels for specific programs restricts the state's ability to make cuts, and gives lawmakers more justification to push for tax increases.

• **Creates Another Government Entity.** At a time when lawmakers are trying to downsize government, this proposal creates another government bureaucracy of political appointees that likely will be a drain on state resources. Funding for the new oversight board is unspecified, and it's unclear whether staffing resources would be redirected from existing state agencies or would come from additional hires. Also, the board is not slated to be abolished, even though its oversight responsibilities will conclude after several years, when revenue will no longer be transferred to the Clean Energy Job Creation Fund.

**BALLOT SUPPORTERS AND OPPOSITION**

The supporters and opponents below are only those who signed the ballot arguments and rebuttals in the **Official Voter Information Guide** for the November 6 statewide election.

**PROPOSITION 39 SUPPORTERS**

Jane Warner – President, American Lung Association in California
Tom Steyer – Chairman, Californians for Clean Energy and Jobs
Mary Leslie – President, Los Angeles Business Council
Alan Joseph Bankman – Professor of Tax Law, Stanford Law School
Ruben Guerra – CEO, Latin Business Association

**PROPOSITION 39 OPPONENTS**

Jack Stewart – President, California Manufacturers and Technology Association
Lew Uhler – President, National Tax Limitation Committee
Pat Fong Fushida – President, California Asian Pacific Chamber of Commerce
Mike Spence – President, California Taxpayer Protection Committee
Robert Ming – Chairman, Friends for Saving California Jobs