California Initiative Review (CIR)

Volume 2010 Article 10

1-1-2010

Proposition 24: Repeal Corporate Tax Loopholes Act. Initiative Statute.

Marla A. Kurtz
University of the Pacific, McGeorge School of Law

Mallory Lass
University of the Pacific, McGeorge School of Law

CALIFORNIA INITIATIVE REVIEW

Proposition 24:
Repeal Corporate Tax Loopholes Act.
Initiative Statute.

By,

Marla A. Kurtz
J.D., University of the Pacific, McGeorge School of Law, to be conferred May 2011
B.A., Law and Society, University of California, Santa Barbara, 2008

&

Mallory Lass
J.D., University of the Pacific, McGeorge School of Law, to be conferred May 2011
B.A., Law and Society & Women's Studies, University of California, Santa Barbara, 2007

I. EXECUTIVE SUMMARY

Each year the California Legislature creates the state's yearly budget. During the 2008 and 2009 closed-door process the Legislature enacted three business tax structures for businesses, scheduled to go into effect in stages between 2010 and 2011.[1] Proposition 24, an initiative statute, is a response to these three tax structures and their expected effect on the California economic crisis.[2]

Proposition 24, the Tax Fairness Act, seeks to remove 2008 and 2009 legislative changes to the business tax structure. The Legislature's 2010-2011 planned corporate tax structure allows for (1) a business to shift their operating losses from one tax year to prior or future tax years, (2) a multistate business to use a sales-based income calculation, and (3) a business to share tax credits among affiliated businesses.[3]

A "yes" vote on Proposition 24 will revert the business tax provisions back to what they were prior to the 2008 and 2009 legislative changes. This means (1) a business will not as easily shift losses from one tax year to another, (2) California incomes of multistate businesses will be determined by a three-factor calculation, and (3) a business will not be able to share tax credits among an affiliated business.[4]

A "no" vote on Proposition 24 will allow for the Legislature's enacted business tax structure to go into effect as planned in 2010-2011 with no change. This means (1) a business will be able to shift losses from the current tax year to two prior years and shift them forward for twenty years, (2) most multistate businesses may choose to have their California incomes calculated by a single sales factor or the three-factor calculation, and (3) a business will be able to share tax credits among affiliated businesses.[5]

II. THE LAW

a. History and Background

In 2009, the state of California faced a $42 billion budget deficit. In the process of passing the budget, over twenty separate bills were passed. As part of the budget process, the Legislature passed business-friendly tax measures in an effort to attract businesses to California, which would ideally increase employment opportunities and stabilize the economy.[6]

---

[1] Proposition 24, Proposition 24 – Full Text of the Proposed Law, http://ag.ca.gov/cms_attachments/initiatives/pdfs/i855_initiative_09-0058_amdt_1-ns.pdf (accessed August 17, 2010) at p. 1., sec. 2., no. 2 [hereinafter *Prop 24 Full Text*].

[2] Cal. Teachers Ass'n, *What is Proposition 24?*, ISSUES & ACTION, http://www.cta.org/Issues-and-Action/Election-2010/Proposition-24.aspx (last visited Oct. 4, 2010).

[3] *Prop 24 Full Text*, *supra* note 1, at p. 2., sec. 3.

[4] *Official Voter Information Guide*, *Proposition 24*, http://www.voterguide.sos.ca.gov/propositions/24/ [hereinafter *Voter Guide*].

[5] *Id.*

[6] *See* Charles W. Swenson, *On the Impact of a Single Sales Factor on California Jobs and Economic Growth*, (June 2010), http://www.stopprop24.com/wp-content/uploads/SSF-Study-_6-2-10_.pdf.

Because this legislation still has not gone into effect, this repeal could have been brought as a referendum rather than an initiative. In order to file a referendum, you need to submit the required signatures within 90 days after the statute goes into effect.[7] Under *Rossi v. Brown*, the California Supreme Court held that a tax measure could be repealed prospectively by initiative, making the more difficult referendum process unnecessary.[8]

States differ in the way they calculate state corporate income tax liability. Many states use a three-factor formula, but there has been some movement in the last decade toward a single factor formula based on a business' sales in the state. In some cases states have not moved entirely to a "single sales" factor, but instead have given it greater weight in the three-factor formula.[9] This reduces the weight of the property and payroll factors; thus, creating a greater incentive for businesses to increase production.[10] Proponents of the "single sales" factor formula believe it will increase jobs. Further, they claim it reduces overall state corporate income tax liability for a business, while creating other tax revenues. State income taxes (through additional workers hired) and sales tax revenues (through increased production and sales of products), as well as business property tax (through additional property purchased to expand production) would be affected.[11] Most recently, in 2006, five states switched to the "single sales" factor including: Georgia, Louisiana, New York, Oregon, and Wisconsin.[12]

Corporate tax revenues make up approximately 10% of the State General Fund and are expected to account for 11.3% of the General Fund in the 2010-2011 fiscal year.[13] Approximately 52%-55% of the General Fund is spent on education each year.[14] Because a significant portion of the General Fund revenues come from corporate taxes, the proponents of Proposition 24 argue corporate tax breaks will have a significant negative impact on education funding due to an overall reduction in the General Fund.[15] The State General Fund is financed by several different taxes, including but not limited to: income, sales, and corporate taxes. Propositions that affect the amount of money in the State General Fund directly impact education funding due to Proposition 98. Proposition 98, which was passed by the voters in 1988, was designed to provide K-14 schools (K-12 schools and community colleges) with a guaranteed source of

---

[7] Cal. Const. Article II, sec. 9(b).

[8] *See* Rossi v. Brown, 9 Cal.4th 688 (1995).

[9] Elliot Dubin, *Changes in State Corporate Income Tax Apportionment Formulas and Changes in State Corporate Income Tax Bases*, MULTISTATE TAX COMMISSION, 10 (February 22, 2010), http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Policy/State%20Corporate%20Income%20Tax%20Article.pdf.

[10] *Id.*

[11] *Id.*

[12] Charles W. Swenson, *On the Impact of a Single Sales Factor on California Jobs and Economic Growth*, 3 (June 2010), http://www.stopprop24.com/wp-content/uploads/SSF-Study-_6-2-10_.pdf.

[13] Governor's Budget Summary 2010-11, *Revenue Estimates*, 89 (2010), http://www.ebudget.ca.gov/pdf/BudgetSummary/RevenueEstimates.pdf

[14] Cal. Dep't of Fin., *California Budget Frequently Asked Questions, Question 7*, (Oct. 2, 2010), http://www.dof.ca.gov/budgeting/budget_faqs/#7.

[15] *Prop 24 Full Text*, *supra* note 1, (accessed October 2, 2010) at p. 2., sec. 2., no. 10. *See also Yes on 24: The Tax Fairness Act*, BALLOT ARGUMENT: IN FAVOR OF PROPOSITION 24 (October 2, 2010), http://yesprop24.org/learn-more/ballot-argument.

funding.[16] Proposition 98 provides three tests for determining how much of the State General Fund is spent on education.[17] These tests vary based on the growth of the economy and the General Fund.[18] When the General Fund decreases, as the proponents argue it will if Proposition 24 does not pass, education funding will decrease due to the Proposition 98 formula being calculated as a proportion of the total General Fund.

b. Prior Law

The law prior to the passage of the 2008 and 2009 State Budget comes from California Revenue and Taxation Code sections 17276 and 24416.

Use of Operating Losses: Carrybacks, which are business losses applied to prior years in order to offset income and receive a refund, are not allowed.[19] Carryovers allow businesses to offset future income for up to 10 years following a loss.[20]

Income of Multistate Businesses: Multistate businesses use a three-factor formula to calculate their income based on the proportion of sales, property, and payroll the business has in California.[21] The three-factor formula uses a weighting factor to apportion each area—sales, property, and payroll; the weighting factor for sales is usually the largest but the three add to one.[22] The proportion of sales a business conducts in California to total sales nationally is multiplied by the sales weighting factor.[23] The proportion of a business' California payroll to payroll nationally is multiplied by the payroll weighting factor.[24] The proportion of property in California to property nationally is multiplied by the property weighting factor.[25] These three figures are added together and multiplied by the businesses total net income.[26]

Tax Credit Sharing: Tax credits are given to businesses engaging in activities the State wants to promote. For instance, a business developing valuable technology can earn a "research and development" credit.[27] Tax credits can be used to offset the amount of tax owed. In some cases a business might have credits exceeding their tax liability, these can usually be carried forward into future years (the number of years varies based on the text of the statute providing for the

---

[16] Legislative Analyst's Office, *Proposition 98 Primer*, 1 (February 1, 2005) http://www.lao.ca.gov/2005/prop_98_primer/prop_98_primer_020805.htm.
[17] *Id.*
[18] *Id.*
[19] Legislative Analyst's Office, *Proposition 24*, 1 (July 15, 2010), http://www.lao.ca.gov/ballot/2010/24_11_2010.pdf (accessed August 24, 2010) [hereinafter *LAO Analysis*].
[20] CAL. REV. & TAX. §§17276(c), 24416(d) (West 2008).
[21] *LAO Analysis* at 2.
[22] Dubin, *supra* note 9, at 5.
[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *LAO Analysis*, *supra* note 19, at 3.

credit).[28] Tax credits given to a business can only be used by that business. They cannot be shared among entities in the same group of businesses.[29]

c. Existing Law

Existing law represents modifications and additions to Revenue and Taxation Code sections 17276, 23663, 24416, and 25128 adopted in the budgets passed by the Legislature and Governor in 2008 and 2009.[30]

Use of Operating Losses: Beginning in 2010, business would be allowed to carry losses back two years prior to the year the loss occurred and apply them against income to receive a refund.[31] The carryover provisions are extended from 10 years to 20.[32]

Income of Multistate Businesses: Beginning in 2011, multistate businesses would get a choice between the prior law, the three-factor formula, and the "single sales" factor formula for calculating income.[33] The "single sales" factor looks to the proportion of a business' sales in California to sales across the nation. Businesses can choose either method in any given year.[34]

Tax Credit Sharing: Beginning in 2010, tax credits given to one business can be transferred to related business entities.[35]

Passage of Proposition 24 would repeal existing law, reverting the corporate tax structure back to its pre-budget form.

In the 2010-2011 Governor's Budget Summary Introduction, it was proposed that the implementation of the following provisions be delayed one year:

- Delay use of business credits by unitary groups of corporations and instead retain current law [that] requires subsidiaries to have their own tax liability to use research and development and other credits ([revenue increase of] $315 million).

---

[28] CAL. REV. & TAX. § 17039(c)(2) (West 2008), *amended by* 2010 Cal. Legis. Serv. Ch. 14 (West).
[29] *LAO Analysis*, *supra* note 19, at 3.
[30] *Prop 24 Full Text*, *supra* note 1, (accessed October 3, 2010) at p. 2., sec. 3. "The people enact this measure to repeal three tax breaks that were granted to corporations in 2008 and 2009: the elective single sales factor provisions contained in ABx3 15 and SBx3 15 of 2009; (2) the net operating loss carryback provisions contained in AB 1452 of 2008; and (3) the tax credit sharing provisions in AB 1452 of 2008." *Id.*
[31] A business utilizes the carryback provision by filing an amended state corporate income tax return for the year in which the entity wants to apply the loss and then if accepted would receive a refund check in the amount the loss offset the previously reported gain.
[32] CAL. REV. & TAX. §§17276(c), 17276.9(c), 17276.10, 24416(d), 24416.9(c), 24416.10 (West 2008), *amended by* 2010 Cal. Legis. Serv. Ch. 14 (West).
[33] CAL. REV. & TAX. § 25128.5 (West 2010).
[34] CAL. REV. & TAX. § 25128.5(a) (West 2010).
[35] CAL. REV. & TAX. § 23663 (West 2008).

- Delay the change to the single sales factor allocation method for multi-state corporate income and instead retain the [three factor formula] ([revenue increase of] $300 million).
- Lower to 30 percent the first year phase-in of the ability of corporations to carry back losses two years to offset prior tax profits ([revenue increase of] $20 million).[36]

However, when the budget passed, only the carryback provision was affected. Therefore, if Proposition 24 does not pass, the following existing law provision will take effect over a three-year period beginning in 2013:

- The ability to carry back losses for two years will be delayed until 2013. Carrybacks will be limited to 50 percent of losses for tax years beginning in 2013, 75 percent of losses for tax years beginning in 2014 and 100 percent of [Net Operating Losses] NOLs will be allowed to be carried back for tax years beginning tax year 2015 and later.[37]

d. Fiscal Effects of Proposed Changes to the Law

If Proposition 24 passes and reverts the tax-structure back to the pre-budget form, it is expected to have a positive effect on state revenues. These effects are summarized as follows:

Effect on State Revenues: Repeal of the business friendly modifications and additions to Revenue and Taxation Code, sections 17276, 23663, 24416, and 25128 are expected to increase State revenue through the continuation of the prior corporate taxation method. This is expected to increase revenues by $1.3 billion annually when in full effect in 2012-13.[38] More than half of this revenue is expected to come from multistate businesses due to the elimination of the “single sales” factor option in calculating corporate income.[39]

Effect on State General Fund and Education Funding: State tax revenue goes to the State General Fund. An increase in corporate tax revenues would increase the General Fund. Under Proposition 98, this is expected to increase the funding for education. The General Fund is responsible for other programs and services including healthcare and public safety. However, proponents focus on increased revenues for education because under Proposition 98 a specific portion of the General Fund must be spent on education and cannot be discretionarily cut.[40]

---

[36] Governor’s Budget Summary 2010-11, *Introduction*, 8 (2010), http://www.ebudget.ca.gov/pdf/BudgetSummary/Introduction.pdf
[37] California State Budget 2010-11, *Full Budget Summary*, 22 (2010), http://www.ebudget.ca.gov/pdf/Enacted/BudgetSummary/FullBudgetSummary.pdf
[38] *LAO Analysis*, *supra* note 19, at 5-6.
[39] *Id.*
[40] The Proponents major sponsor is the California Teachers Association, so this is another likely reason they are focusing so heavily on education funding.

Effects of Proposition 24 on California Business Tax Law[41]

Issue	**Prior Law**	**Current Law**	**Law if Proposition 24 Passes**
Use of Operating Losses	Carrybacks. Business losses cannot be used to get refunds of taxes previously paid.	Carrybacks. Beginning in 2010, business losses can be used to get refunds of taxes paid in the prior two years.	Same as prior law.
	Carryforwards. Businesses can use losses to offset income in the 10 years following the loss.	Carryforwards. Beginning in 2010, businesses can use losses to offset income in the 20 years following the loss.	Same as prior law.
Income of Multistate Businesses	A single formula determines the level of a multistate business' income that California taxes based on the business' sales, property, and payroll in California.	Beginning in 2011, most multistate businesses will choose every year between two options to determine the level of income that California can tax: (1) the formula under prior law, or (2) a formula that considers only the business' sales in California relative to its national sales.	Same as prior law.
Tax Credit Sharing	Tax credits given to a business entity can only reduce that entity's taxes. That entity cannot share its tax credits with entities in the same group of businesses.	Beginning in 2010, tax credits given to a business entity can be used to reduce the taxes of other entities in the same group of related businesses.	Same as prior law.

III. CONSTITUTIONAL ISSUES

United States Constitution: One potential but unlikely source of post-election litigation my lie within the Commerce Clause and the way that California determines taxes for multistate businesses. If Proposition 24 does not pass, and the current law remains, California, in essence, will be favoring in-state businesses, in hopes of bringing more business and more jobs to the state. The Commerce Clause has been interpreted to protect out-of-state businesses from discrimination and prohibits states from giving preferential treatment solely to in-state businesses. However, it is unlikely a Commerce Clause challenge would be successful here because multi-state businesses as well as California-only businesses will benefit from the proposed breaks.[42] Businesses that are not incorporated in California, but have operations in the

[41] *LAO Analysis*, *supra* note 19, at 4.
[42] Interview with Leslie Jacobs, Director of the Capital Center, University of the Pacific, McGeorge School of Law, McGeorge School of Law (Sept. 13, 2010).

state and are subject to tax in California, would still qualify for the tax benefits by electing either the "single sales" factor or the three-factor formula.[43] In *Mobile Oil Corp. v. Commissioner*, taxpayer Mobil, a New York domiciled business argued taxation by Vermont violated the Commerce Clause. The court determined that if the tax was fairly apportioned and applied uniformly and the business conducted an activity taxable in the state, there was no Commerce Clause issue.[44]

California Constitution: Proposition 24 does not appear to raise any issues under the California Constitution.

IV. POLICY CONSIDERATIONS

a. Proponents' Arguments

The Proponents of Proposition 24 claim that the estimated $1.7 billion in corporate tax breaks allowed by the current tax-structure will instead be used to benefit public schools, healthcare, and public safety.[45] The Proponent's primary backer is the California Teachers Association (CTA). Other supporters include: California Nurses Association (CNA), CALPIRG, Consumer Federation of California, Congress of California Seniors, League of Women Voters of California, and California Tax Reform Association.[46]

Proponents of Proposition 24 focus on four points. First, Proponents claim that the current law does not ensure increased employment opportunities. Proponents argue, that the corporations receiving these tax breaks "made no guarantees that a single job would be created or saved."[47] Further, they highlight that the Legislature did not write in a requirement to create new jobs in order for multistate corporations to receive these tax savings.[48] Accordingly, corporations receiving the tax breaks may still send jobs overseas or to other states.[49] Additionally, "in 2009 alone, the big corporations [contributing] to defeat Proposition 24 laid off over 100,000 employees.[50]

Second, Proponents argue that the tax provisions will not help small businesses because "less than 2% of California's wealthiest multistate corporations" benefit from the tax provisions, while the other 98% of California businesses, "especially small businesses[,] would get virtually no benefit."[51] Proponents allege the tax provision will allow "6 multistate corporations [to] receive

---

[43] *Id.*
[44] Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 443 (1980).
[45] *Voter Guide, supra* note 4.
[46] *Yes on 24: The Tax Fairness Act*, FAQ, 7 (Sept. 7, 2010), http://yesprop24.org/wordpress/learn-more/faqs/ [hereinafter *FAQ*].
[47] *Official Voter Information Guide, Proposition 24 – Arguments and Rebuttals,* http://www.voterguide.sos.ca.gov/propositions/24/arguments-rebuttals.htm [hereinafter *Voter Guide A&R*].
[48] *Id.*
[49] *See Yes on 24: The Tax Fairness Act*, http://www.yesprop24.org/index.html
[50] *FAQ, supra* note 45.
[51] *Voter Guide A&R, supra* note 46.

new cuts averaging $23.5 million each in 2013-2014."[52] And, for example, "87% of the benefits from one tax break [will only] go to 0.03% of California corporations...all of which have gross incomes over $1 billion."[53] Proponents contend, "instead of creating unfair tax loopholes for giant out-of-state corporations, we could be giving tax incentives to California's small businesses that actually create jobs for Californians."[54]

Third, proponents argue that businesses should pay their share of state taxes, highlighting that corporate tax breaks "put an even bigger burden on the average individual tax payer."[55] In last year's budget, the "Legislature gave corporations $1.7 billion in tax breaks," "made $30 billion in cuts," and "raised $18 billion in taxes on people."[56] While big corporations want to use "tax credits they did not earn to reduce their taxes and shift losses" the Legislature's cuts resulted in "laying off 16,000 teachers, raising college tuition by more than 30 percent, and putting 6,500 prisoners back on the street."[57]

Finally, Proponents argue Proposition 24 will help increase education funding. The proposition will "increase state general fund revenues by increasing the taxes paid by businesses."[58] Proposition 98 determines the minimum amount of state and local funding for K–12 schools and community colleges each year.[59] Under Proposition 98's formulas "a significant part of Proposition 24's revenue increases would be allocated to schools and community colleges."[60] Although there will be "smaller increases in 2010-2011 and 2011- 2012, "when fully implemented by 2012-2013, revenues would increase by an estimated $1.3 billion each year."[61] Proponents allege, "more than one-half of these estimated increased taxes would be paid by multistate businesses as a result of the elimination of the 'single sales' factor option."[62]

b. Opponents' Arguments

The opposition to Proposition 24 is organized but has been working behind the scenes. They have structured themselves as a "coalition of taxpayers, employers and biotechnology associations" against the jobs tax.[63] They represent themselves as the voice of the small

[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Yes on 24: The Tax Fairness Act*, BALLOT ARGUMENT: IN FAVOR OF PROPOSITION 24 (Sept. 8, 2010), http://yesprop24.org/learn-more/ballot-argument.
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] Stop Prop 24, *No on 24: Stop the Jobs Tax, About Us*, (Sept. 7, 2010) http://www.stopprop24.com/about-us/.

business, yet the opposition's primary financial backers are Genentech[64] and Cisco Systems, Inc.[65]

Opponents of Proposition 24 argue four points. First, opponents couch the measure as a jobs tax that will substantially decrease employment opportunities for California workers. They argue, "the Jobs Tax Initiative would take us back to an outdated formula that increases [corporate] income taxes every time [businesses] create a new job here, which an economic study reveals would cost California 144,000 jobs."[66] This is based on the theory that using the three-factor formula rather than the "single sales" factor discourages in-state production, which decreases jobs.

Second, opponents allege that getting rid of the carrybacks provision harms small businesses. "To help them survive the recession, federal tax laws were recently updated to allow small businesses to carry back net operating losses five years. The recent state tax update allows businesses two years. Proposition 24 takes away that lifeline altogether. It would force more small businesses to close shop, causing even more layoffs."[67]

Third, opponents argue the disallowance of tax credit sharing hits the job producing industries hardest. Further, they argue this will drive businesses out of state. "We're counting on our high tech, clean technology, biotechnology, and other innovative, high-growth industries to help pull California out of the recession and provide tomorrow's high-paying jobs. But Proposition 24 would tax them for each new job they create here, prohibit the full use of earned research and development tax credits, and limit their ability to level out their losses over their natural business cycles."[68]

Finally, opponents counter the proponents' arguments about education funding. Opponents believe Proposition 24 will have an overall negative impact on the economy and will actually reduce the state's tax revenue in the long-term: "The slower our recovery, the fewer long-term tax revenues we'll have to fund our schools and hospitals and roads."[69]

V. CONCLUSION

Proposition 24 will have short-term and long-term effects on California. If passed, the tax provisions set to go into effect starting 2010-2011 will not occur, and instead the tax provisions will return to what they were prior to the 2008-2009 budget. Business losses will not be shifted as easily between tax years, multistate business tax will continue to be determined by a three-

[64] Genetech is expanding its operations into Oregon, a neighboring state that recently moved to the "single-sales" factor. Genentech contributed $1 million to the no on proposition 24 efforts.
[65] Greg Lucas, *Proposition 24's Opponents Receive a $1 Million Contribution*, CAL. CAPITOL BLOG (Sept. 12, 2010, 6:50 PM), http://californiascapitol.com/blog/?p=3580.
[66] Stop Prop 24, *No on 24: Stop the Jobs Tax, Fact Sheet,* (Sept. 7, 2010), http://www.stopprop24.com/get-the-facts/fact-sheets/.
[67] *Id.*
[68] *Id.*
[69] *Id.*

factor calculation, and tax credits will not be shared among related business. This may mean more money for public schools, healthcare, and public safety.

If Proposition 24 does not pass the tax provisions set to go into effect starting 2010-2011 will continue as planned. Businesses will be able to shift losses from the current tax year to either of the prior 2 years or shift losses into future years. California will join thirteen other states in giving multistate corporations the choice to use a “single sales” factor tax determination, and tax credits may be shared among related businesses. This may mean more businesses and more jobs in California.

The fate of Proposition 24 is with the voters and depends on whether they believe corporate tax cuts will add to California’s economic crisis, or help to rebuild the economy.