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Summary of Selected Revenue Options for 2008-09, 2009-10 and Beyond

The intent of this document is to provide a list of selected revenue options for helping close the state's \$22 billion plus budget gap.

This memo is divided into four sections (summary charts are included on the following pages):

- 1) **Major Revenues:** This section includes billions of dollars in progressive tax increases. This section does not include a sales tax rate increase, as proposed by the Governor or the LAO, which would raise several billion a year in additional revenues.
- 2) **Loophole Closures:** This section includes tax policy changes that seek to close loopholes in the state's tax system which bring in significant dollars but far less than the major revenue increases. These loopholes serve no economic value and serve no other purpose than to maintain a tax system that is inequitable and outdated.
- 3) **Majority Vote Revenues:** This section includes tax policy changes which increase revenues that can be enacted with a majority vote of the Legislature. The Democratic majority should undertake these changes immediately to increase revenue.
- 4) **Carbon Tax and Environmental Fees:** The carbon tax changes the tax paradigm—it creates a significant economic disincentive to pollute by taxing pollution. Economists believe that a carbon tax has an overall positive economic impact. There are a variety of other fees on emissions of pollutants which can raise up to \$1 billion a year on the principle of polluter pays.

While some of these proposals raise smaller amounts of revenue, we need to seek out every revenue opportunity, as the Legislative Analyst's Office (LAO) does. We need a multiple year solution, and some of these revenues grow over time, allowing us to avoid some of the devastating cuts to vital state programs and services in the future.

Note on taxes during a recession: As the LAO notes, both taxes and program cuts can have negative impacts, but the overall impact is small compared to the state's \$1.7 trillion economy. Furthermore, some taxes will have very little or no impact on decision-making in a recession, particularly loophole closures.

This report was written and researched by Lenny Goldberg and David Kersten with the California Tax Reform Association. We accept full responsibility for errors or inaccuracies, and will correct them if they are brought to our attention.

Summary Charts of Selected Revenue Options

1) Major Revenues

Revenue Estimate By Year

(in billions of dollars)

<u>Proposal</u>	2008-09	2009-10	2010-11
Reinstate the top-income tax brackets: Incomes above \$250,000 tax at 10%, and above \$500,000 taxed at 11%	\$5.63 ¹	\$4.27	\$4.48
5% surcharge on personal income tax liability: All taxpayers would pay an additional 5% on their current liability (LAO proposal)	\$2.5 ²	\$2.7	\$2.9
Broaden sales tax base: To include entertainment, sports, recreation, admissions, hotel and lodging, cable and satellite TV	\$2-4	\$2-4	\$2-4
Reassess non-residential property: --Statutory redefinition of change of ownership --Constitutional amendment	-- --	\$1-2 \$4-6 ³	\$1-2 \$4-6
Oil severance tax: Impose 9.9% tax on of the price of a barrel of oil as proposed by Governor	\$0.53	\$1.2 ⁴	\$1.2
Restore Vehicle License Fee: --To 1% of the value of a vehicle (LAO proposal) --To 2% of the value of a vehicle (full restoration)	-- \$1.4	\$1.3 \$4.3	\$1.3 \$4.3
Corporate tax credit limitation: Limit use of tax credits to no more than 50% of liability, eliminate carrybacks and trading as included in last year's budget agreement	\$0.59	\$0.54	\$1.5
Increase Subchapter S corporation rate: Restore 2.5% rate. Subchapter S currently pay 1.5% entity level tax	\$0.60	\$0.54	\$0.57

¹ FTB estimate, July 2008. Revised numbers expected to be significantly lower.

² CTRA estimate. LAO number spread over two years.

³ Additional research needed.

⁴ Governor's estimate. Temporarily lower due to oil price decline

Summary Charts of Selected Revenue Options (cont.)

2) Loophole Closures

Revenue Estimate By Year

(in millions of dollars)

<u>Proposal</u>	2008-09	2009-10	2010-11
Eliminate like-kind exchange of commercial property: (LAO proposal)	\$65	\$290	\$290
Eliminate ability to shelter multinational income in tax havens: Consider tax havens as part of the “water’s edge” for CA tax purposes	\$65	\$65	\$65
Enterprise Zones: --Tighten enterprise zone statutes --Eliminate enterprise zone program	\$100 \$400	\$100 \$400	\$100 \$400
Eliminate “nowhere income” loophole: Section 338	\$50	\$65	\$65
Eliminate accelerated deduction for research and exploration costs: IRC section 174	\$390	\$300	\$180
Eliminate intangible drilling allowance and accelerated deduction of development/exploration for oil: IRC sections 263/291 and 616/617	\$20	\$21	\$17
Eliminate capital gains tax break for the sale of small business stock: (LAO proposal)	--	\$55	\$55
De-link California law from IRS ruling in bank bailout: Avoids \$200-300 million state revenue loss	\$300	\$200	\$175
Apply sales tax to digital downloads:	\$114	\$114	\$114

Summary Charts of Selected Revenue Options (cont.)

3) Majority Vote Revenues

Revenue Estimate By Year

(in millions of dollars)

<u>Proposal</u>	2008-09	2009-10	2010-11
Clarify sales tax nexus for online retailers:	\$55	\$55	\$55
Allow FTB to better locate assets of tax avoiders by using financial institution data matches: (removed from conference committee proposal, suggested by LAO)	\$35	\$100	\$100
Require disclosure of disparities between book and taxable income for corporations:	\$50-100 ⁵	\$50-100	\$50-\$100
Impose income tax withholding requirements/failure to report penalties on independent contractors: --5% withholding rate (increased compliance) --5% withholding rate (revenue acceleration)	\$100 \$3.6 bil.	\$270 -\$100	\$400 -\$1.4 bil.
License suspension for tax debtors: (AB 1925—Eng)	\$13	\$13	\$13
Conformity to federal back-up withholding: (AB 1848—Ma)	\$37	\$37	\$37
Delete provision allowing lenders to collect sales tax refunds on worthless accounts: (AB 1839—Calderon)	\$42	\$42	\$42
Use tax collection on income tax form: (AB 1857—Eng)	\$10	\$11	\$12

⁵ Number highly approximate, actual revenue unknown, could be larger

Summary Charts of Selected Revenue Options (cont.)

4) Carbon Tax and Environmental Fees

Revenue Estimate By Year

(in millions of dollars)

<u>Proposal</u>	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>
Impose a tax of \$20/ton on carbon dioxide emissions:	\$8 bil.	\$8 bil.	\$8 bil.
Fees on other pollutants: Environmentalists have identified a variety of fees on the emissions of pollutants which can raise up to \$1 billion annually to pay for mitigation and program costs.	\$1 bil.	\$1 bil.	\$1 bil.
Eliminate deduction for employer-provided parking:	\$80	\$80	\$80

1. Major Revenues:

A. Reinstating the top income tax brackets: Reinstating the Wilson/Reagan 10% and 11% top income tax brackets as proposed by the Democrats last year. The 10% bracket would be imposed on taxpayers with incomes above \$250,000 and the 11% bracket would be imposed on taxpayers making above \$500,000.

Revenue Estimate: The Franchise Tax Board estimates that this proposal would raise \$5.63 billion in 2008-09, \$4.27 billion in 2009-10 and \$4.48 billion in 2010-11. These estimates may be significantly lower now given the economy and the reduction in capital gains but will recover over the longer term.

Comments: These changes will have a minimal impact on the economic decisions of the wealthy, even during a recession, and the amounts are deductible from federal taxes. The share of income nationally held by the top 1% has gone from 8% in 1980 to 23% currently—the highest since 1928.

B. Enact a 5% surcharge on personal income tax (LAO proposal): All taxpayers would pay 5% more than their current tax liability.

Revenue estimate: The LAO estimates that this would raise \$2.25 billion over the current year and budget year. The ongoing revenue is estimated to be \$2.5-3 billion annually.

Comments: While this tax change would impact the middle-class, tax increases for these taxpayers would be small. A moderate income taxpayer owing \$500 would pay \$25 more; a middle-income taxpayer owing \$2,000 would pay \$100 more. The personal income tax is progressive, so this increase would build on top of a progressive tax. Working families with children earning under \$50,000 pay little or no tax and would not be significantly affected. This tax increase would have little effect on behavior or economic decision-making, because you only pay if you earn it, and if income declines you will not pay.

C. Broaden sales tax base to include entertainment, sports, recreation, admissions, hotels and lodging, cable and satellite:

Revenue estimate: The Board of Equalization estimates that the broadening of the sales tax base would raise \$2-\$4 billion a year, depending on the extent to which telecommunications and information services are included. The Governor's more limited proposal raises \$357 million immediately and \$1.2 billion in 2009-10. Including hotels and lodging adds \$750 million.

Comments: This expansion does NOT include a base broadening to include labor services, such as auto repair, but rather extends the sales tax to intangible goods (digital goods) and to temporary use of space (golf course, hotels, ski lift tickets, parking etc.). It is easy to implement and much less controversial with the public than taxing labor services. There are many billions more in revenues that could be raised by a broader expansion of the sales tax to other services.

D. Reassess non-residential property, first by statutory redefinition of change of ownership in the Legislature and then enact a constitutional amendment to periodically reassess non-residential property at market value:

Revenue estimate: The statutory change is estimated to raise \$1-2 billion a year. A constitutional amendment to periodically reassess non-residential property at market value is estimated to raise \$4-6 billion or more annually for cities, counties and schools, although a recent estimate by opponents of this proposal estimate substantially more, closer to \$7-8 billion.

Comments: This is the single most irrational part of the tax system—bad economics (taxes new investment, fails to tax windfalls, unfair to competitors), is loophole-ridden (change ownership without reassessment), is unfair to homeowners, leads to bad land use, and fails to provide reasonable revenues from economic growth. If the legislature were to tighten the change of ownership rules, it would pave the way for going to the ballot with the appropriate policy, a constitutional amendment which periodically reassessed non-residential property.

E. Enact an oil severance tax of 9.9% on the price of a barrel of oil, as proposed by the Governor:

Revenue estimate: The Governor's Office estimates that this would raise \$530 million in 2008-09 and \$1.2 million in 2009-10. However, the recent collapse in oil prices would mean significantly less, depending on when prices stabilize.

Comments: California is the only state without a severance tax on oil, and the only place in the world which does not collect either taxes or royalties from the production of oil. Economic studies (i.e. RAND) show that the enactment of an oil severance tax has no impact on either price or production of oil. The amount of revenue raised will vary as the price of oil varies. This tax change could go into effect immediately because California already levies a small fee on the wellhead price of oil.

F. Restore the vehicle license fee to 1%, as proposed by the LAO:

Revenue estimate: The LAO estimates that restoring the vehicle license fee to 1% of the value of a vehicle would raise \$1.3 billion in 2009-10 and \$1.3 billion in 2010-2011. The full restoration to 2% of vehicle value is estimated to raise \$4.3 billion in 2009-10 and \$4.3 billion in 2010-2011.

Comments: This tax change would make taxpayers pay the same 1% tax rate that they pay on other property. Proposition 1A would encourage the realignment of the additional revenues to local governments. This is not an unfair tax increase, since owners with more valuable cars pay more and it is deductible from federal taxes. Moreover, although it would hit all taxpayers, this change is not likely to affect economic decision-making even during a recession.

G. Limit the use of corporate tax credits to reduce a taxpayers tax liability by no more than 50%, eliminate the carryback of credits and trading of credits among taxpayers in a unitary group as contained in last year's budget deal:

Revenue estimate: The Franchise Tax Board estimates that limiting the use of tax credits to 50% of tax liability would increase revenues by \$585 million in 2008-09, \$535 million in 2009-10 and \$560 million in 2010-11. Retaining this change in 2010-11 and beyond, and reversing the carryback and trading of tax credits would raise an estimated \$1 billion in 2010-11 and beyond.

Comments: Limiting the use of credits to reduce no more than 50% of corporate tax liability would prevent the significant out-year revenue losses created by the 2008-09 budget deal. Eliminating the new ability, passed in last year's budget deal, to carry-back losses and to trade credits among affiliates in the future would reverse additional revenue losses. The last budget agreement accelerated revenue but created significant revenue losses in the out-years, which this proposal would eliminate.

F. Increasing the Subchapter S entity rate by 1%:

Revenue estimate: The Franchise Tax Board estimates that this change would raise \$600 million in 2008-09, \$540 million in 2009-10, and \$570 million in 2010-11.

Comments: Subchapter S corporations currently only pay a 1.5% entity level tax, as opposed to the prevailing 8.83% corporate tax rate, despite the fact that many of these are large closely-held corporations. The original rate was 2.5% when California adopted the Sub S form, so this proposal would restore the previous rate. It is unlikely to have any impact on economic decision-making in a recession, since the Sub S form has many advantages.

2. Loophole Closures

A. Eliminate like-kind exchanges of commercial property (LAO proposal):

Revenue estimate: The Franchise Tax Board estimates that this would raise \$65 million in 2008-09, \$290 million in 2009-10 and \$290 in 2010-11.

Comments: Current law allows real estate investors to exchange one commercial property for another without paying any capital gains on the sale of the exchanged asset, even if it is exchanged for an out-of-state property. This permits major tax avoidance on the sale of investment property.

B. Eliminate the ability to shelter multinational income in tax havens

Revenue estimate: The Franchise Tax Board estimates that this change would raise \$65 million annually.

Comments: California-based corporations and multinational corporations can park income in Caribbean tax havens to avoid paying taxes on income which should be attributed domestically. Tax havens should become part of the "water's edge" for purposes of California taxation.

C. Tighten enterprise zone hiring credit; or, eliminate enterprise zone program

Revenue estimate: Tightening the statutes governing the enterprise zone program is estimated to raise \$100 million annually. Eliminating the program would save the state roughly \$400 million a year.

Comments: Companies receive credits for hiring temporary workers, workers without healthcare, workers who are not disadvantaged, and for those already hired. The entire program is of questionable value to disadvantaged areas or disadvantaged employees, mostly rewarding activity which would take place in the state in any case. Many enterprise zones are not even in disadvantaged parts of the state.

D. Eliminate “nowhere income” loophole (section 338):

Revenue estimate: The Franchise Tax Board estimates that closing this loophole would raise \$50 million in 2008-09, \$65 million in 2009-10, and \$65 million in 2010-11.

Comments: Businesses can elect how to deal with gains from sale of assets differently for state and federal tax purposes. California requires that most elections be the same for state and federal purposes, but continues to allow this loophole which allows for income that is not taxed in any state.

E. Eliminate accelerated deduction for research and exploration costs (IRC section 174):

Revenue estimate: The Franchise Tax Board estimates that this change would raise \$390 million in 2008-09, \$300 million in 2009-10, and \$180 million in 2010-11.

Comments: There is little justification for permitting companies to accelerate their exploration costs, which provides no benefit to the state. This acceleration appears to benefit primarily oil and pharmaceutical companies.

F. Eliminate remaining loopholes for oil including the intangible drilling allowance and accelerated deduction of development/exploration (IRC sections 263/291 and 616/617):

Revenue estimate: The Franchise Tax Board estimates that this change would raise \$20 million in 2008-09, \$21 million in 2009-10, and \$17 million in 2010-11.

G. Eliminate capital gain break for sale of small business stock (LAO proposal):

Revenue estimate: The LAO estimates that this change would raise \$55 million in 2009-10.

Comments: There has never been any evidence that this tax break has led to any additional investment in California, or encouraged any venture capital which would not have been invested in any case.

H. De-link from Internal Revenue Service (IRS) ruling in bank bailout:

Revenue estimate: This would prevent an estimated revenue loss of \$300 million annually and potentially \$2 billion in losses over several years.

Comments: The IRS allowed banks to shelter income by using losses from acquired banks, in violation of the intent of the law to limit the use of losses from acquired companies.

I. Apply sales tax to digital downloads:

Revenue estimate: The Board of Equalization estimates that this tax change would raise \$114 million annually.

Comments: Under current law, identical products are treated differently for sales tax purposes depending on how they are delivered (e.g. downloaded music vs. cd's). There is no tax policy justification for this.

3. Majority Vote Revenues

A. Clarify sales tax nexus for online affiliates (i.e. Amazon):

Revenue estimate: The Board of Equalization estimates that this change would raise \$55 million a year, increasing over time.

Comments: Clarify definition of nexus to include an associate program that is located in state, as contained in the New York language, would force in state affiliates to collect sales tax. Amazon now collects sale tax on all orders in New York, and should do so in California. AB 1840 (Calderon) attempted to address this issue in a somewhat different manner.

B. Allow the Franchise Tax Board to use financial institution data matches to improve collections

Revenue estimate: This is estimated to raise \$35 million initially, \$100 million subsequently, per FTB estimate.

Comments: This proposal was removed from the Conference Committee budget and was also suggested by LAO. It allows the FTB to better locate assets of tax avoiders.

C. Require disclosure of disparities between book and tax income for corporations:

Revenue estimate: Likely to be \$50-100 million, potentially more, but unknown. Potentially, the difference between book and tax income is as much as \$500 million.

Comment: The Governor vetoed Legislation to require corporation to make a state filing on the difference between income reported to shareholders and income reported for tax purposes. State reporting could expose significant corporate tax sheltering.

D. Require Withholding on Independent Contractors/Penalize Failure To Issue Form 1099's:

Revenue estimate: The Franchise Tax Board estimates that this would raise \$100 million in 2008-09, \$270 million in 2009-10, \$400 million in 2010-11 and lead to a \$3.6 billion revenue acceleration in 2008-09. These estimates reflect the money that would be raise if a 5% income withholding rate were implemented.

Comments: The underground economy is a significant drain on revenue, and efforts to address it, such as amnesty in income tax payments and offers in compromise on child support payments, have been proposed but are only piecemeal fixes. This revenue is already due to the state, and the state has strengthened reporting for new hires of independent contractors. The state has not moved forward on a real enforcement program on independent contractors since the Wilson Administration proposed withholding of tax on payments to independent contractors in 1991. The proposal was later withdrawn.

E. Enact various collection proposals which failed last year:

- License suspension for tax debtors (AB 1925, Eng): \$13 million
- Conformity to federal back-up withholding (AB 1848, Ma): \$37 million
- Delete provision allowing lenders to collect sales tax refunds on worthless accounts (AB 1839, Calderon): \$42 million
- Use tax collection of income tax form (AB 1857, Eng): \$10-12 million

Comments: These are all reasonable collection proposals. See bill analyses for more detail.

4. Carbon Tax and Environmental Fees

A. Impose tax of \$20/ton on carbon dioxide emissions:

Revenue estimate: \$8 billion annually.

Comments: Economists have long argued that it is better to tax “bads” not goods—that is, tax the generation of pollution instead of the generation of income and products. California is currently examining a carbon permit fee, falling mostly on refineries and power plants, and potentially will auction carbon permits. At 400 million tons of carbon dioxide, a tax of \$20/ton would raise \$8 billion, and would translate to 18 cents per gallon of gasoline. There are a number of distributional questions, in terms of impacts on the poor, which would need to be mitigated. If this were done as a fee, it would be used to finance the costs of the transition to a lower carbon economy.

B. Fees on other pollutants

Revenue estimate: Hundreds of millions of dollars, up to \$1 billion annually.

Comments: There are a variety of fees on the emissions of pollutants which have been identified by environmentalists which can raise up to \$1 billion on the principle of polluter pays. These potentially can be used to pay for a variety of mitigation and program costs. If done as pollution taxes, they could contribute to the general fund.

C. Deductibility of employer-provided parking:

Revenue estimate: \$80 million annually

Comments: Employer costs for parking are deductible for the employer and excludible from income for the employee. A green tax policy should not provide incentives for individual commuting.

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