

Continuing Budget Crisis

What Should Employers Expect on Tax Front in 2012?

On January 10, 2011, just days after being sworn in to office, Governor Edmund G. Brown Jr. released his proposal to address the state's \$25.4 billion budget deficit, stating that, "For 10 years, we've had budget gimmicks and tricks that pushed us deep into debt. We must now return California to fiscal responsibility and get our state on the road to economic recovery and job growth."

His plan called for \$12.5 billion in spending cuts, elimination of the enterprise zone hiring credit, and a mandatory single sales factor. He also proposed placing a package of temporary tax extensions, originally enacted in 2009, on the ballot.

During his campaign, Governor Brown pledged that he would not raise taxes without a vote of the people. His stated preference was to gain the support of two-thirds of the Legislature to place the matter on the ballot, rather than pursuing the initiative route.

Ultimately, legislators were unable to come to agreement on comprehensive measures that would garner enough votes to get the Governor's tax extension proposal on the ballot.

Although the final budget package was technically balanced, and passed substantially earlier than those in recent years, it was far from an optimal solution. It relied on forecasts that tax receipts would continue to come in much higher than originally predicted, and built in just over \$2.4 billion in automatic cuts, mostly affecting education, should that revenue not materialize.

On December 13, 2011, the Department of Finance released its official budget forecast, which estimated that revenues would fall short by \$2.2 billion for the fiscal year, in turn triggering about \$980 million in automatic spending cuts. Starting in January 2012, these cuts will include \$100 million each to the University of California, California State University, developmental services, and In-Home Supportive Services, along with \$328 million in reductions to K-12 schools, mostly of subsidies for school transportation services.

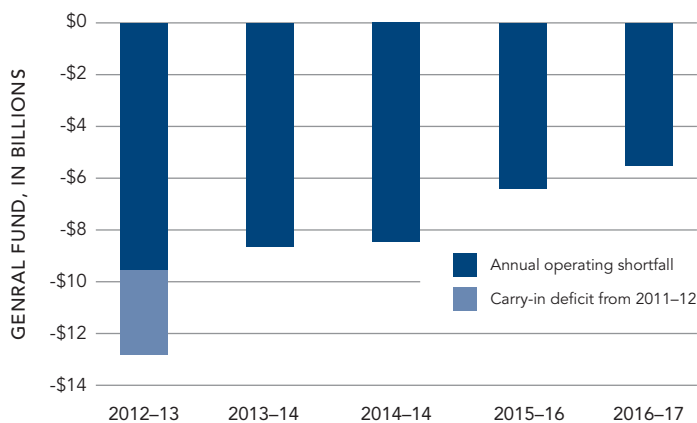
Also in late 2011, the Legislative Analyst's Office (LAO) released its fiscal outlook report, which forecasted that the state would see a year-end deficit of \$3 billion and a shortfall (given current revenue trends and statutory spending mandates) of \$10 billion for the 2012–13 fiscal year.

That number also assumes the state will prevail in litigation now pending in relation to several components of the June 2011 budget, including reductions to health and social services, and the exclusion of sales tax revenues from Proposition 98 calculations. If parts of the budget package are ultimately undone by court decisions, the deficit for 2012–13 could be even larger.

CalChamber Position

Whether tax increases are warranted at times of fiscal crisis, generally, should be decided on a case-by-case basis. If tax increases are warranted, the least harmful to the economy are those that are temporary, impose low rates, and are applied to a broad tax base.

Operating Shortfalls Decline Gradually Over Forecast Period



Source: Legislative Analyst's Office

Anticipated Tax Threats for 2012

Elective Single Sales Factor

Since January 1, 2011, employers have been allowed to elect annually between two formulas to determine their taxable sales for state income tax purposes. Before 2011, all businesses had been required to use a four-factor apportionment formula based upon their in-state sales (double weighted), in-state property, and in-state payroll, which, in some cases, punished employers with higher taxes when they invested more in the state.

The single sales factor (SSF) formula, on the other hand, looks solely at the proportion of a business' sales made in California when calculating its tax liability, and for many it lowers their tax liability and eliminates a disincentive to hire in California. Adoption of elective SSF preserved existing tax rates for many California businesses that would have had to pay higher taxes under the SSF formula, while spurring job growth for those who had been penalized under the old formula. In this way, the Legislature made clear it did not seek to raise taxes on some California employers in order to help others grow and invest here.

Ever since its adoption, however, elective SSF has been under attack. Although the policy was put into statute in February 2009, its implementation was delayed to postpone any potential revenue loss to the state. Then in 2010, a bill was introduced that would have made SSF mandatory, but it did not pass. In November 2010, voters also rejected Proposition 24, which would have repealed the election and forced all businesses to continue using the traditional four-factor approach.

The Governor's January 2011 budget proposal and his May Revision both included a plan to eliminate elective SSF, which would have cost California employers upwards of \$1.4 billion in tax increases over two years. In addition, several bills to mandate SSF were introduced, including ABX1 40 (Fuentes; D-Sylmar). This bill proposed to use tax revenues gained from elimination of the election to fund several incentives for other businesses in the state, as well as applying some of that money to help backfill the state General Fund. This is the first such bill to receive the two-thirds vote necessary to make it out of its house of origin. While ABX1 40 cleared the Assembly, it was never brought up for a vote on the Senate floor before the session adjourned, though the proposal could be considered again in 2012.

Besides the possibility of another legislative attack on elective SSF, a ballot measure was filed with the Attorney General in November 2011 proposing to eliminate the existing election and require all businesses to calculate their income using the SSF formula. Should the measure qualify and voters approve it, the resulting revenues would be used to fund energy efficiency projects in schools, colleges and universities.

CalChamber Position

The California Chamber of Commerce opposes punitive taxation that undermines economic development and stability of investments.

Enterprise Zones

Enterprise zone reform also was a part of the Governor's 2011 budget proposal, and similarly did not wind up as part of the final package, though it will likely remain a topic of discussion during 2012. California's enterprise zone (EZ) program offers the state's largest, most significant economic development tax incentives, broadly applying to businesses of all sizes across virtually all industry sectors. Established in 1984, it offers a variety of tax credits and other incentives to encourage businesses to locate, invest, and create jobs in economically distressed communities within the state, and both businesses and employees are eligible for benefits under the program.

By far the most significant part of the program is the hiring credit for businesses, which allows them to earn \$37,440 or more in state tax credits over a five-year period for each qualified employee hired. Governor Brown's first budget plan proposed to eliminate the hiring credit, including outstanding credits that had not yet been claimed, and would have cost employers more than \$900 million during 2011–12. The Governor's May Revision included a scaled-back proposal that would have limited the circumstances under which businesses could claim new hiring credits, and also would have shortened the period these credits could be carried forward to offset future tax liabilities. The hit to businesses would have been a smaller, but still significant, \$100 million over the same period.

This is by no means the first time the EZ program, and hiring credits in particular, have come under attack. In the October 2008 budget, AB 1452 (Committee on Budget, Chapter 763, Statutes of 2008) placed a two-year limit on the ability of businesses to use all business tax credits, including enterprise zone credits. The bill also capped use of the credits so that businesses can use them only to offset up to 50 percent, rather 100 percent, of their tax liability for each of the two years.

The next year, a CalChamber-led coalition defeated a bill that would have effectively gutted the California EZ program. AB 1139 (J. Pérez; D-Los Angeles) proposed new conditions and requirements that would have drastically reduced the number of businesses, particularly small businesses, that would have been able to participate in the EZ program.

In 2010, another attempt was made to significantly undermine the EZ program in SB 974 (Steinberg; D-Sacramento). This bill again proposed eliminating use of the EZ hiring credit for employees residing in targeted employment areas, and set even stricter constraints on the timeline under which an employer would have to apply

LAO General Fund Revenue Forecast (Dollars in millions)

Revenue Source	2010-11	2011-12 ^a	2012-13	2013-14	2014-15	2015-16	2016-17
Personal income tax	\$49,779	\$50,812	\$53,134	\$55,692	\$57,682	\$61,811	\$65,625
Sales and use tax	26,983	18,531	19,980	21,573	23,220	24,483	25,856
Corporation tax	9,838	9,483	9,432	9,958	10,806	11,316	11,492
Subtotals, "Big Three"	(\$86,600)	(\$78,826)	(\$82,546)	(\$87,223)	(\$91,708)	(\$97,610)	(\$102,973)
Percent change	7.3%	-9.0%	4.7%	5.7%	5.1%	6.4%	5.5%
Insurance tax	\$2,070	\$1,895	\$1,989	\$2,210	\$2,326	\$2,434	\$2,536
Vehicle license fee	1,330	80	5	-	-	-	-
Other revenues ^b	2,395	2,511	2,546	2,148	2,314	2,530	2,479
Net transfers and loans	1,897	1,451	-1,048	-1,126	-966	-235	-162
Total Revenues and Transfers	\$94,292	\$84,764	\$86,038	\$90,455	\$95,382	\$102,339	\$107,826
Percent change	8.3%	-10.1%	1.5%	5.1%	5.4%	7.3%	5.4%

^a Beginning in 2011-12, does not include funds redirected from the General Fund to the Local Revenue Fund (LRF) 2011. Sales and use tax funds deposited into the LRF in 2011-12 are estimated to total \$5.1 billion. Also, 2011-12 revenues are lower due to the expiration of temporary tax increases passed in 2009.

^b Does not include the resumption of estate tax revenues in 2012-13 and beyond.

Source: Legislative Analyst's Office

for the credit, in effect making them impossible to claim in some circumstances. The bill made it out of its house of origin before the coalition stopped it in the Assembly.

Many legislators have EZs that benefit their districts, and as such, have looked for ways to preserve the program but address some of the criticisms through legislative reforms. During the 2011 session, Assemblyman V. Manuel Pérez (D-Coachella) introduced several bills to enact a comprehensive reform package he has developed through a multi-year discussion with stakeholders on all sides of the issue, but none of these bills made it to the Governor. Pérez plans to pursue these proposals in 2012. Assemblyman Jerry Hill (D-San Mateo) also introduced AB 1278, which targeted a controversial use of the EZ hiring credit by a company in his district, but this bill, too, failed.

The EZ program remained a topic of conversation throughout the interim recess, and it is likely that it will be addressed during 2012 as part of the legislative and regulatory processes, if not as part of the budget.

CalChamber Position

The CalChamber opposes any attempt to undermine or retroactively limit access to the EZ program hiring credit. The CalChamber supports appropriate changes to the program that will increase the value of the economic development incentives for the state and for employers.

Net Operating Loss (NOL) Deductions Suspended

Another tax issue that could be revisited in 2012 is the suspension of two deductions that allow businesses

to offset their losses against past or future tax liabilities. In September 2008, the Legislature adopted two policies designed to promote more equitable taxation of businesses including the addition of an NOL carryback deduction, and an extension of the NOL carryover deduction from 10 to 20 years. Together, these deductions make it possible for businesses to more evenly distribute their losses, helping to moderate the effect of California's high corporate income tax rate, and to keep struggling businesses afloat.

In order to give the economy more time to recover, these changes were enacted with delayed implementation dates. Then in October 2010, faced with another huge deficit, the Legislature suspended both for two years for taxpayers with an annual income of \$300,000 or more. When lawmakers begin working on a 2012-13 budget solution, it is possible that these deductions will again become part of the conversation, as they are both set to take effect during the next budget cycle.

CalChamber Position

The CalChamber supports tax policies that help resolve inequities between taxpayers caused by the state tax structure. Elimination, suspension or reduction of the NOL deductions during difficult economic times places additional burdens on the businesses most needing to recover.

The CalChamber opposes frequent changes to tax policies, which create unpredictability for employers, undermine long-term investment in the state economy and, should long-term budgets remain unbalanced, create

pressure in out-years to prevent employers from using accumulated NOLs from preceding years.

Efforts to Sidestep Proposition 26

Proposition 26, which voters approved in November 2010, clarifies the definition of a tax and prohibits the practices of disguising tax increases as majority-vote fees or passing revenue-neutral tax increases by majority vote. The measure provides more certainty for business taxpayers, who often rely on the requirement that any tax increase be approved by a two-thirds vote to protect them when state revenues drop. With political wrangling over tax increases as contentious as ever, it is inevitable that legislators will continue to look for ways to generate revenue that sidestep the requirements of Proposition 26, or by arguing that Proposition 26 does not apply in certain situations.

In 2011, for example, the Legislature considered AB 832 (Ammiano; D-San Francisco), which would have increased the burden of proof for corporate taxpayers to show eligibility for a software tax exemption. Due to the complexities of trying to value personal property, this change would have, in effect, eliminated the tax exemption for most taxpayers, making it the functional equivalent of a tax increase. Based on Legislative Counsel's interpretation of Proposition 26, however, AB 832 was scored as a majority-vote bill. This bill got hung up in the Assembly during 2011, but is eligible to be heard in 2012.

For a more detailed discussion of Proposition 26 issues expected during 2012, including a pending ballot measure, see the next article.

Ballot Measures Proposing Business Tax Increases

In 2011, lawmakers were unable to agree on a plan to put tax increases on the ballot, or to pass significant revenue proposals through the legislative process. This forced them to rely heavily on cuts to state programs to balance the budget. The political gridlock over tax increases in the Legislature, combined with the toll resulting cuts have taken on important state programs, is expected to spur a large number of revenue proposals on the November 2012 ballot.

Although initiative campaigns can be very expensive, and tax proposals in particular tend to be unpopular with voters, with so much at stake in the coming year, many interest groups will still be willing to fund campaigns to protect their constituents. Businesses and high-income earners tend to make easier targets for ballot-measure tax increases, and as such, initiatives pose one of the most significant tax threats on the horizon for employers.

'Split Roll' Property Tax

One proposal that has been discussed repeatedly in recent years involves changing the treatment of commercial

property for property tax purposes, eliminating Proposition 13 protections for commercial properties and accelerating how often their value is reassessed. Proposals that use this approach are referred to as "split roll" proposals because they split the roll between residential and commercial properties.

Approved by voters in 1978, Proposition 13 capped property tax rates for both residential and commercial properties at 1% of the assessed value. It also prevents a property's assessed value from growing more than 2% a year. Only when ownership changes or there is new construction may the value of the property be reassessed at more than 2%. Any changes to Proposition 13 would require another ballot initiative.

Since the passage of Proposition 13, there have been numerous efforts to remove its protections from commercial properties like apartment buildings, commercial developments and industrial facilities. Legislatively, the biggest threat to Proposition 13 in 2012 is a bill introduced at the end of last year by Assemblyman Tom Ammiano (AB 448), which would redefine "change of ownership" for business properties in order to increase how often they are reassessed, increasing their property taxes as a result. This bill is substantially similar to Ammiano's AB 2498, which failed to receive the necessary votes for passage in 2010. Another proposal, an initiative recently filed with the Attorney General and aimed at the November 2012 ballot, would also split the roll between residential and commercial properties, and require reassessment of commercial properties on a set schedule, rather than according to a change in ownership or major renovations.

Depending on the type of proposal, a split roll could result in tax increases from \$3 billion to \$7 billion on the business community, which would have a huge impact on the ability of employers to invest in the state and create jobs going forward. According to a recent study by a former state legislative analyst, increasing property taxes on businesses by even 1% will lead to the loss of 43,000 additional jobs.

Contrary to claims by split roll proponents, income-producing properties already contribute significantly in tax dollars—generating approximately two-thirds of the property tax revenues, just as they did before the passage of Proposition 13.

Another problem with these proposals is that commercial property owners would be required to pass the increase in property tax on to their tenants and customers. Higher property taxes would result in higher rents for the thousands of California businesses (not to mention individuals) that lease their commercial space. Higher taxes and higher rents would also result in higher consumer prices, which would further slow the housing market and the state's economy.

CalChamber Position

The CalChamber opposes any attempt to erode

Proposition 13 protections for taxpayers. Imposing billions of dollars in new taxes on income-producing properties would harm California businesses and result in higher consumer prices and higher rents—all of which slows the economy.

Taxing High-Income Earners

In 2004, voters approved Proposition 63, which imposed a 1% tax on incomes of more than \$1 million to pay for state mental health services. In 2006, voters rejected Proposition 82, which would have imposed a 1.7% tax on individual income over \$400,000 to fund a universal preschool program. While these examples make clear that not all tax increases targeting high-income earners are destined to pass, they do highlight an increasingly popular approach to trying to pay for specific state programs—namely, targeting a small group of taxpayers at the ballot box. These proposals often are sold by proponents as taxes on the rich who can afford to pay more and currently do not pay their fair share. In reality, though, these proposals are, in many cases, a tax on small business owners, who frequently file their business taxes as individuals, but whose income is used to pay employees and cover other business expenses.

In 2011, two bills introduced in California specifically targeted high-income earners. AB 1239 (Furutani; D-South Los Angeles County), which may still be considered in 2012, increases California's tax rate from 9.3% to 10% for individual incomes over \$250,000 and joint incomes over \$500,000, and from 9.3% to 11% for individual incomes over \$400,000 and joint incomes over \$800,000. AB 1130 (Skinner; D-Berkeley) increases California's personal income tax rate from 9.3% to 10.3% for incomes of \$500,000 or more. Several state ballot measures also have been filed proposing tax increases for high-income earners (see details below).

At the same time, Congress is struggling to identify a balanced approach to tax reform that will produce sustainable revenue, but yet not overburden citizens who are already financially strapped with this depressed economy. One idea that is receiving increasing attention is a national tax increase on high-income earners.

Although proposals like these often are popular with the majority of taxpayers who do not fall in the top tax brackets, others argue that targeting high-income earners can cause unanticipated problems at both the state and national levels. For example, opponents of these proposals argue that the income of high-income earners is more susceptible to sharp inclines as well as sharp declines because the sources of their income, such as capital gains, dividends and business-related income, are unpredictable. Revenue from any increased tax rate would rise and fall according to this volatility, leaving the state and federal governments to backfill government program funding during an economic downturn, when they are least able to do so.

Opponents also argue that, based upon statistics at the federal and state levels, high-income earners already pay their fair share of the tax burden. Recently, the Internal Revenue Service released data regarding individual income taxes for 2009. According to the data provided, the top 1% of earners in the country had an adjusted gross income of \$343,947 or more, which was 10% lower than in 2008. The top 1% of earners accounted for 36.7% of all federal personal income taxes paid. The top 5% of earners in 2009 earned \$154,643 or more and paid 58.7% of the federal individual income taxes received. Not accounting for any credits, exemptions or deductions, the 2009–2010 federal income tax rate on the top 1% was between 33% and 35%, and the tax rate for the top 5% of earners was 28%.

In January 2011, the LAO released its Cal Facts report showing that the top 1% of earners in California since 2005 paid approximately 45% of the total personal income tax in the state. In 2000, at the height of the technology boom in California, the top 1% paid an even larger 50% of the total personal income tax collected. Overall, personal income in California declined by 2.4% in 2009, the first decline since 1938. Currently, California imposes a 9.3% personal income tax for income over \$44,814.

Finally, state income tax hikes targeting high-income earners can backfire because these taxpayers are more mobile and can choose to relocate if a state tax system becomes punitive or uncompetitive.

June Ballot Tax Increase Proposal

One proposal set for the June 2012 ballot is a tobacco tax increase. It would impose a 5-cent tax on each cigarette and an equivalent tax on other tobacco products to fund cancer and disease research and prevention.

Other Possible Ballot Box Tax Increases

In addition to the ballot proposals referenced above on split roll, SSF, Proposition 26 and tobacco products, several other measures may wind up on the November 2012 ballot. The following proposals have either qualified for the ballot already, or were at some stage in the initiative approval process as this *Guide* went to print.

- **Governor's Proposal:** To help fund state programs, including education, the plan divides the top income bracket into three brackets and retroactively raises the rates for those brackets by 1%, 1.5% and 2% respectively. It also imposes a half-cent sales tax increase. Both proposals would expire after 2016.

- **Think Long Proposal:** Imposes a sales tax on most services, eliminates most tax credits and all itemized tax deductions, lowers the personal and corporate income tax rates, and makes SSF mandatory to increase General Fund revenues to benefit all state programs.

- **Income Tax Increases:** Two proposed initiatives

Employer Tax Law and Changes of 2008–2011

September 2008 Budget—\$7.4 Billion Over 2 Years

1. **Corporate Understatement Penalty Punishes Reasonable Tax Disputes (SBX1 28):** Estimated to raise more than \$2.5 billion from employers as of June 1, 2009. Effective: Retroactive to 2003, May 31, 2009 “amnesty” deadline, permanently thereafter.
2. **50% Limit on Research and Development Tax Credit and Enterprise Zone Program Credits (AB 1452):** Estimated to raise \$900 million from employers. Effective: Tax years 2008 and 2009.
Offsetting Improvement: **Tax credit sharing (SBX1 28).** Effective: January 2010 and permanently thereafter.
3. **Full Suspension of Net Operating Loss Deduction (AB 1452):** Estimated to raise \$1.6 billion over two years. Effective date: Tax years 2008 and 2009.
Offsetting Improvement: **2-Year Carryback and Expanded 20-Year Carryover (from 10 years)** in partial conformity with federal law. Effective: January 2011 and 2010, respectively, and permanently thereafter.
4. **Accelerated Estimated Tax Payments (SBX1 28):** Estimated to accelerate \$2.3 billion over two years. Effective: January 2009 and permanently thereafter.
5. **Accelerated Limited Liability Company Fee and New Penalties (AB 1452):** Estimated to accelerate \$360 million from employers. Effective: January 2009 and permanently thereafter.

February 2009 Tax Increases—\$12.5 Billion Over 2 Years

1. **Sales and Use Tax Rate Increase of 1% (ABX3 3):** Estimated to raise over \$6 billion (\$2.4 billion from employers). Effective: April 1, 2009 for two years.
2. **Vehicle License Fee Increase (ABX3 3):** Estimated to raise \$1.7 billion (\$425 million from employers). Effective: May 19, 2009 for two years.
3. **Personal Income Tax Rate Increase of 0.25% (ABX3 3):** Estimated to raise \$6 billion (\$2 billion from employers). Effective: January 1, 2009 for two years.
4. **Tax Apportionment Changes (ABX3 15):** Estimated to raise unspecified sum in the millions from employers. Effective: January 1, 2011 and permanently thereafter.
Offsetting Improvements:
Elective Single Sales Factor (ABX3 15). Effective: January 1, 2011 and permanently thereafter.
Motion Picture Credit (ABX3 15). Effective: January 1, 2011, but applies to tax years 2009 through 2013.
Small Business Hiring Credit (ABX3 15). Effective: January 1, 2009 until \$400 million used up.

July 2009 Budget—\$3.5 Billion Over 2 Years

1. **Accelerated Estimated Tax Payments (ABX4 17):** Estimated to accelerate \$700 million. Effective: Tax years 2009 and 2010.
2. **10% Income Tax Withholding Increase (ABX4 17):** Estimated to accelerate 1.8 billion. Effective: November 1, 2009 and permanently thereafter.
3. **Backup Withholding Mandate (ABX4 18):** Estimated to raise \$64 million. Effective: January 1, 2010 and permanently thereafter.
4. **Use Tax Registration/Reporting (ABX4 18):** Estimated to raise \$149 million. Effective: April 15, 2010 and permanently thereafter.

February 2010—No Additional Tax Revenues From Employers

October 2010—\$1.6 Billion Over 2 Years

1. **Full Suspension of Net Operating Loss Deduction (AB 1618):** Estimated to raise \$1.2 billion over two years. Effective date: Tax years 2010 and 2011.
Offsetting Improvement: **Safe Harbor for Corporate Understatement Penalty (AB 1618):** Estimated to save taxpayers \$130 million over two years. Effective: Taxable years beginning on or after January 1, 2010.
Offsetting Improvement: **Fix for Sourcing of Intangible Goods (AB 1618):** Estimated to save taxpayers \$123 million over two years.
2. **Board of Equalization Cost Recovery Fees (AB 1618):** Estimated to raise \$4.8 million–\$5.9 million in 2011 if implemented in April, and \$18 million–\$20.6 million annually starting in 2012.

March 2011—\$300 Million Over 2 Years

1. **Voluntary Compliance Initiative 2—Abusive Tax Avoidance Transactions (SB 86):** Estimated to accelerate approximately \$260 million in 2010–11.
Financial Institution Record Match (SB 86): Estimated to generate \$10 million in 2010–11, and \$30 million in 2011–12. The first data exchange with financial institutions shall occur no earlier than April 1, 2012.

increase income tax rates on high-income earners to fund education. The California Federation of Teachers plan raises rates 3% for income between \$1 million–\$2 million, and 5% for income over \$2 million. Another proposal increases income tax rates for most Californians using a sliding scale to more heavily target those with higher incomes.

- **Oil and Gas Severance Tax:** Two proposed initiatives impose a tax on oil and gas severance (at 10% or 15%) to fund education programs.

If all these tax proposals were to appear on the November ballot and pass, they would impose overlapping tax increases on some taxpayers.

CalChamber Position

The CalChamber opposes industry-specific taxes because they force one class of earners to bear primary financial responsibility for programs that benefit all Californians. In addition, industry-specific taxes kill jobs in targeted industries. To the extent that most recent service-tax proposals have targeted specific sectors of the service economy, they would have a similarly negative impact on the economy as an industry-specific tax.

Targeting Business Tax Incentives

In 2011, the Legislature revisited several tax bills designed to provide transparency and accountability for business tax incentives, and it is likely that more bills like these will be proposed in 2012. Tax credits are mechanisms purposefully created by the Legislature to encourage certain behaviors by employers, and otherwise offset the state's above-average tax rate. In recent years, though, skeptics have become more aggressive about characterizing tax credits as inadvertent "loopholes," and have sought to reduce and/or eliminate many of them to help fund other programs. One such bill, SB 508 (Wolk; D-Davis), required that all future tax credits include an automatic sunset provision.

A nearly identical bill was vetoed in 2010 by then-Governor Arnold Schwarzenegger. Governor Brown similarly vetoed SB 508, stating the Legislature should examine all of its bills on a case-by-case basis to determine how long they should exist, if at all.

Another repeat bill idea showed up in 2011, AB 318 (Skinner; D-Berkeley), seeking to create a publicly searchable database with information about companies and the various tax incentives they utilize. Although the CalChamber supports the goals of increasing transparency for all government programs and expenditures, most of the information this bill sought to provide is already available to the public and/or the Legislature through annual reports published by the state Department of Finance and the Franchise Tax Board. In addition, the new database it proposed to create would have provided the required information without any context, stigmatizing California employers who make legitimate use of tax incentives to provide jobs. This bill

stalled early on in the session and was amended to address a different policy issue at the start of 2012.

In 2011, Senator Leland Yee (D-San Francisco) also took another run at imposing a penalty on businesses that claim tax credits but do not maintain a net increase in employment year over year. SB 364 did ultimately make it to the Governor, unlike its predecessor in 2010, but it was vetoed. It is unclear if Senator Yee will revisit this idea for a third time during 2012.

CalChamber Position

The CalChamber believes the Legislature should take time to periodically review the effectiveness of all state expenditure and incentive programs, and eliminate or modify those that do not benefit the economy. The CalChamber supports policies that address tax credits on a case-by-case basis, and that narrowly tailor changes to avoid making these incentives unpredictable for employers.

The CalChamber supports genuine improvements in transparency in all areas of government, but opposes legislation that unnecessarily undermines taxpayer privacy, unfairly increases reporting burdens for employers, or that creates a biased picture of how the tax system affects a particular group or industry.

Recent Legislative Tax Changes Affecting Employers

As predicted by the CalChamber in the *2011 Business Issues and Legislative Guide*, lawmakers tackled several tax issues affecting California employers in 2011.

Tax Amnesty

In March, in order to address impending cash flow problems and buy time for bipartisan budget talks to take place, the Legislature passed, and Governor Brown signed, SB 86 (Committee on Budget and Fiscal Review), which established the Financial Institution Record Match (FIRM) program, and a new voluntary compliance initiative (VCI 2), a tax amnesty program, targeting companies that engaged in certain types of transactions before January 1, 2011. Together these items were predicted to cost California employers \$300 million over two years.

Although the adoption of the FIRM program went largely unopposed by the business community, VCI 2 was a more controversial budget fix because it made retroactive changes to the tax code, and then forced taxpayers to report and pay "back taxes" on their earlier transactions to avoid penalties. The Franchise Tax Board reports that the program produced \$350 million in revenues for the state during the amnesty window in 2011, but taxpayers who opted in to the amnesty program still will be eligible to seek refunds for any amounts that they overpaid in order to avoid penalties imposed by the law. If some of those funds eventually are returned to taxpayers, they will have

served as an interest-free loan to the state in the meantime. Repayment of those “loans” could also, subsequently lead to budget shortages in future years.

CalChamber Position

The CalChamber opposes tax amnesty programs that trap law-abiding taxpayers into overpayments to avoid harsh penalties and lost rights.

Tax Collection for Out-of-State Purchases

Another issue that has been heavily contested in recent years, and which was finally put to rest during the 2011 legislative session, involved tax collection for Internet purchases. The tax subject to so much debate is the use tax, the equivalent of sales tax, but which is applied to out-of-state purchases. Unlike sales tax, which is collected by retailers at the time a purchase is made, use tax is supposed to be paid by individuals and businesses on their annual income tax forms. Because of constitutional restrictions, states have a limited ability to require out-of-state retailers to collect state sales tax, but individuals are notoriously bad at reporting their own use taxes, and enforcement of the use tax obligation against individuals is very costly and inefficient for state tax collection agencies.

Specifically, the U.S. Constitution requires an out-of-state retailer to have a physical connection, or nexus, to a state before that state may require the retailer to collect its sales and use tax. States that want to require out-of-state retailers to collect use tax from consumers must therefore find ways to establish nexus between those retailers and the state.

California legislators began working on use tax enforcement in earnest during 2008 by proposing to define “nexus” as use of an in-state server, thereby forcing out-of-state retailers to collect California use tax if they used in-state servers to interact with customers. Although the approach purported to target out-of-state sellers, it had the potential to cause significant harm to California server companies and no bill ever made it to the Governor.

Three bills in 2009 all proposed language that would have created nexus for any out-of-state retailer that entered into a referral agreement with a California resident in exchange for compensation or commission, such as by a link, website, or other advertisement. Like the 2008 approach, these bills posed a threat to many in-state businesses, including advertisers and web-based marketplaces that feared they would lose revenue if out-of-state retailers severed their ties in California to avoid having to collect the tax. One bill, SBX3 17 (Ducheny; D-San Diego), did make it to the Governor, but was vetoed when Overstock.com threatened to pull all of its advertising relationships with California affiliates.

In 2010, the Legislature considered AB 2078 (C. Calderon; D-Montebello), which proposed to establish nexus for an out-of-state retailer that was in the same

controlled group of corporations as another in-state business. In addition, it would have required out-of-state retailers without nexus to post a notice on their websites to educate Californians about their use-tax obligation, and to report detailed information about individual purchases by Californians on a quarterly basis to the Board of Equalization. This bill raised numerous, serious constitutional and privacy issues, would have been difficult to implement, and ultimately failed passage.

Finally, in 2011, AB 155 (C. Calderon; D-Montebello) became law in California, and large out-of-state retailers will now be required to collect California use tax from California customers starting in late 2012 or early 2013. This was a hard-won compromise between in-state and out-of-state retailers, and many other in-state businesses that had been caught in the middle by prior proposals. AB 155 establishes California nexus for an out-of-state retailer if that retailer 1) has a subsidiary in the state where there is at least 80% ownership, or 2) has a sales referral source located in the state that refers at least \$10,000 in sales to the retailer annually AND has at least \$1 million in annual total sales to California residents.

CalChamber Position

The CalChamber is supportive of efforts to improve enforcement of the individual obligation to report use taxes to the state, and believes more can be done to educate individuals about their obligation to remit this tax. To the extent that this is a federal issue, the CalChamber is supportive of efforts by Congress to create a uniform law that will allow retailers to compete fairly in all 50 states.



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