



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date:	04/17/12	Bill No:	<a href="#">Assembly Bill 2638</a>
Tax Program:	Sales and Use	Author:	Eng
Sponsor:	State Controller	Code Sections:	GC 13305 & 13305.5
Related Bill:		Effective Date	01/01/13

### BILL SUMMARY

This bill requires the Department of Finance's (DOF) current tax expenditure reporting to include the year that a tax expenditure was enacted and the anticipated revenue loss for that expenditure. It also requires the Board of Equalization (BOE) and the Franchise Tax Board (FTB) to submit to the DOF and the Legislature a report on tax expenditures from sales and use tax, personal income tax, and corporation tax, by January 10<sup>th</sup> of each year to coincide with the Governor's Budget. The report would be limited to tax expenditures with an annual revenue loss of at least \$5 million (\$5,000,000).

#### Summary of Amendments

Since the previous analysis, this bill was amended to: (1) specify that the BOE shall report on tax expenditures from sales and use tax only, and (2) limit the report to tax expenditures with an annual revenue loss of at least \$5 million.

### ANALYSIS

#### CURRENT LAW

Since 1971, pursuant to Section 13305 of the Government Code, the DOF has been required to provide a tax expenditure report to the Legislature. Chapter 1762, Statutes of 1971, required that a biennial report be submitted to the Legislature and that the report include the following: a comprehensive list of tax expenditures, additional detail on individual categories of tax expenditures, and historical information on the enactment and repeal of tax expenditures. Chapter 268, Statutes of 1984, increased the reporting frequency from once every two years to once a year.

Effective January 1, 2007, Assembly Bill 1809 (Chapter 49, Statutes of 2006, Committee on Budget) modified the report to require the DOF to provide a report to the Legislature by September 15 of each year on each tax expenditure exceeding \$5 million annually. A tax expenditure is defined as a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by state law. The required report is to include each of the following:

- The statutory authority for each tax expenditure.
- A description of the legislative intent for each tax expenditure, where the act adding or amending the expenditure contains legislative findings and declarations of the intent, or such intent is otherwise expressed or specified by the act.
- The sunset date of each tax expenditure, if applicable.
- A brief description of the beneficiaries of the tax expenditure.
- An estimate or range of estimates for the state and local revenue loss for the current fiscal year and the two subsequent fiscal years. For sales and use tax expenditures,

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this would include partial year exemptions and all other tax expenditures when the BOE has obtained such information.

- For sales and use tax and personal and corporation tax expenditures, the number of returns filed or taxpayers affected, as applicable, for the most recent tax year for which full year data is available.
- A listing of any comparable federal tax benefit, if any.
- A description of any tax expenditure evaluation or compilation of information completed by any state agency since the last report made under this section.

#### **PROPOSED LAW**

This bill would add Section 13305.5 to the Government Code to require, at the time of submission of the Governor's budget, within the first 10 days of each calendar year, that the BOE and FTB submit to the DOF and the Legislature a report on the fiscal and tax effect of tax expenditures from sales and use tax, personal income tax, and corporation tax. The report shall be limited to tax expenditures with an annual revenue loss of at least \$5 million (\$5,000,000). To the extent allowed under federal law, the report shall include the most recent data to characterize the economic, tax, and demographic profile of claimants, including, but not limited to, the following:

- An estimate or range of estimates for the state and local revenue loss for the current fiscal year and the two subsequent fiscal years. For sales and use tax expenditures, this shall include partial tax exemptions and all other tax expenditures when the BOE has obtained that information.
- If available, anticipated revenue loss pursuant to the final fiscal committee analysis of the act that established the tax expenditure, adjusted for inflation.

For sales and use tax expenditures, the report shall identify to the extent possible, at a minimum, the revenue loss, for the most recent tax year for which full year data is available, and estimated revenue loss for the current state fiscal year and subsequent fiscal year by industry code.

The report shall also include the following information for each of those tax expenditures:

- (A) For the most recent taxable year for which a full year of data is available, average, median, highest, and lowest amounts claimed, by taxpayer liability.
- (B) For the most recent taxable year for which a full year of data is available, amounts claimed and, as of the time the report is prepared, amounts disallowed.
- (C) Where deemed appropriate by the BOE, citations of academic studies pertaining to the tax expenditure or similar tax expenditures.
- (D) Usage data, where available, for the same or similar tax expenditures adopted by other states with similar economics, business entity types, and tax laws.
- (E) Any other distinguishing tax characteristics, including, but not limited to, other tax expenditures claimed.

However, the BOE shall report this information only to the extent that the BOE is in possession of this information. The information may reflect BOE staff estimates or taxpayers' self-reported data.

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When filing the required report, the BOE and FTB will provide sufficient data to support a subsequent analysis of the revenue loss for the tax expenditure.

For the purpose of this new section, “tax expenditure” means a credit, deduction, exclusion, exemption, or any other tax benefit as provided by the state.

The measure would also amend Section 13305 to require the DOF to provide the year of enactment for each tax exemption and the annual tax expenditure report due to the Legislature to include, if available, the anticipated revenue loss pursuant to the final fiscal committee analysis of the act that established the tax expenditure, as adjusted for inflation.

#### BACKGROUND

There have been several bills introduced in recent years related to tax expenditure reports. These include:

**AB 831 (Parra, 2007)** required that on and after January 1, 2008, any legislative measure creating a new tax expenditure, or extending the operation of an existing tax expenditure, would include a repeal of the expenditure in a manner that reflects the needs and conditions of the proposed expenditure. This bill would have defined a “tax expenditure” as a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by state law. The measure died in the Senate Revenue and Taxation Committee.

**AB 1933 (Coto, 2006)** would have required: (1) the DOF to review, over a 10-year period, all tax expenditures in excess of \$1 million that were in existence since January 1, 2007, as specified; and (2) that any legislative measure creating a new tax expenditure, or extending the operation of an existing tax expenditure, meet certain requirements, as specified. This bill failed passage in Senate Revenue and Taxation Committee.

**AB 168 (Ridley-Thomas, 2005)** would have required: (1) the BOE and the FTB to each provide to the Legislature, the DOF, and the Legislative Analyst Office (LAO) a report, based on a static revenue analysis, of the estimated revenue losses attributable to each tax expenditure, to the extent feasible, that produced a revenue loss in excess of \$25 million in the prior fiscal year; (2) the DOF to provide, biennially, to the Legislature and the LAO, a report, based on a dynamic revenue analysis, of the estimated revenue losses attributable to tax expenditures that produced revenue losses in excess of \$25 million, as specified; (3) the LAO to review the reports and make recommendations to the Legislature as to which tax expenditures should be modified or repealed.

AB 168 was vetoed by Governor Schwarzenegger because:

“The Department of Finance and the Legislative Analysts Office currently have broad authority to review and report tax expenditures to the Legislature. This bill’s restatement of the existing tax reporting requirements is redundant and unnecessary.”

**AB 735 (Arambula, 2005)** would have: (1) required the LAO to establish a process to review all tax exceptions and submit a report to the Legislature by December 31, 2006; (2) required the LAO to review and analyze any relevant reports prepared by the DOF and request assistance from the BOE and the FTB in order to make the report as comprehensive as possible; and (3) directed the Assembly and Senate Revenue and Taxation Committees to review the report submitted by the LAO and authorize them to

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select a group of tax exceptions for deletion or modification, reporting their recommendations to the fiscal committees for consideration during the budget process. This bill was never heard by a committee.

**SB 577 (Figueroa, 2005)** would have, among other things, required the DOF, in consultation with the BOE and the FTB, to report to the Legislature by January 1, 2008, on the effectiveness of “tax expenditures,” as defined. This provision was amended out of the bill.

**AB 2106 (Ridley-Thomas, 2004)** would have, among other things, required the DOF, in conjunction with the Governor’s Budget, to submit to the Legislature a report of tax expenditures currently in effect. The bill would have specified, among other things, based on information provided by the BOE to the extent feasible, that the report include the number of tax returns or taxpayers affected by any sales or use tax expenditure, the distribution of that expenditure, and the size and type of business or industry to which that expenditure is made available.

AB 2106 was vetoed by Governor Schwarzenegger and the veto message states:

“Under existing law, the Department of Finance already is required to provide an annual tax expenditure report to the Legislature containing specific information. This bill changes the type of information that is provided in the annual report. However, some of the information that Department of Finance would be required to report is not available. For example, the original intent of a given tax expenditure is often not clearly defined in the enabling statute. In addition, the number and income distribution of taxpayers benefiting from sales tax exemptions would not be known because this information is not required to be reported by retailers when filing their tax returns. Furthermore, some of the information might not be available for reporting to the Legislature because of existing confidentiality requirements.”

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the State Controller. According to the author’s office, this bill is intended to make the costs and reporting of tax expenditures more transparent and relevant to the budget process to determine the impact these tax expenditures have on state revenues and if they cost more or less than originally expected when adopted.
2. **The April 17, 2012 amendments** (1) specify that the BOE shall report on tax expenditures for the sales and use tax only, (2) specify that the report shall be limited to tax expenditures with an annual revenue loss of at least \$5 million, (3) delete the requirement to identify the revenue loss for tax expenditures by region, (4) replace requirements to report expenditure data for “the prior year, current year, and budget year” with “the most recent tax year for which full year data is available, and estimated revenue loss for the current state fiscal year and subsequent fiscal year”, and (5) make other clarifying and technical changes.
3. **DOF annual tax expenditure report.** BOE staff currently provides information to the DOF regarding tax expenditures, which is used in the DOF’s annual tax expenditure report. The most recent report is for the fiscal year [2011-12](#).
4. **The bill would require the BOE to only report on sales and use tax expenditures with an annual revenue loss of at least \$5 million.** The report would identify, to the extent possible, a three-year estimate of the revenue loss for

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tax expenditures by industry code. Information about each tax expenditure would also include (1) one-year data of the average, median, highest, and lowest amounts claimed, by taxpayer liability; (2) one-year data of amounts claimed and amounts disallowed; (3) citations of academic studies pertaining to tax expenditures; (4) usage data, where available, for the same or similar tax expenditures adopted by other states with similar economics, business entity types, and tax laws; and (5) any other distinguishing tax characteristics. The bill specifies that the BOE would report the information required only to the extent that the board is in possession of such information.

#### 5. **Administrative considerations.**

- The bill requires the report to include information on the average, median, highest, and lowest amounts claimed, by taxpayer liability. The BOE has this information but only on the tax expenditures for which there is a separate line on the return (see comment 7). In addition, it is our understanding that the purpose of this provision is to provide information on the amount of claimed tax expenditures in relation to the size of a business. However, the provision may not accomplish the author's intent since tax liability for sales and use tax expenditures is not necessarily a measure of business size. There are many manufacturing and wholesale distribution businesses that actually make a small amount of taxable sales and consequently report a small amount of sales tax on their returns. BOE staff suggests amending the bill to provide data on tax expenditures based on total (gross) sales. BOE staff will work with the author's office to draft language that accomplishes the author's intent.
- The bill requires the report to include for the most recent taxable year for which a full year of data is available, amounts claimed and, as of the time the report is prepared, amounts disallowed. The BOE does not track tax expenditures disallowed through return processing or audit. Since the bill states the information on sales and use tax expenditures shall be provided, "only to the extent that the board is in possession of that information," the provision would not require the BOE to redesign its current system to capture this data. If in the future such information is collected, then providing this requested breakdown would not be a problem.

#### 6. **Technical amendments.** Recommended technical corrections are provided as follows:

- On page 3, line 37, substitute "fiscal" for "tax" after "most recent"
- On page 4, line 6, substitute "fiscal" for "taxable" after "most recent"
- On page 4, line 9, substitute "fiscal" for "taxable" after "most recent"

#### 7. **The following details some of the information currently available based on taxpayer reports.**

**Sales and Use Tax Expenditure Reporting.** In general, revenue estimates and expenditure data for the Personal Income Tax and Corporation Tax Laws are easier to quantify than for the Sales and Use Tax Law. Personal income and corporation tax returns contain significant detail information regarding different sources of income and types of exemptions, exclusions, deductions, and credits claimed. Thus, tax return data are often available when estimating the fiscal impact of various income and corporate tax expenditure programs. In contrast, returns filed by

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taxpayers under the Sales and Use Tax Law [www.boe.ca.gov/pdf/boe401a2.pdf](http://www.boe.ca.gov/pdf/boe401a2.pdf) contain little information regarding tax expenditures.

As shown in the linked sales and use tax return, some of the more common tax expenditures allowed under the Sales and Use Tax Law are separately identified on the return itself for purposes of allowing taxpayers to claim the deduction. These include deductions for sales of food products, sales to the U.S. Government, sales in interstate or foreign commerce, and nontaxable labor (note, the law contains numerous other tax exemptions and exclusions not separately identified on the return).

However, instead of actually itemizing these deductions, many taxpayers simply report their taxable sales, netting out any exempt sales. Any attempt to capture the amount of exempt transactions would require a much more detailed and extensive tax return and would require a very large effort from taxpayers to report such detail for these transactions.

Consequently, return information does not capture specific data on the myriad of tax exemptions and exclusions provided under the law and is not a reliable source to use in making estimates of revenue losses attributable to those exemptions and exclusions. As such, the BOE generally relies on independent data sources when estimating the revenue impacts of various sales tax expenditure programs.

**Partial Sales and Use Tax Expenditure Reporting.** The exception to this is for partial exemptions. The BOE currently requires the taxpayer to specify the amount of those exemptions that apply to only a portion of the combined state and local sales and use tax. There are currently five such exemptions in effect:

- Teleproduction Equipment
- Farm Equipment
- Diesel Fuel Used in Farming and Food Processing
- Timber Harvesting Equipment and Machinery
- Racehorse Breeding Stock

Sales of these items are exempt from a portion of the state sales and use tax. Local and special district sales and use taxes continue to apply. In order for a taxpayer to claim these partial exemptions, they must report the amount of the transactions that are subject to the partial exemption. For these partial exemptions, the BOE knows how much is being claimed as well as how many retailers are claiming the partial exemption.

**Consumer Use Tax Expenditure Reporting – Vehicles, Vessels and Aircraft.** There are several exemptions or exclusions from the use tax for purchases of vehicles, vessels and aircraft. Some of the major tax exemptions are on purchases involving the following: vehicles, vessels or aircraft used in interstate or foreign commerce; aircraft used as a common carrier; vehicles, vessels, and aircraft purchased for use outside California; and vessels purchased for use in commercial deep-sea fishing.

For these exemptions, there is a separate line on the consumer use tax return. However, some taxpayers do not submit a return to the BOE. When the taxpayer has not submitted a return to the BOE, a determination (billing) is issued to the taxpayer. Once the taxpayer receives the billing, they contact the BOE and request a claim for exemption from the use tax. The BOE's Consumer Use Tax Section

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(CUTS) processes all claims for exemptions from the use tax on purchases of vehicles, vessels, and aircraft. The CUTS collects and maintains data on such claims for exemption. Thus, information regarding certain consumer use tax expenditures on purchases of vehicles, vessels, and aircraft is available. However, it should be noted, that the information is not easily accessible, and in some cases it would require manual extraction of the data, including verifying the data for accuracy.

8. **The BOE's Publication 61, *Sales and Use Taxes: Exemptions and Exclusions*, provides a detailed listing of various exemptions and exclusions from the sales and use tax.** The publication has two listings: one by category and another by alphabetical reference. The listings provide a brief general description of the exemption or exclusion, including the statutory authority. The listing by category also provides an estimate of the revenue loss for the exemption or exclusion, if available. As previously stated in Comment 6, a revenue loss for a particular tax expenditure is not always possible to quantify.

### **COST ESTIMATE**

As explained previously, the BOE does not capture reliable data on tax expenditures from tax returns or from taxpayers, other than that obtained on the five partial tax exemptions. The bill states that the BOE would provide a report for sales and use tax expenditures only with an annual revenue loss of at least \$5 million when the BOE has obtained that information. It is assumed that the BOE's report would contain information that we currently obtain from returns, and for all other tax expenditures, the BOE would estimate the revenue losses using independent sources. Based on that assumption, any costs associated with this bill would be minor and absorbable.

### **REVENUE ESTIMATE**

This bill would not in itself directly impact revenues.

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