STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**04/17/07**	Bill No:	**AB 831**
Tax:	**Sales and Use Special Property**	Author:	**Parra**
Related Bills:			

BILL SUMMARY

This bill would require the Department of Finance (DOF) to review, over a 9-year period, and provide a report of the review to the Legislature, all tax expenditures in excess of $5 million that are in existence on or after January 1, 2008. This bill would also require that any legislative measure creating a new tax expenditure, or extending the operation of an existing tax expenditure, to meet certain requirements, as specified.

Summary of Amendments

Since the previous analysis, this bill was amended to: 1) require that the review include additional information on each tax expenditure, including, but not limited to, the statutory authority and description of the legislative intent, and information on sales and use tax expenditures, as specified; 2) for sales and use tax expenditures, specifies that an estimate of the revenue loss include partial year exemptions and all other tax expenditures when the Board has obtained that information; and 3) clarified that the review would be conducted over a 9-year period, rather than a 10-year period.

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 DOF annual report to require them to provide a report to the Legislature by September 15th 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 tax expenditures.
- A description of the legislative intent for a 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 tax expenditures, 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, this would include partial year exemptions and all other tax expenditures when the Board 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 the DOF to review all tax expenditures that exceed $5 million per calendar year that were in existence on or after January 1, 2008, as follows:

1) Review 10 percent of the total tax expenditure programs or mechanisms by July 1, 2008;
2) Review 10 percent of the tax expenditures by July 1 of each of the succeeding nine calendar years, so that all of the tax expenditures have been reviewed by July 1, 2017;
3) Require that the review include all of the following:
   - The statutory authority;
   - A description of the legislative intent, 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, 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, this would include partial year exemptions and all other tax expenditures when the Board 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;
   - An evaluation of the benefits attributable to each tax expenditure relative to the revenue losses; and,
   - A recommendation to the Legislature as to how to modify or repeal the tax expenditure.

This bill would also require 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 the following:

1) A legislative finding and declaration of the purposes to be served by the tax expenditure;
2) An estimate of the revenue losses attributable to each tax expenditure;
3) A specific methodology for measuring the state's return on the investment to be provided by the tax expenditure, including performance criteria that establish minimum benefits and maximum costs for retaining the tax expenditure;
4) A repeal of the expenditure on a date no later than five years after the effective date of the measure.

This bill would define a "tax expenditure" as a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by state law.

BACKGROUND

There have been several bills introduced during the last few years related to tax expenditure reports. These include:

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) any legislative measure creating a new tax expenditure, or extending the operation of an existing tax expenditure, to 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 Board and the Franchise Tax Board (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 and the veto message states:

> "The Department of Finance and the Legislative Analysts Office currently have broad authority to review and report tax expenditures to the Legislature. This bills 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 Board 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 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 Board 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 that, among other things, based on information provided by the Board to the extent feasible, 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 American Federation of State, County, and Municipal Employees. According to the sponsor, while the annual tax expenditure report prepared by the DOF provides information about tax expenditures, there needs to be a periodic review of those tax expenditures to determine whether they are continuing to serve the public.

2. **The April 17, 2007** amendments: 1) for sales and use tax expenditures, specify that an estimate of the revenue loss include partial year exemptions and all other tax expenditures when the Board has obtained that information; 2) require that the review include additional information on each tax expenditure, including, but not limited to, the statutory authority and description of the legislative intent, and other information on sales and use tax expenditures (number of returns filed or business entities affected); and 3) clarified that the review would be conducted over a 9-year period, rather than a 10-year period. **The March 26, 2007 amendments**: 1) require the DOF, rather than the Legislature, to review all tax expenditures that exceed $5 million per calendar year and that are in existence on or after January 1, 2008; 2) require the DOF to review 10 percent of the tax expenditures by July 1, 2008, and 10 percent by July 1 of each of the succeeding nine years, so that all of the tax expenditures are reviewed by July 1, 2018; and 3) require any legislative measure creating a new tax expenditure, or extending the operation of an existing tax expenditure, to meet certain requirements, as specified.

3. **DOF annual tax expenditure report.** Board staff currently provides information to DOF regarding tax expenditures, which is used in the DOF's annual tax expenditure

report. The most recent report is for the fiscal year 2006-07 and can be found on the Department of Finance website at: www.dof.ca.gov/HTML/FS_DATA/TAX/Tax_Expenditure_Rpt_06-07.pdf.

4. **Should the term "partial year exemptions" be changed to "partial exemptions?"** This bill provides that the review include an estimate or range of estimates for the state and local revenue loss for the current fiscal year and the two subsequent fiscal years. This bill specifies that, for sales and use tax expenditures, the information would include *partial year exemptions* and all other tax expenditures when the Board has obtained such information.

   Would the term *partial year exemption* mean an exemption that has been operative for a partial fiscal year, or did the Legislature mean to include those partial exemptions for which the sale or purchase is exempt from a portion of the sales and use tax? The Board administers full exemptions and partial exemptions. There are currently five partial exemptions in effect (see Comment 6). These partial exemptions apply to the 5 percent state General Fund portion of the tax, but do not apply to the two 0.5 percent statewide taxes (i.e., Local Revenue Fund and Local Public Safety Fund), or the taxes imposed under the Bradley-Burns Uniform Local Sales and Use Tax Law and the Transactions and Use Tax Law.

   It appears that the intent of the bill is to state that the tax expenditure report would include information on *partial exemptions*, rather than an exemption that is operative for a *partial fiscal year*.

5. **Board does not have the number of returns filed on all tax expenditures.** This bill requires the DOF to include information in a section of their report on sales and use tax expenditures on the number of tax returns filed or business entities affected. As explained under Comment 6, only partial tax expenditures and some of the more common tax expenditures are separately identified on the return. For all other tax expenditures, the Board does not have information on the number of returns or business entities affected.

6. **The Board does not have specific data on tax expenditures.** This bill does not specifically require the Board to provide data on tax expenditures. However, an explanation regarding the information available on the tax returns, including the differences between tax return data captured for state income tax purposes versus tax return data captured for sales and use tax purposes, is provided below:

   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 taxpayers under the Sales and Use Tax Law www.boe.ca.gov/pdf/boe401a2.pdf contain little information regarding tax expenditures.

   As shown on the attached 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, but not limited to, 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 extensive tax return and would require a very large effort from taxpayers to detail 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 Board 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 Board 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 Board 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, with reporting of the consumer use tax expenditures, some taxpayers do not submit a return to the Board. When the taxpayer has not submitted a return to the Board, a determination (billing) is issued to the taxpayer. Once the taxpayer receives the billing, they contact the Board requesting a claim for exemption from the use tax. The Board's Consumer Use Tax Section (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 would require manual extraction of the data, including verifying the data for accuracy.

7. **The Board'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 of the exemption or exclusion, if available. As previously stated in Comment 4, a revenue loss of a particular tax expenditure is not always possible to quantify.

8. **Special tax and fee expenditures**. The Board administers the following special tax and fee programs: Alcoholic Beverage Tax; Tire Recycling Fee; Childhood Lead Poisoning Prevention Fee; Cigarette and Tobacco Products Tax; Diesel Fuel Tax; Covered Electronic Waste Recycling Fee; Emergency Telephone Users Surcharge; Energy Resources Surcharge; Hazardous Substances Tax; Tax on Insurers; Integrated Waste Management Fee; Marine Invasive Species Fee; Motor Vehicle Fuel Tax; Natural Gas Surcharge; Occupational Lead Poisoning Prevention Fee; Oil Spill Response, Prevention; and Administration Fees; Underground Storage Tank Maintenance Fee; Use Fuel Tax; and Water Rights Fee.

   Some of the major tax exemptions are on transactions involving the following: distilled spirits exported or sold to common carriers; distilled spirits sold to armed forces; beer and wine exported from California; exempt distributions of cigarettes sold and shipped in interstate or foreign commerce; exempt distributions of cigarettes sold to interstate foreign passenger common carriers; exempt distributions of cigarettes sold to U.S. Military exchanges, commissaries, ship stores and U.S. Veterans Administration; motor vehicle and diesel fuel exported out of state; fuel sold to the United States Government; diesel and use fuel sold for farm use; diesel and use fuel used by exempt bus operators; diesel and use fuel sold for off-highway vehicle operations; aircraft jet fuel sold to the United States Armed Forces; aircraft jet fuel sold to air common carriers; and aircraft jet fuel exported out of state.

   As shown above, some of the more common special tax expenditures are separately identified on the return. However, like sales and use tax expenditures, many taxpayers net exempt sales or combine exempt sales on one line of the return. For these reasons, the return does not capture data on the individual exemptions. Consequently, the Board generally relies on independent data sources when estimating the revenue impacts of various special tax expenditure programs. It should be noted that for some of the special tax exemptions, the taxpayer reporting and filing the return may not be the one benefiting from the exemption.

9. **Property taxes are largely administered by county assessors in the state's 58 counties. The Board provides oversight to the 58 county assessors and monitors the adequacy of their assessment practices.** The California Constitution provides for a variety of full and partial exemptions from property tax. Some of the exemptions are required by the Constitution. Others are not specifically required but the Constitution provides that the Legislature may, by statute, provide for the exemption. This bill defines "tax expenditures" to mean a credit, deduction, exclusion, exemption, or any other tax benefit as provided by state law. Would the

exemptions required by the state Constitution be considered "tax expenditures" under the provisions of this bill?[1]

There are over 100 exemptions and exclusions from property tax. An exclusion, for property tax purposes, is the deferral of reassessment. For real property, some of the major exemptions are: Disabled Veterans Exemption, Homeowners' Exemption,[2] and Welfare Exemption. For real property, some of the major exclusions are: Disabled New Construction Exclusion, Disaster Relief Change in Ownership and New Construction Exclusions, Interspousal Change in Ownership Exclusion, Over 55 and Disabled Homeowners' Change in Ownership Exclusion, Parent-Child and Grandparent-Grandchild Change in Ownership Exclusion, and Seismic Safety New Construction Exclusion.

Data on some of the exemptions are maintained by the county assessors. For the exclusions, in general, the data is not maintained. In the case where data is not maintained, the Board would estimate the revenue impact using independent data sources, to the extent feasible. However, in some cases, it is not possible to quantify the revenue loss of a tax expenditure because the data is not available.

In addition, there are preferential tax treatments for real property. Would preferential tax treatments be considered tax expenditures? One of the major preferential tax treatments is included in the Williamson Act. The Williamson Act program provides a tax incentive for the conservation of farmlands, open space, and wildlife habitat lands by reducing the property tax on land that is restricted for these purposes. For real property qualifying for special treatment under the Williamson Act,[3] data is available to develop an estimated revenue loss.

For personal property, some of the major exemptions are: Aircraft Being Repaired, Aircraft of Historical Significance, Business Inventories,[4] Cargo Containers Used in Ocean Commerce, Financial Assets, Household Furnishings and Personal Effects, Vessels, Documented Vessels, and Vessels Under Construction. For the personal property tax exemptions, data is maintained on some of the exemptions. For those exemptions where data is not maintained, a revenue estimate would be developed using independent data sources, to the extent feasible, unless such data was not available. An example of a personal property tax expenditure for which a revenue loss could not be quantified would be Financial Assets.

10. **This bill provides that any new tax expenditure be repealed within five years from its effective date.** Any Legislative measure creating a new tax expenditure, or extending the operation of an existing tax expenditure, must contain a provision that the expenditure be repealed no later than five years after its effective date. To implement a tax expenditure can require all or some of the following: preparing special notices, notifying affected taxpayers, posting information on the Board's website, developing or revising a regulation or a publication, preparing guidelines or instructions for taxpayers and Board staff, modifying tax returns, and programming. In addition, taxpayers also may need to reprogram their cash registers and/or

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[1] One of the largest tax expenditures is the Proposition 13 revenue loss, and the Proposition 8 decline in value.
[2] The Homeowners' Exemption is a budget expenditure. The counties are reimbursed by the state. It is shown in Schedule 9 under Tax Relief of the Budget Act.
[3] The Williamson Act is a budget expenditure. The counties are reimbursed by the state. It is shown in Schedule 9 under Tax Relief in the Budget Act.
[4] Business Inventories are 100 percent exempt starting 1980-81. This exemption is often overlooked because the owner does not have to file a claim.

computer systems and train staff. In general, both Board staff and taxpayers must perform many of the same tasks in implementing a tax expenditure, as well as preparing to end it. For these reasons, it may not be cost effective to require all tax expenditures to sunset within five years from the effective date of the expenditure.

COST ESTIMATE

This bill would require the DOF to review all tax expenditures that exceed $5 million annually and have been in existence since January 1, 2008, and to make a recommendation to the Legislature whether to modify or repeal a tax expenditure. The review would include an estimate of the revenue losses attributable to each tax expenditure. This bill also specifies that, with respect to sales and use tax expenditures, the report would include only those tax expenditures where the Board has obtained such information. If the Board were called upon to supply revenue estimates for the various special tax and fee and property tax expenditures it administers, the Board would need one Research Analyst II position to perform such duties.

REVENUE ESTIMATE

This bill would not in itself directly change any revenues as further legislation would be required to repeal an ineffective tax expenditure.

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