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Corporate tax breaks in dire time draw flak

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By Timm Herdit
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SACRAMENTO — As most Californians are well aware, there were a lot of losers in the two state budget deals crafted last September and again in February.

Schoolchildren will be packed into crowded classrooms, disabled people will have to cope with shrinking monthly benefit checks, middle-class families with young children will pay significantly more in income taxes, all consumers now pay an extra penny per dollar in sales taxes on their purchases.

Unknown to most Californians, however, is that there were some substantial winners in these deals: chiefly large corporations that will benefit from three major corporate income tax changes that will lower their collective annual tax bills by $2 billion in the years ahead.

As the state faces yet another round of massive budget cutbacks, some are rethinking the wisdom of the corporate tax reductions and asking whether they should be rescinded.

Last-minute deals

“These tax cuts were slipped into budget deals at the last minute, with no public input, during the worst budget crisis in the state’s history,” said Jean Ross, executive director of the California Budget Project, a nonprofit think tank that advocates for low- and moderate-income taxpayers. “In a transparent and open process, they would have never become law.”

The budget-balancing plan unveiled by Democrats in the Legislature last week seeks to repeal two of the corporate tax breaks. One provision would rescind a law to allow companies to apply losses in bad years retroactively in order to receive refunds on taxes they paid in previous good years. The other would rescind a law that allows corporations to shift tax credits earned by one subsidiary to offset the tax liability of an affiliated company.

Left in place, those two laws will save businesses an estimated $80 million in the coming budget year, rising gradually to $850 million in 2014.

Although it seems unlikely those proposals will generate the two-thirds majority vote that would be required for passage, Assembly Speaker Karen Bass said last week it was important to Democratic members that they be given the chance “to vote their priorities.”

Tax rate choice to remain

The Democratic plan leaves in place the most valuable of the new laws designed to reduce corporate taxes, the so-called “single sales” formula that will allow companies to reduce their tax bills by recalculating what percentage of their profits are subject to California taxes. That change will save companies an estimated $1 billion a year by 2014.

Art Pulaski, executive secretary of the California Labor Federation, said those new corporate tax breaks send exactly the wrong message at a time when the state is cutting services across the board.

“It’s time to share the pain,” Pulaski said. “It’s a dollar-for-dollar deal. The hard reality is that you don’t give corporations these benefits when you’re taking away the caregiver for someone who’s in a wheelchair and can’t get up.”

The corporate tax changes were included in the past two state budget deals at the insistence of Gov. Arnold Schwarzenegger and Republican lawmakers, who said they would spur business investment and job creation in the state.

Schwarzenegger said last week he will brook no changes in what he called “the economic stimulus” provisions.

But the head of the research arm of the California Chamber of Commerce, which strongly supports the new laws, said there is no economic-investment rationale for the two laws targeted by Democrats for repeal.

Business calls it equity issue

The ability to carry back operating losses and to share tax credits among affiliates is important not because it will affect companies’ investment decisions, but rather because it is a matter of “tax equity and fairness," said Loren Kaye, president of the California Foundation for Commerce and Education, a think tank affiliated with the state Chamber of Commerce.

"A tax collector looks at a distinct year," Kaye said. "They look at a company's income for a particular period. That doesn't consider that over a period of time there may be eventual losses. A company's business cycle isn't the same as the state's fiscal year."

Kaye acknowledges that an individual who has been laid off or taken a salary cut cannot go back and receive refunds on personal income taxes paid during previous good years. The difference, he said, is individuals "don't create jobs."

Ross said giving companies the ability to carry losses backward will compound state budget problems in future recessions.

"It's incredibly destabilizing," she said. "They'd go back during a bad year when the state's likely to have a deficit and ask for a refund on taxes the state has already collected and spent."

As for the ability to transfer tax credits among affiliates, Kaye said that is a clear issue of fairness. Under the state's unitary corporate tax laws, he said, corporate taxes are assessed on the aggregate profits of all a firm's affiliates. That being the case, he argues, it only makes sense to allow businesses to apply tax credits earned by one affiliate to offset profits made by a different affiliate.

Ross said the idea of allowing affiliates to transfer tax credits came out of the blue in last year's budget negotiations, and that over at least the past 25 years not a single bill had been proposed in the Legislature to enact such a policy. Because of that, there is no record of which companies might have specifically advocated for the change.

"I'd love to know who the beneficiaries are," she said.

Ross said the point of tax credits is to encourage companies to engage in activities the public deems desirable, such as investing in urban areas or spending money on research or energy efficiency. It makes no sense, she argues, for a more profitable affiliate that did not engage in such activities to use the credits to lower its taxes.

Keeping state competitive

If the debate over the first two corporate tax changes centers on fairness, the argument over the third is about competitiveness.

Business groups argue strongly that the single sales factor will directly encourage California companies to expand in the state rather than look elsewhere.

The existing three-factor formula for determining the share of corporate profits subject to California taxes weighs not only where sales occur but also the amount of property and payroll based in the state.

In a well-publicized 2006 action, the South San Francisco-based biotech firm Genentech decided to build an expansion facility in Oregon. Company officials said the fact that they would save on California taxes by expanding out of state was a major factor in their decision.

“It’s an important factor, and it’s not marginal,” said Matt Gardner, president of Bay Bio, an association of 50 San Francisco area biotech firms. “There are lots of compelling reasons why companies do things in California, including its unique talent pool. But everything matters. The playing field is not level.”

Gardner notes that 20 states calculate a company’s state tax liability based on the single sales formula.

Lenny Goldberg, president of the California Tax Reform Association, disputes the claim that a switch to the single sales formula will spur business investment in the state. He said there’s no evidence states that have switched to that formula have fared any better than others in attracting new investment.

Law gives wiggle room

Goldberg said it’s particularly troubling that the new California law will give companies the ability each year to use either the old, three-factor formula or the new single-factor formula.

In years when companies experience losses, he said, they will attribute more income to California. In years when they experience gains, they will use the formula that attributes less income to California.

“You can advantage yourself every year,” he said. “Corporate tax attorneys are chuckling over the opportunities for ‘tax planning,’ as they call it. They’re just endless.”

The California Budget Project, using data from the Franchise Tax Board, issued a report this month that says just nine multinational corporations would realize a combined $33 million in tax savings in the year 2014 under the new law.

Although the confidential data do not name the companies, the study notes among the companies that have lobbied for the change in the past are Apple, Intel and the Disney Corp.

Ballot initiative possible

Goldberg is hopeful lawmakers will rescind the new tax laws. If they don’t, he’s preparing a ballot initiative to try to overturn them.

“We will file an initiative to repeal the secret corporate tax loopholes,” he said. “The Legislature ought to do this. But if the Legislature fails miserably and we still have these huge loopholes in place, then we’ve got a strategic decision to make.”

Pulaski said the Labor Federation is aware of Goldberg’s activities and will consider supporting a potential ballot measure if lawmakers do not act.

“The public would support the Legislature if in fact it did say we want to eliminate corporate tax breaks until we get ourselves on the right footing again,” he said. “We’re not saying raise taxes. We’re saying close corporate loopholes.”

Business groups that celebrated and applauded these changes are worried their gains could be lost in the latest budget deal.

“We are very concerned that a knee-jerk response could hurt California’s opportunities for job creation over the long term,” said Gardner of the biotech association. “We need jobs programs now more than ever.”