Tax Expenditure Report

2016-17

Table of Contents

Descriptive Detail

Personal Income Tax

Corporation Tax

Sales and Use Taxes

Fuel Taxes

Property Tax

Introduction

The Department of Finance has been required to provide a tax expenditure report to the Legislature since 1971. Chapter 1762, Statutes of 1971, required that a biennial report be submitted to the Legislature. Chapter 268, Statutes of 1984, increased the reporting frequency from once every two years to once a year. Chapter 49, Statutes of 2006, required the report to include each of the following:

- A comprehensive list of tax expenditures exceeding $5 million.
- The statutory authority for each provision.
- A description of the legislative intent of each provision, if specified in the enacting legislation.
- The sunset date of each provision.
- The beneficiaries of the provision.
- An estimate of the state and local revenue loss for the current and two subsequent fiscal years.
- For personal income tax expenditures, the number of taxpayers and returns affected for the most recent tax year.
- For corporation and sales tax expenditures, the number of returns or businesses affected for the most recent year for which data is available.
- A listing of any comparable federal benefit.
- A description of any tax expenditure evaluation or compilation of information completed by any state agency since the last tax expenditure report by the Department of Finance.

This report fulfills the Department's statutory requirement pursuant to Government Code Section 13305. The narrative descriptions and revenue estimates for the tax expenditures included in this report are based on state laws for these tax expenditures as of June 30, 2016.

Definitions

There is no absolute rule for defining tax expenditures, and the concept of a "tax expenditure" can be defined in several different ways. Section 13305 defines tax expenditure as "a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by the state." Although this definition is very broad, Finance has interpreted it to mean that aspects of the law that are basic to the tax structure are not tax expenditures. While the term "basic" is still ambiguous, it at least presents a framework for discussion as to what is not a tax expenditure. Following are some examples of items that are not considered tax expenditures.

- Because the basic structure of each tax is used as the starting point for determining what constitutes a tax expenditure, elements of the basic tax structure that exempt certain groups are not considered tax expenditures. For example, the sales tax is imposed on retailers for the privilege of selling tangible personal property at retail. According to its basic definition, California's sales tax does not apply to sales or leases of real property, sales of services, wholesale transactions, or sales of securities and insurance. These exemptions are therefore not considered tax expenditures.
- The net operating loss (NOL) deduction levels the playing field for firms with volatile and steady income, and is also not considered a tax expenditure for this report. For example, consider two firms, one with a $100 loss in year one and a $300 gain in year two, the second with a $100 gain in each year. Without a NOL deduction, over the two years, the first firm would report $300 taxable income, while the second would report $200, even though each had $200 net income.
- Across-the-board tax rate reductions do not represent tax expenditures. Tax expenditures resulting from changes in the rate structure only exist if different sets of rates are applied to a similar base.

- Progressive rate structures do not constitute tax expenditures. The basic structure of California's income tax is progressive. For that reason, application of different tax rates to different income levels is a basic characteristic of the tax and does not represent a tax expenditure.
- Exemptions or exclusions required by the U.S. Constitution, the California Constitution, or federal laws are not considered tax expenditures.
- Changes in tax law that alter penalties or interest or that accelerate or defer tax payments are generally not considered tax expenditures unless they are very narrowly targeted.

There is no single rule for determining what constitutes an element of the basic tax structure. For this reason, this report may exclude items that are included in other tax expenditure reports and vice versa.

This report, for the first time, does not include apportionment rules as a tax expenditure. In the past, the state has at various times adopted the following rules for apportioning income to California for most businesses that operate both inside and outside California: equal-weighted three-factor formula, double-weighted sales factor, elective single-sales factor, and mandatory single-sales factor. Previous versions of this report had considered equal-weighted three-factor formula to be normal tax law. The revenue impact of any of the other three apportionment rules was measured against this normal law. However, now that mandatory single-sales factor apportionment is required for most multi-state businesses and is used by almost one-half of the states in the nation, it should be treated as part of California's basic tax structure. As such, this report does not treat mandatory single-sales factor as a tax expenditure.

Why Adopt Tax Expenditures

Tax expenditures may be classified into the following two broad groups:

- Those which provide an incentive for a particular type of behavior.
- Those which provide tax relief for taxpayers facing a particular economic hardship.

There are several differences between tax expenditures and direct expenditures (those authorized through the budget process). First, tax expenditures are reviewed less frequently than direct expenditures once they are in place. This can offer taxpayers more certainty than if tax expenditures were subject to annual review, but can also result in tax expenditures remaining in the tax code when their cost outweighs their social benefits.

Also, with certain notable exceptions, there is no control over the amount of foregone revenue that results from a tax expenditure once that provision has become part of the tax code. Finally, the vote requirements for tax expenditures and direct expenditures may be different. Tax expenditures that are adopted legislatively (except those adopted as urgency measures) require approval by a simple majority of both houses of the Legislature. A two-thirds vote is required for General Fund appropriations outside the Budget. Additionally, the repeal of a tax expenditure requires a two-thirds majority vote, while normal expenditures can be repealed with a simple majority vote.

Revenue Estimates

The estimates listed in this report are intended as a general indication of revenue losses from tax expenditure programs. In general, revenue estimates for the Personal Income Tax and Corporation Tax Laws are easier to quantify than those for the Sales and Use Tax Law. Personal income and corporation tax returns contain significant detail 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 corporation tax expenditure programs. In contrast, returns filed by taxpayers under the Sales and Use Tax Law contain little specific information regarding items purchased from individual retailers. For this reason, independent data sources must be used when estimating the revenue impacts of various sales tax expenditure programs, and these estimates can be less accurate than those for the Personal Income Tax and Corporation Tax Laws. In addition, certain estimates under all of the tax laws for which tax expenditure costs are cited can be subject to significant margins of error due to data limitations.

Due to the effects of tax law interactions and taxpayer reactions to changes in tax law, the estimates for any individual tax expenditure in this report do not necessarily reflect the revenue gain that would occur if the tax expenditure was repealed. For example, repeal of the Section 529 Scholarshare plans may shift savings into Coverdell education savings accounts with similar tax benefits. Or, elimination of the mortgage interest deduction could lead to lower home prices and a reduction in the amount of property tax deductions for income tax purposes. Further, while the report displays the total value of the major identified expenditures within each major tax, these figures are best viewed as a general indication of revenue losses. Since each tax expenditure is measured separately and independently of other tax provisions, the fiscal impact of individual tax expenditures cannot be summed to generate the total fiscal impact of all tax expenditures.

With the exception of the deduction for charitable contributions, the revenue loss for tax expenditures that are included in both Corporate and Personal Income Tax Laws are shown under the tax with the greatest revenue loss. For Subchapter S corporation treatment, the revenue gain under the personal income tax is netted against the loss for the corporation tax and the result is shown under the corporation tax.[1]

State Revenue Losses

Personal Income Tax—The Personal Income Tax Law includes the vast majority of all tax expenditure programs approved to date. It is estimated that tax expenditures will reduce 2016-17 Personal Income Tax General Fund revenues by more than $41 billion.

Sales and Use Tax—The Sales and Use Tax Law contains separately identifiable state tax General Fund expenditures worth about $10 billion in 2016-17. Examples of these include food; prescription medicines; gas, electricity, and water delivered through mains; farm equipment; and fuel sold to common carriers.

Corporation Tax—Fiscal year 2016-17 General Fund tax expenditures in the corporation category amount to over $6 billion. Examples of these expenditures include provisions for research and development, interest on state and local government obligations, and provisions for water's edge election.

Other Taxes—Remaining tax expenditure programs are estimated to reduce revenues by over $100 million annually. Much of this revenue loss results from aircraft jet fuel used by common carriers and the armed services, and diesel fuel used by transit districts and schools.

Local Revenue Losses

The revenue losses to local governments are also shown for the sales tax and the property tax. Property taxes are local taxes, and the legislative exemptions or preferential provisions do not constitute state tax expenditures. Nonetheless, they impact state finances because local tax exemptions reduce property tax allocations to schools. Under school finance law, the state is generally required to provide the difference in funding between local property tax allocations and school districts' revenue limits. Consequently, each dollar of property tax revenue foregone by schools results in additional state funding through the school apportionment process. Passage of Proposition 98 in November 1988 created an additional link between property taxes and state operations. The Proposition 98 minimum funding guarantee is determined each year according to a particular test—Test 1, Test 2, or Test 3—based on specified economic and fiscal circumstances in a given year. Under the Test 2 and Test 3 formulas, the minimum funding level is affected by the level change in property taxes. However, under Test 1, property taxes allocated to schools and community colleges are not part of the guaranteed funding level.

Local government revenue losses from identifiable property tax exemptions are estimated to be in excess of $100 million, while losses from sales tax expenditures are estimated to be in the range of $10 billion.

[1] The Earned Income Tax Credit is subject to legislative appropriation each year by a simple majority vote to set its adjustment factor for a given year.

Unknown Revenue Loss Areas

It is not always possible to quantify the revenue loss of a particular tax expenditure. Fortunately, in most instances, those tax expenditures whose revenue impact cannot be estimated represent unique situations and probably do not result in significant revenue losses. Some examples of tax expenditures for which revenue losses cannot be quantified include sales tax exemptions for livestock and for meals furnished by institutions, and property tax exemptions for intangibles and air carrier ground time.

Legislative Intent

This report includes the legislative intent of the tax expenditure when that intent was specified in the enacting or amending legislation.

Other Tax Expenditure Reports

The Franchise Tax Board released the latest version of their report, California Income Tax Expenditures, Compendium of Individual Provisions: Report for 2012 Tax Year Data, covering personal income tax and corporation tax expenditures, in November 2015. This report can be accessed on the Internet at www.ftb.ca.gov under "About Us" in "Reports, Plans and Statistics."

The Board of Equalization released the latest version of its Publication 61 Sales and Use Taxes: Exemptions and Exclusions in July of 2014. This report can be accessed on the Internet at www.boe.ca.gov in "Forms and Pubs."

The Legislative Analyst's Office released a report, Options for Modifying the State Child Care Tax Credit, in April 2016. The report provided background information on the Child and Dependent Care Expenses Credit which allows filers with income below $100,000 to reduce their tax liability by a percentage of their eligible child care expenses. The Legislative Analyst's Office issued another report, Community Development Financial Institution (CDFI) Tax Credit, in June 2016. This report evaluates the effectiveness of the tax credits allowed for qualified investments in Community Development Financial Institutions. Both of these reports can be accessed on the Internet at www.lao.ca.gov in "Publications."

Personal Income Tax

Major Identifiable Tax Expenditures of $5 Million or More
(Dollars in Millions)

Personal Income Tax	State General Fund Revenue Loss				
Provision	2014-15[e]	2015-16[e]	2016-17[e]	2017-18[e]	2018-19[e]
Exclusion of employer contributions to health plans	$5,800	$5,800	$6,000	$6,400	$6,200
Exclusion of employer pension contributions	4,300	5,500	6,500	7,500	7,500
Home mortgage interest deduction	3,500	3,800	4,200	4,500	4,600
Exclusion of social security benefits[1]	3,200	3,400	3,600	3,800	3,700
Exclusion of capital gains on sale of principal residence	2,500	2,700	3,000	3,200	2,900
Basis step-up on inherited property	2,400	2,400	2,500	2,600	2,400
Charitable contributions deduction	2,370	2,470	2,660	2,850	2,940
Real estate, personal property and other taxes deduction	1,730	1,840	1,840	1,940	1,840
Exclusion of benefits provided under cafeteria plans	1,400	1,400	1,500	1,600	1,500
Dependent exemption in excess of personal exemption credit	1,300	1,300	1,400	1,500	1,500
Employee business and miscellaneous expenses deduction	1,300	1,300	1,400	1,400	1,400
Exclusion of investment income on life insurance and annuity contracts[2]	1,200	1,200	1,300	1,300	1,200
Head-of-household and qualifying widower filing status	1,000	1,100	1,100	1,200	1,200
Exclusions for individual retirement accounts	750	800	850	900	900
Medical and dental expenses deduction	480	550	550	600	600
Exclusions for self-employed retirement plans	450	470	500	500	550
Exclusion of miscellaneous fringe benefits	300	310	310	320	300
Deduction of health insurance paid by self-employed	260	260	260	250	240
Exemption for senior citizens	240	260	270	290	310
Earned Income Tax Credit	0	255	295	325	357
Exclusion of transportation-related fringe benefits	200	210	220	230	220
Exclusion of unemployment insurance benefits	170	160	160	150	150
Exclusion of employer contributions to life insurance plans	130	130	130	130	130
Renters' credit	110	110	110	120	120
Exclusion of scholarship/fellowship income	110	110	120	130	130

Personal Income Tax (continued)

Major Identifiable Tax Expenditures of $5 Million or More
(Dollars in Millions)

Personal Income Tax (continued)					
	State General Fund Revenue Loss				
Provision	2014-15[e]	2015-16[e]	2016-17[e]	2017-18[e]	2018-19[e]
Exclusion of non-resident military pay	80	80	80	85	85
Exclusion of meals and lodgings furnished by non-military employers	80	85	90	90	90
Exclusion of employee child care benefits	80	85	85	85	80
Exclusion of state lottery winnings	75	90	100	100	95
Student loan interest deduction	75	85	85	90	90
Exclusion of compensation for injuries or sickness	65	70	70	70	65
Exclusion of employer-provided educational assistance	60	60	60	60	60
Child and dependent care credit (Nonrefundable)	34	34	34	34	34
Exclusion of housing for clergy	31	32	32	32	30
Exclusion of income earned on Section 529 (Scholarshare) plans	30	35	45	55	55
Moving expense deduction	26	27	29	30	30
Exclusion of foster care payments	16	16	16	16	15
Casualty losses deduction	13	13	14	14	14
Limited partnerships investment source rules	12	12	11	10	10
Agricultural Soil or Water Conservation and Prevention of Erosion Cost Expensing[2]	5	4	4	4	4
Total	**$35,882**	**$38,563**	**$41,530**	**$44,510**	**$43,644**

[e]Estimated

[1]Some recipients of Social Security are not required to report this income on their federal tax returns. The number of returns reported here is the number o
with Seocial Security income that was reported on their federal tax return.

[2]This item includes corporate tax amounts.

Major Identifiable Tax Expenditures of $5 Million or More
(Dollars in Millions)

Corporation Tax	State General Fund Revenue Loss				
Provision	2014-15e	2015-16e	2016-17e	2017-18e	2018-19e
Water's edge election	$2,000	$2,200	$2,300	$2,400	$2,600
Research and development credit[1]	1,400	1,500	1,600	1,700	1,700
Enterprise Zone And Similar Areas[1]	850	600	410	310	250
Like-kind exchanges[1]	750	750	750	800	750
Subchapter S corporations	230	220	210	200	190
Tax-exempt status for qualifying nonprofit and charitable corporations	150	160	160	160	170
Charitable contributions deduction[2]	130	130	140	150	160
Accelerated depreciation of research and experimental costs[1]	110	120	130	140	140
Film credit[3]	91	104	110	157	195
Credit union treatment	80	90	95	100	110
California Competes Credit	10	39	75	115	155
Exemption from the Minimum Tax for First-Year Corporations	50	55	55	60	60
Low-income housing credit[1]	37	39	41	43	46
Employee stock ownership plans[1]	31	38	40	42	43
New advanced strategic aircraft hiring credit	0	0	20	20	20
Percentage depletion of mineral and other natural resources[1]	19	19	20	22	22
Hiring Credit (2013 Budget Act)	3	7	10	14	17
Jobs Tax Credit 2009[1]	10	5	3	2	1
Expensing of timber growing costs[1]	8	9	9	9	9
Reforestation[1]	6	6	7	8	8
Community Development Financial Institutions Tax Credit[1]	4	6	6	4	2
Natural Heritage Preservation Credit[1]	1	3	4	6	7
Corporate Tax Total	**$5,970**	**$6,100**	**$6,195**	**$6,462**	**$6,655**

[e]Estimated

[1]This item includes personal income tax amounts.

[2]This includes only corporate tax amounts; personal income tax amounts are seperately reported.

[3]Sales tax exclusions are included in the totals here. Actuals were $11 million in 2014-15 and $9 million in 2015-16. Estimated to account for 17 percent of the total beginning in 2016-17.

Sales and Use Taxes

Major Identifiable Tax Expenditures of $5 Million or More
(Dollars in Millions)

Sales and Use Taxes	2014-15			2015-16			2016-17		2017-18		2018-19	
Provision	State General Fund	Local[2]	State Fiscal Recovery Fund	State General Fund	Local[2]	State Fiscal Recovery Fund[1]	State General Fund[3]	Local[2]	State General Fund	Local[2]	State General Fund	Local[2]
	4.1875%	3.9825%	0.2500%	4.1875%	3.9825%	0.1250%	4.0625%	4.2325%	3.9375%	4.2325%	3.9375%	4.2325%
Food products	$3,413	$3,246	$204	$3,602	$3,426	$108	$3,665	$3,819	$3,715	$3,993	$3,868	$4,158
Prescription medicine	1,978	1,881	118	2,087	1,985	62	2,124	2,212	2,152	2,314	2,241	2,409
Gas, electricity, and water	1,896	1,803	113	2,001	1,903	60	2,036	2,121	2,064	2,218	2,149	2,310
Animal life, feed, seeds, plants, fertilizer, drugs, medicines	878	835	52	926	881	28	942	982	955	1,027	994	1,069
Candy, confectionery, snack foods, and bottled water	417	397	25	441	419	13	448	467	454	488	473	508
Manufacturing and research & development equipment exemption	136	0	0	190	0	0	210	0	220	0	220	0
Farm equipment and machinery	176	0	10	185	0	6	188	0	191	0	199	0
Fuel sold to common carriers	103	98	6	109	104	3	111	116	113	121	117	126
Custom computer programs	69	65	4	73	69	2	74	77	75	80	78	84
Diesel fuel used in farming and processing	48	45	3	50	48	2	51	53	52	56	54	58
Subscription periodicals	39	37	2	40	40	1	40	44	43	46	45	48
Water common carriers	26	25	2	28	26	1	28	29	29	31	30	32
Teleproduction and post-production equipment	14	13	1	14	14	0	15	15	15	16	15	17
Film Credit (sales tax portion only)	5	5	0	5	4	0	10	10	13	14	17	18
California Alternative Energy	8	8	1	9	9	0	14	14	18	20	19	21
Motion picture production services[4]	-	-	-	-	-	-	-	-	-	-	-	-
Meals furnished by institutions[4]	-	-	-	-	-	-	-	-	-	-	-	-
Leases of motion pictures, television films, tapes[4]	-	-	-	-	-	-	-	-	-	-	-	-
Printed advertising[4]	-	-	-	-	-	-	-	-	-	-	-	-
Total	**$9,206**	**$8,459**	**$541**	**$9,761**	**$8,927**	**$285**	**$9,957**	**$9,960**	**$10,108**	**$10,424**	**$10,519**	**$10,857**

[1] In effect for the first 6 months of 2015-16.

[2] Rate includes the 2011 Realignment 1.0625%,1991 Local Revenue Fund 0.50%, Local Public Safety Fund 0.50%, Local Bradley Burns 1.00% (reverted to 1.25% on January 1, 2016), and the average county add-on of .92%.

[3] Rate includes one-half year impact from the sales tax imposed by Proposition 30, which expires at end of 2016.

[4] Unknown revenue losses.

Fuel Taxes

Major Identifiable Tax Expenditures of $5 Million or More
(Dollars in Millions)

Fuel Taxes	2014-15 Revenue Loss			2015-16 Revenue Loss			2016-17 Revenue Loss			2017-18 Revenue Loss			2018-19 Revenue Loss		
Provision	State General Fund	State Special Fund	Local	State General Fund	State Special Fund	Local	State General Fund	State Special Fund	Local	State General Fund	State Special Fund	Local	State General Fund	State Special Fund	Local
Aircraft jet fuel used by common carriers and military	$0	$40	$0	$0	$41	$0	$0	$41	$0	$0	$41	$0	$0	$43	$0
Diesel and use fuel used by transit districts and schools	0	7	0	0	7	0	0	8	0	0	8	0	0	8	0
Total	**$0**	**$48**	**$0**	**$0**	**$48**	**$0**	**$0**	**$49**	**$0**	**$0**	**$49**	**$0**	**$0**	**$51**	**$0**

Property Tax

Major Identifiable Tax Expenditures of $5 Million or More
(Dollars in Millions)

Property Tax					
	Local Revenue Loss				
Provision	2014-15	2015-16	2016-17	2017-18	2018-19
Computer programs[1]	-	-	-	-	-
Fixtures excluded from the supplemental roll[2]	-	-	-	-	-

[1]Unknown, but in excess of $100 million per year.

[2]Unknown, but in low tens of millions of dollars per year.

Sales and Use Taxes

Teleproduction and Post-Production Equipment

Description:
Sales of teleproduction and post production equipment to businesses primarily engaged in teleproduction and post production activities is exempt from the 5.5 percent state sales and use tax when that property is used 50 percent or more in those activities.

Statutory Authority:
Revenue and Taxation Code Section 6378

Sunset Date:
None

Legislative Intent:
Not specified

Beneficiaries:
Businesses

Number of Taxpayers/Number of Returns:
In 2014-15, 2,190 returns claimed this exemption.

Comparable Federal Benefit:
There is no federal sales tax

Sales and Use Taxes

California Alternative Energy

Description:
Authorizes the California Alternative Energy and Advanced Transportation Financing Authority to approve a sales and use tax exemption on the purchase of tangible personal property that is used for the design, manufacture, production, or assembly of advanced transportation technologies or alternative energy products.

In 2012, this program was expanded to allow the sales tax exemption for tangible personal property used in advanced manufacturing projects. In 2016, the sales tax exemption was expanded to projects that process and use recycled feedstock.

Statutory Authority:
Public Resources Code Section 26003

Sunset Date:
The entire sales and use tax exclusion program will sunset on January 1, 2021.

Legislative Intent:
Not specified

Beneficiaries:
Businesses

Number of Taxpayers/Number of Returns:
Not available

Comparable Federal Benefit:
There is no federal sales tax

Property Tax

Computer Programs

Description:
Computer programs other than basic operational programs which are necessary for the fundamental functioning of the computer are exempt from tax. The storage media for the programs are, however, taxable.

Statutory Authority:
Revenue and Taxation Code 995

Sunset Date:
None

Legislative Intent:
Not specified

Beneficiaries:
Businesses

Number of Taxpayers/Number of Returns:
Not available

Comparable Federal Benefit:
None

Property Tax

Fixtures Excluded From the Supplemental Roll

Description:
Fixtures that are valued as a separate appraisal unit from the structure on the property are exempt from supplemental property tax assessment. Fixtures are personal property such as equipment that are affixed to and incorporated into real property.

Statutory Authority:
Revenue and Taxation Code Section 75.5 and 75.15

Sunset Date:
None

Legislative Intent:
Not specified

Beneficiaries:
Businesses

Number of Taxpayers/Number of Returns:
Not available

Comparable Federal Benefit:
None