Tax Expenditure Report

2004-05

Department of Finance California

Prepared by
the Department of Finance

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. The required report includes each of the following:

- A comprehensive list of tax expenditures.
- Additional detail on individual categories of tax expenditures.
- Historical information on the enactment and repeal of tax expenditures.

This report fulfills the Department's statutory requirement pursuant to Government Code Section 13305.

Definitions

There is no absolute rule for defining tax expenditures, and the concept of a "tax expenditure" can be defined in several different ways. For the purposes of this report, the Department has chosen to define a tax expenditure as any special provision in the tax law that results in the collection of fewer tax revenues than would be collected under the basic tax structure. This report is also intended to identify only tax expenditures with large revenue effects in order to focus attention on those areas of the tax structure with major fiscal significance.

Although broad, this definition does exclude several provisions of the tax law from classification as 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. They are elements of the basic tax structure.

- 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.

However, the definition of "tax expenditure" is subject to debate, and there is no single rule for determining what constitutes an element of the basic tax structure or defining how costly an expenditure must be for inclusion. For these reasons, this report may exclude items that are included in other tax expenditure reports and vice versa.

Why Adopt Tax Expenditures

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

- Those which conform California tax law to federal provisions.

- Those intended to remove perceived inequities in the basic tax structure.

- Those intended to ease tax administration.

- Those which grant targeted tax reductions through exemptions, credits, deductions, or exclusions.

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 long after outliving usefulness.

In general, there is also 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 are 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 budgetary appropriations.

Recent Changes in Tax Expenditures

Tables 1 and 2 provide an overview of recent changes in tax expenditure programs. Table 1 lists the tax expenditures that are either repealed or sunset. Table 2 lists the tax expenditures enacted since 1990. This report omits programs with an annual cost of under $5 million in an effort to focus on tax expenditures of fiscal significance.

Revenue Estimates

The estimates listed in this report are intended as a general indication of revenue losses from tax expenditure programs. These estimates represent full fiscal year revenue impacts. Thus, if a tax expenditure is enacted part way through a fiscal year, the revenue impact cited is that which resulted during the first *full* year in which the expenditure was effective.

Tables 3 and 4 list the major revenue losses estimated to result from the principal tax expenditures for which estimates can reasonably be developed. Both tables have been limited to tax expenditures of $10 million or more. Examples of excluded expenditures are personal income tax credits for political contributions, the elderly, and the military, and sales tax exemptions for master records and tapes and for bullion.

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 the precision of these estimates can be lower 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. Other factors complicating this report's estimates include the effects of tax law interactions and taxpayer reactions to changes in tax law. Therefore, while Tables 3 and 4 display the total value of the major identified expenditures within each major tax, these figures are best viewed as illustrative, only. The fiscal impact of individual tax expenditures cannot be summed to generate the total fiscal impact of all tax expenditures due to the complicating factors of tax law interactions and taxpayer behavioral responses.

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 special income tax provisions account for approximately $19.5 billion in annual tax expenditures.

Sales and Use Tax—The Sales and Use Tax Law contains identifiable state tax expenditures worth nearly $250 million annually. Examples of these include custom computer programs, farm equipment, printed advertising, and motion picture leases.

Corporation Tax—Tax expenditures in the corporation category amount to more than $4 billion annually. Examples of these expenditures include provisions for S-corporations, water's edge election, provisions for research and development, and special treatment for economically depressed areas.

Other Taxes—Remaining tax laws are estimated to contain tax expenditure programs valued at $125 million. Much of this revenue loss results from motor vehicle fuel tax and insurance tax expenditures.

Local Revenue Losses

Table 4 lists revenue losses from the principal exemptions or preferential provisions of property tax law. 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 current 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 further impacts state school financing by establishing minimum funding levels for public schools and community colleges, based on both property taxes and state funding. In addition, some property tax exemptions result in state subventions to local governments other than school entities in order to make up some or all of their revenue losses.

Local government revenue losses from identifiable property tax exemptions are estimated at approximately $200 million, while losses from sales tax expenditures are estimated at $86 million.

Unidentifiable 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.

Table One

State Tax Expenditures with Savings of $5 Million or More Eliminated Since 1990

(Dollars in millions)

SS=Sunset

Year	Chapter	Description	First Full Year Savings
1990		**None**	
1991		**Personal Income Tax**	
	117	Reduced itemized deductions for high income taxpayers	$248
		Sales and Use Tax[1]	
	85	Common carrier fuel (aircraft)[2]	106
	85	Newspapers	57
	85	Non-subscription periodicals[3]	30
1992		**Personal Income Tax**	
	SS	Child care credit provisions expired December 31, 1992	106
1993		**None**	
1994		**None**	
1995		**Personal Income Tax**	
	SS	Ridesharing expenses credit expired December 31, 1995	13
1996		**None**	
1997		**Personal Income Tax**	
	SS	Los Angeles Revitalization Zone incentives expired December 31, 1997	51
		Corporation Tax	
	SS	Los Angeles Revitalization Zone incentives expired December 31, 1997	67
1998		**None**	
1999		**None**	
2000		**None**	
2001		**None**	
2002	35	**Corporation Tax**	
		Executive compensation deduction denial	5
		Club dues deduction denial	10
		Lobby expense deduction denial	7
2003		**None**	
2004		**Personal Income Tax**	
	SS	Manufacturer's Investment Credit expired December 31, 2003	20
	SS	**Corporation Tax**	
		Manufacturer's Investment Credit expired December 31, 2003	175
	SS	**Sales and Use Tax**	
		Manufacturer's Investment Credit expired December 31, 2003	7
	226	Vehicle, vessel and aircraft use tax[4]	35

[1] Chapter 85, Statutes of 1991, also repealed the exemptions for candy, snack foods, and bottled water. However, these exemptions were reinstated in November 1992 by Proposition 163.

[2] Chapter 85, Statutes of 1991, repealed the exemptions for air, rail, and watercraft common carrier fuel. Chapter 905, Statutes of 1992, reinstated the exemption for watercraft common carrier fuel and reinstated a partial exemption for aircraft common carrier fuel used on international flights.

[3] Chapter 85, Statutes of 1991, repealed the exemption for all periodicals. Chapter 903, Statutes of 1992, reinstated the exemption for subscription periodicals.

[4] Effective October 1, 2004 through June 30, 2006.

Table Two

State Tax Expenditures of $5 Million or More Enacted Since 1990
(Dollars in millions)

Year Enacted	Chapter	Description	First Full Year Cost
1990		**Personal Income Tax**	
	1347	Stay-at-home parent credit	$25
		Corporation Tax	
	1513	Increased compliance penalties	5
1991		**Personal Income Tax**	
	117	Extension of net operating loss (NOL) carryover[1]	45
		Corporation Tax	
	117	Extension of net operating loss (NOL) carryover[1]	164
	117	Extension of research and development credit	64
		Sales and Use Tax	
	461	Newspapers and periodicals distributed free of charge	20
1992		**Personal Income Tax and Bank and Corporation Tax**	
	17	Establishment of revitalization zone for LA riot area	7
		Sales and Use Tax	
	903	Subscription periodicals	10
	905	Watercraft common carrier fuel	21
1993		**Personal Income Tax**	
	874	Limited partnerships investment source rule	10
	881	Manufacturers' investment credit	32
	881	Small business stock exclusion	26
		Corporation Tax	
	881	Manufacturers' investment credit	365
	1121	Expanded credit union income exemption	13
	946	Double-weighted sales factor	130
		Sales and Use Tax	
	881	Manufacturing equipment for start-up firms	10
	887	Intangible rights	Unknown
1994		**Corporation Tax**	
	748	Extended and limited the employer child care credit	5
1995		**None**	
1996		**Personal Income Tax**	
	954	Long-term care deduction	9
	954	Medical savings accounts	8
	954	Increased spousal IRAs	8
	954	Educational assistance exclusion	7
		Corporation Tax	
	953	Expanded Enterprise Zone program	10
	954	Expanded research and development tax credit	22
	954	Reduced minimum franchise tax for new businesses	8
		Insurance Tax	
	967	Coverage provided through California Earthquake Authority	30

Table Two continues ►

[1] The use of net operating loss (NOL) carryovers was suspended for the 1991 and 1992 tax years, and the sunset was extended for five years. The costs represent the first year of extension. Chapter 880, Statutes of 1993, repealed the sunset date.

State Tax Expenditures of $5 Million or More Enacted Since 1990

(Dollars in millions)

Year Enacted	Chapter	Description	First Full Year Cost
1997		**Personal Income Tax**	
	612	Expanded exclusion of capital gains on the sale of principal Residences	$105
	612	Expanded IRA provisions including the Roth IRA and education IRA	31
		Corporation Tax	
	613	Expanded research and development tax credit	46
1998		**Personal Income Tax**	
	322	Nonrefundable renters' credit	141
	322	Student loan interest deduction	15
	322	Expanded home office deduction	8
	323	Increased health insurance deduction for self-employed	12
	323	Permanent extension of employer child care credits	11
		Corporation Tax	
	322	Joint Strike Fighter credit	61
	323	Increased alternative incremental research and development credit	18
	323	Reduced minimum franchise tax for first two years for new, small businesses	11
	323	Expanded the manufacturers' investment credit to computer programming and software activities	7
		Sales and Use Tax	
	323	Expanded and extended exemption for property used in space flights	8
	323	Partial exemption for property used in teleproduction or postproduction	8
	323	Exemption for non-annual plants	7
1999		**Personal Income Tax**	
	117	Increased health insurance deduction for self-employed taxpayers	19
		Corporation Tax	
	64	Minimum franchise tax exemption for first two years for new corporations	58
	77	Increased research and development credit	7
2000		**Personal Income Tax**	
	75	Teacher retention credit[2]	200
	114	Refundable child care credit	189
	107	Graduate student exclusion	10
		Corporation Tax	
	107	Increased research and development tax credit	33
	107	Increased net operating loss carryover	5
		Sales and Use Tax	
	599	Deduction for worthless accounts	at least 6
	107	Rural investment exemption	5

Table Two continues

[2] Chapter 488, Statutes of 2002 suspended the credit for the 2002 tax year and Chapter 226, Statutes of 2004 suspended the credit for the 2004 and 2005 tax years.

Table Two (continued)

State Tax Expenditures of $5 million or More Enacted Since 1990

(Dollars in millions)

Year Enacted	Chapter	Description	First Full Year Cost
2001		**Personal Income Tax**	
	12	Solar energy systems tax credit	$7
		Corporation Tax	
	12	Solar energy systems tax credit	13
		Sales and Use Tax	
	156	Exemption for farm machinery and equipment	36
	156	Exemption for diesel fuel used in agriculture	14
	156	Exemption for liquefied petroleum gas	7
2002		**None**	
2003		**Sales and Use Tax**	
	712	Exemption for bunker fuel	21

Table Three

Major Identifiable State Tax Expenditures of $10 Million or More, 2004-05

(Dollars in millions)

Personal Income Tax	Full Year Cost
Exclusion of pension contributions and earnings	$4,215
Home mortgage interest deduction	3,800
Exclusion of employer contributions to health plans	3,220
Exclusion of capital gains on sale of principal residence	1,410
Real estate and other taxes deduction	1,106
Exclusion of investment income on life insurance and annuity contracts	1,100
Charitable contributions deduction	1,026
Exclusion of Social Security benefits	1,000
Exclusion of benefits provided under cafeteria plans	970
Employee business and miscellaneous expenses deduction	630
Contributions to IRAs	605
Contributions to self-employed retirement plans	340
Exclusion of miscellaneous fringe benefits	260
Child and dependent credit	215
Medical and dental expenses deduction	200
Deduction of health insurance paid by self-employed	118
Renters' credit	114
Special treatment for economically depressed areas	105
Exclusion of employer contributions to life insurance	103
Exemption for senior citizens	101
Exclusion of unemployment insurance benefits	81
Exclusion of compensation for injuries or sickness	58
Exclusion of scholarship / fellowship income	57
Exclusion for small business stock	44
Exclusion of employer-provided child care	41
Exclusion of meals and lodgings furnished by non-military employer	37
Exclusion of state lottery winnings	29
Exclusion of foster care payment	25
Research and development credit	23
Moving Expenses	17
National Heritage Preservation tax credit	14
Casualty losses deduction	13
Student interest deduction	10
Limited partnerships investment source rule	10
Subchapter S-corporations[1]	–1,565
Total	**$19,532**

table three continues ▸

[1] The gain represents the net results after allowing the pass-through of net business gains and losses to shareholders, as well as the impact of business source income to non resident shareholders.

[2] 5.00 percent General Fund rate.

Table Three (continued)

Major Identifiable State Tax Expenditures of $10 million or More, 2004–05
(Dollars in millions)

Sales and Use Tax[2]	Full Year Cost
Exemption for farm equipment	$86
Custom computer programs	49
Leases of motion pictures	40
Motion picture production services	29
Printed advertising	27
Subscription periodicals	16
Total	**$247**
Local government revenue loss (2.67 percent average rate)[3]	$86

Corporation Tax	Full Year Cost
Subchapter S-corporations	$2,490
Water's edge election	450
Research and development credit	428
Special treatment for economically depressed areas	195
Double-weighted sales factor	130
Accelerated depreciation of research and experimental costs	124
Charitable contributions deduction	114
Corporations exempt from minimum tax	110
Low income housing credit	49
Joint Strike Fighter property and wage credit	35
Percentage depletion of mineral and other natural resources	22
Credit union treatment	10
Total	**$4,157**

Other Taxes	Full Year Cost
Motor Vehicle Fuel Tax	
Aircraft jet fuel used by common carriers and military	$56
Diesel and use fuel used by transit districts and schools	21
Total	**$77**
Insurance Tax[4]	
Pension and profit-sharing plans	$23
Cigarette Tax[4]	
Sales to the military	$25

[3] Includes 0.50 percent Local Revenue Fund, 0.50 percent Local Public Safety Fund, 1 percent Uniform Local Sales Tax, and 0.67 percent average county add-on rate.

Table Four

Major Identifiable Property Tax Expenditures of $10 Million or More, 2004-05

(Dollars in millions)

	Full Year Cost
Computer programs[4]	$101
Open space and historical property[4]	97
Total	**$198**

[4] Estimates are based on data published in the 2003–04 Tax Expenditure Report.