CONTACT: Margarita Fernández | (916) 445-0255, x343 | MargaritaF@auditor.ca.gov

The California State Auditor released the following report today:

Corporate Income Tax Expenditures

The State's Regular Evaluation of Corporate Income Tax Expenditures Would Improve Their Efficiency and Effectiveness

BACKGROUND

Contributing roughly 7 percent to the State's General Fund, corporate income taxes are one of the three largest sources of revenue. Corporations doing business in California are generally required to pay taxes to the State based on a percentage of their net income. Certain exceptions to the tax structure, referred to as *corporate income tax expenditures* (tax expenditures), substantially reduce this revenue. These tax expenditures—which can include credits, deductions, exclusions, and exemptions in order to encourage certain behaviors—reduce the taxpayers' overall tax liability and thus, reduce the revenue to the State.

KEY FINDINGS

In our audit of the benefits and cost-effectiveness of six of the State's tax expenditures, we noted the following:

- The State does not consistently define the purposes of its tax expenditures or create specific metrics to measure their performance. Legislation that authorizes new income tax credits must contain information on policy goals and performance metrics, but the requirement only pertains to tax credits. Only two of the nine bills introduced in 2015 that proposed new income tax credits included this information.
- The State's oversight of tax expenditures could be improved by implementing some best practices from other states such as clearly stated policy objectives, performance measures, sunset provisions to prompt legislative review, and an evaluation process to make recommendations to decision makers.
- Because no state entity oversees or regularly evaluates tax expenditures to make recommendations to the Legislature, there is insufficient evidence to determine if two of the six tax expenditures we reviewed are fulfilling their purposes.
  - ✓ We could not determine whether the $1.5 billion of forgone revenue related to a research and development (R&D) credit in fiscal year 2012-13 is fulfilling its purpose or benefitting the state economy.
  - ✓ It is unclear whether the franchise tax exemption, which cost the State $45 million in forgone revenue in tax year 2012, had a noticeable effect on encouraging new corporations to form in California.
- Three other tax expenditures appear to be achieving their respective purposes, but they could be improved.
  - ✓ The water's edge election allows multinational corporations to limit their taxable base to income derived from domestic sources, but may allow them to shield income in offshore tax havens. Extending water's edge to countries deemed tax havens could bring $20 million to $40 million additional state revenue.
  - ✓ Changing who can purchase low-income housing credits may increase funding for construction and thus, provide additional low-income housing units without additional forgone revenue to the State.
  - ✓ The film and television credit—intended to encourage film and television production in California —may be going to corporations that would have filmed in the State without the credit.

KEY RECOMMENDATIONS

We made several recommendations to the Legislature, including the following:

- Adopt best practices that other states use to evaluate their tax expenditures' effectiveness.
- Commission studies to evaluate the cost-effectiveness of the R&D credit and franchise exemption and whether these tax expenditures meet their policy objectives.
- Improve the effectiveness of other tax expenditures by making modifications to other tax credits and elections.

Date: April 12, 2016 **Report: 2015-127**