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Via Email

Mr. Gerald Parsky
Chair
Commission on the 21st Century Economy

Re: Recommendations to Improve California's Tax System

Dear Chairman Parsky:

Thank you for your invitation to COST to provide the Commission on the 21st Century Economy with recommendations to improve California's tax system. My February 12 testimony to the Commission provided information on the current state and local tax burden on California businesses, discussed the principles supporting exempting business inputs from the sales tax base and made recommendations for reform of California's system of tax administration.

In response to your request, COST recommends that the Commission support the following changes to California's tax system:

- Provide for an independent tax appeals system and eliminate "pay to play";
- Provide a broad sales tax exemption for business purchases of machinery and equipment used to produce goods and services; and
- End mandatory unitary combined reporting.

Additional information regarding each of these recommendations is contained herein.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of over 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Provide for Independent Tax Appeals and End "Pay to Play"

Regardless of the types of taxes utilized in any state's revenue system, taxpayers deserve fair, efficient and customer-focused tax administration. In COST's most recent survey of state tax administration systems, California scored poorly.[1] California's C- grade placed it among the bottom seven states. Two of the states ranked with or below California—North Carolina and Texas—have since made significant changes to their tax administrative statutes and practices to improve their fairness, efficiency and customer-focus.

Foremost in good tax administration is a fair and efficient tax appeals system. A state's ability to recognize the potential for error or bias in its tax department determinations and to provide taxpayers access to an independent appeals tribunal is the most important indicator of the state's treatment of its tax customers.

Today, almost half of the states provide an independent non-judicial appeals process specifically dedicated to hearing tax cases. Although the structure and rules may differ from state to state, taxpayers in these states are able to establish a record for appeal in an independent adjudicative body, before judges well-versed in tax matters. The ability to reach an independent tribunal, non-judicial or judicial, without prepayment is another key factor of a fair and efficient appeals process. Currently, almost two-thirds of states offer this opportunity with a non-judicial forum at a minimum, often with both judicial and non-judicial review. In addition, many tax dispute systems are designed to allow taxpayers and the state adequate opportunity to meet and discuss settlement opportunities before incurring the hazards and costs of litigation.

States like California, without an independent tax tribunal or similar appeals system, limit a taxpayer's real ability to challenge a state tax assessment. States that do not offer an independent tribunal are less attractive to businesses and are more likely to see taxpayers avoiding potential problems with the state by engaging in structural tax planning to minimize potential liabilities in the state.

States with fair and efficient tax appeal systems share three essential elements:

- The tax tribunal is independent;
- The tribunal's judges are specifically trained in tax law; and
- Taxpayers are not required to prepay a disputed tax or post a bond in order to receive an independent, impartial hearing.

Independent Tribunals: First, the tax court or tribunal must be truly independent. It must not be located within or report, directly or indirectly, to the department of revenue or to any subordinate executive agency. Without independence, the *appearance* of objectivity is simply not present. That perception, regardless of its accuracy, necessarily detracts from even exemplary personnel and work product of the adjudicative body. Independent tribunals are less likely to be perceived to be driven by concerns over revenue collection, upholding departmental policies, or offending departmental decision-makers.

Trained Judges: Second, the tax tribunal's judges must be specifically trained as tax attorneys, and the tribunal should be dedicated solely to deciding tax issues. The tribunal should be structured to accommodate a range of disputes from less complex tax issues, such as those arising from personal

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[1] Lindholm, Douglas and Stephen Kranz, "The Best and Worst of State Tax Administration: Scorecard on Tax Appeals and Procedural Requirements," April 2007, http://www.cost.org.

income tax matters, to highly complex corporate tax disputes. The tremendous growth and complexity in the body of tax law and the nature of our multi-jurisdictional economy makes this consideration paramount. Judges not trained in tax law are less able to decide complex corporate tax cases on their merit, and a perception exists (rightly or wrongly) that the *revenue impact* of these complex cases too often helps guide decision-makers through the fog of complicated tax statutes, regulations, and precedent. That perception reflects poorly on a state's business climate and reputation as a fair and competitive place to do business.

No Prepayment Required: Finally, taxpayers should not be required to post bond or pay a disputed tax before an initial hearing. More than 60% of the states grant taxpayers at least a *de novo* hearing on the validity of the assessment, in front of an independent arbiter, before payment of the tax is required. As a matter of fundamental fairness and due process, taxpayers should have this right in every state. It is unfathomable that taxpayers would be denied a fair hearing before being deprived of property (*i.e.*, disputed taxes). It is inherently inequitable to force a corporate taxpayer to pay a tax assessment, often based on the untested assertions of a single auditor or audit team, without the benefit of a hearing before an independent trier of fact. Free access to an independent hearing without having one's property confiscated by the law is especially important during difficult state economic climates; once tax money is paid into the system, it is often difficult or impossible to wrest a refund from the state, even after disputes are resolved in the taxpayer's favor.

The Commission should support the creation of an independent, prepayment tax appeals system for California taxpayers. This system should be available for appeals of all tax types, regardless of which agency administers the tax being appealed.

Exempt from Sales Tax Business Purchases of Machinery and Equipment

The sales tax comprises the single largest state and local tax imposed on business in California, generating $19.7 billion in tax revenue in FY08.[2] More than 45% of all sales tax revenue in California comes from impositions on business inputs, which is above the national average.[3] California is one of only five states in which the sales tax is the largest business tax.

All states that impose sales tax currently tax business inputs to some extent, but few states tax services principally purchased by businesses. California, however, places a greater than average sales tax burden on business by failing to provide any meaningful exemption for purchases of machinery and equipment used by businesses. California is one of only seven states in this category; 31 states fully exempt manufacturing machinery and equipment. Taxing business inputs:

- Places companies selling in international, national and regional markets at a competitive disadvantage to many of their competitors, leading to a reduction in investment and employment in the state;
- Unfairly and inefficiently taxes some products and services more than others by taxing many business inputs in addition to a general tax rate on final sales; and

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[2] Phillips, Andrew, Robert Cline and Tom Neubig, "Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2008," February 2009, http://www.cost.org. This figure includes sales taxes paid on business purchases of operating inputs and capital equipment; it does not include taxes collected on sales to final consumers.
[3] Cline, Robert, John Mikesell, Tom Neubig and Andrew Phillips, "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," January 2005, http://www.cost.org.

- Hides the true cost of government services by embedding a portion of the sales tax in the final price of goods and services.

Recognizing the nature of the 21st century economy, the Commission should support a sales tax exemption for the purchase of machinery and equipment used to produce goods and services.

End Mandatory Unitary Combined Reporting

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the corporate income tax base for multistate corporations with multiple businesses and entities. One possible system—mandatory unitary combined reporting (MUCR), which was pioneered by California—arbitrarily assigns income to a state, negatively impacts the real economy, and imposes significant administrative burdens on both the taxpayer and state.[4]

- <u>Arbitrarily Assigns Income</u> – Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude that there is a significant risk that MUCR will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state.

- <u>Negatively Impacts the Real Economy</u> – Proponents of MUCR have focused on the benefits in terms of reducing tax planning opportunities, but they fail to acknowledge that MUCR may result in higher effective corporate income tax rates. Economic theory suggests that these higher effective tax rates will ultimately be borne by labor in the state through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.

- <u>Significant Administrative Burden</u>

    - *Determining the Unitary Group:* The concept of a "unitary business" is uniquely factual and universally poorly-defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not exist) often significantly influences, or in fact controls the auditor's finding. Determining the scope of the

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[4] A thorough discussion of the problems associated with MUCR can be found in the study prepared for COST by Ernst & Young LLP, *"Understanding the Revenue and Competitive Effects of Mandatory Unitary Combined Reporting"* (www.cost.org).

unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

- *Calculating Combined Income* **–** Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors.

Many public finance economists "find little justification for the state corporate income tax" in the first instance.[5] Mandating unitary combined reporting exacerbates the problems with the corporate income tax. In light of the underlying conceptual flaws in the state corporate income tax, the Commission should support a New Mexico-style election that allows corporations to choose to file on a separate, combined or consolidated basis.

Conclusion

In reviewing the existing tax system, the Commission should seek opportunities to minimize or eliminate existing obstacles to investment and job creation. The three recommendations contained in this letter would significantly improve California's business tax system and send a message to the world that California encourages investment and job creation.

Sincerely,

Joseph R. Crosby

cc: Douglas L. Lindholm, President & Executive of Director, COST
Board of Directors, COST

[5] Fox, William F., Matthew N. Murray and LeAnn Luna, "How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?" National Tax Journal, March, 2005.