

Memorandum

To: Gerald Parsky, Chairman
Commission on the 21st Century Economy

From: June Summers Haas

Re: Deductibility of State Value Added or Consumption Tax

Date: August 26, 2009

California is currently considering replacing its general fund sales tax and corporate income tax with a net receipts tax. If California adopts a net receipts tax classified as a value added tax or similar consumption tax, it would be deductible for U.S. federal income tax purposes as discussed below.

Law and Analysis

The Internal Revenue Code of 1986, as amended (the “*Code*”) generally allows taxpayers to deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Code Section 162. In addition, Code Section 164(a)(3) specifically allows taxpayers to take an itemized deduction for State and local (a) real property, (b) personal property, and (c) income and excess profits and (d) GST tax imposed on income distributions taxes paid or accrued within the taxable year. Code section 164(a)(3). In other contexts certain business privilege or franchise taxes have been treated as an income tax for federal income tax purposes. The penultimate sentence of Code Section 164(a) adds a catch-all that allows taxpayers to deduct other State and local taxes paid or accrued within the taxable year in connection with the conduct of a trade or business or other income-producing activity. If California adopts a net receipts tax imposed on business receipts for the tax year, the payment of any such tax incurred by a trade or business should be deductible under Code Section 164(a).

Currently, the Code allows a taxpayer to elect to deduct State sales tax in lieu of deducting State income tax. This election is set to expire for tax years beginning in 2010 although there is a bill currently pending in Congress that would put in a permanent State sales

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tax deduction. The term “general sales tax” is defined as a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. Code Section 164(b)(5)(B). The current proposed structure of the business net receipts tax does not meet this definition.

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