STATE OF CALIFORNIA

COMMISSION ON THE 21st CENTURY ECONOMY

STATE OF CALIFORNIA

REVENUE & TAXATION

Commission BNRT Workshop

Wednesday, August 26, 2009
9:00 a.m. – 12:51 p.m.

University of California, San Francisco
Mission Bay Conference Center
William J. Rutter Community Center
Robertson Auditorium, 2nd Floor
1675 Owens Street
San Francisco, California

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A P P E A R A N C E S

COMMISSION ON THE 21ST CENTURY ECONOMY

Commissioners Present

GERRY PARSKY
Commission Chair
Aurora Capital Group

RUBEN BARRALES
President/CEO
San Diego Regional Chamber of Commerce

JOHN COGAN
Professor
Stanford University

CHRISTOPHER EDLEY, JR.
Dean/Professor of Law
Boalt Hall School of Law

WILLIAM HAUCK
Trustee, California State University
Director
Blue Shield of California & Blue Shield Foundation

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BNRT Workshop Panel

ALAN J. AUERBACH
Robert D. Burch Professor of Economics & Law
University of California, Berkeley

ANDREA CHANG
Multistate Taxation Bureau
Legal Division
Franchise Tax Board

ROBERT J. CLINE
National Director
State and Local Tax Policy Economics
Ernst & Young

A P P E A R A N C E S

BNRT Workshop Panel

JUNE SUMMERS HAAS
Partner
Honigman Miller Schwartz & Cohn LLP

CARL JOSEPH
Director
Multistate Taxation Bureau
Legal Division
Franchise Tax Board

PATRICK KUSIAK
Franchise Tax Board

DOUG POWERS
Franchise Tax Board

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COTCE Staff Present

MARK IBELE
Commission Staff Director
Board of Equalization

ASHLEY SNEE GIOVANNETTONE

ANTONIO LOCKETT

MICHELLE QUINN
Staff Writer

PHIL SPILBERG
Chief, Financial Research
Department of Finance

MARGIE RAMIREZ WALKER

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A P P E A R A N C E S

Presenters

BILL BARRETT
Vice President, Tax and Trade
Applied Materials

DAVID CHASE
Governor's Office
(Presented statements from various parties)

DAVID GOLLAHER
President/CEO
California Healthcare Institute

JOE GREENSTREET
Broadstreet Financial Group

MARTY KELLER
Director
Office of Small Business Advocate

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Public Testimony

KYLA CHRISTOFFERSEN
California Chamber of Commerce

TONY FISHER
New United Motor Manufacturing, Inc

MARK JACOB
Vice President
Pacific Merchant Shipping Association

MICHELE PIELSTICKER
Cal TAX

MICHAEL D. SHAW
Legislator Director
National Federation of Independent Business

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BE IT REMEMBERED that on Wednesday, August 26, 2009, commencing at the hour of 9:05 a.m., at the University of California, San Francisco, 9:04 a.m., at Mission Bay Conference Center, William J. Rutter Community Center, Robertson Auditorium, Second Floor, San Francisco, California, before me, DANIEL P. FELDHAUS, CSR 6949, RDR, CRR, in the state of California, the following proceedings were held:

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CHAIR PARSKY: We'll get started. This is intended to be a close-knit, informal working group. It's a little more formal in structure. However, I just want to make a few comments. And then the whole session really is meant to be an open give-and-take. We've planned two working group sessions: One today, here in San Francisco, and one on Friday.

And, first of all, we are here to discuss the possibility of a new form of tax. We're referring to this as the "*business net-receipts tax*." It would be part of a package of recommendations. We're not here to talk about the package. But I think it's very important as people step back and assess, once we determine the exact technical aspects of this tax, whether you are supportive or not, that you look at it in combination with the rest of the recommendations that would potentially impact the personal income tax, the corporate income tax, the sales and use tax, among others. And we've posted on our Web site a package that we will be discussing on September 10th.

And one element of that package was the possibility of proposing a business net-receipts tax. And that's the reason for these two working groups, is to make sure that interested parties who wanted to submit something in writing or would be willing to come forward and talk to us about it, have an exchange about this tax so that it could be understood and that, frankly, those of us on the Commission could get the benefit of input from parties that would be affected directly by such a tax.

Two of the commissioners -- John Cogan and Chris Edley -- agreed to work with me in planning for these sessions, and in helping to craft with staff the proposal that, with some obvious options still out there, has been made public and has been provided to all of the panelists on a fairly detailed description of this proposed tax -- or this proposed policy, and with examples.

We also have another commissioner here, Ruben Barrales. All commissioners are welcome to come and listen to this exchange.

We've also secured some expertise from a number of people that are at this table. I think all of the public is aware of the staff that has been doing terrific work for us here.

Mark Ibele is here, Phil Spilberg is here, both of whom have done a great deal of work.

We also have Bob Cline from Ernst & Young who has been doing a great deal of work for us.

June Haas is here as well. She has the benefit of extensive background in the state of Michigan and an extensive background in a form of business tax, not exactly the same, but provides expertise.

Alan Auerbach is here. And, Alan, in addition to being a first-rate overall economist, is also very familiar with this form of tax.

We have representatives of the Franchise Tax Board that are here, lead by Carl Joseph. And we obviously have gotten input and have the staff support of the Department of Finance within Governor Schwarzenegger's office.

So we have tried to go about this. It's an incredibly complicated task for this Commission to undertake. And all of us are very concerned about the way in which a recommendation would be made.

In particular, this is a new form of tax. The impact of it can't be predicted with precision. And so you will notice, among other things -- and we will want to talk about this extensively over these two sessions -- you will notice that the proposal that we are contemplating is not a proposal where such a tax would be imposed immediately. It's a proposal that would have a rather extensive transition period, the exact details of which we would like input on.

And there is, as I said, an interrelationship, especially, between the corporate tax and the business net-receipts tax that we will want to also talk about.

So I hope the public and all the interested parties will exercise some level of patience. We think the task that we're undertaking is extremely important to the future of California. I think that most of us have watched with great consternation, great pain, what has happened as a result of the budget problems that have been faced by the Legislature and the Governor. And the purpose behind the effort of the Commission is to see if -- not that we can solve the current problems, but if we can make some recommendations that will make it less onerous, or said another way, that the revenue stream that is needed in order for the government to provide the services that all Californians want, can be much more predictable; and that the kind of budget deficits that are being faced now and the cuts that have happened, which cause all of us a great deal of pain, won't happen in the future.

So that's by way of introduction.

I would ask any of the commissioners -- John or Chris -- do you have any comments that you'd like to make?

(No response)

CHAIR PARSKY: Or Ruben?

(No response)

CHAIR PARSKY: Okay.

COMMISSIONER COGAN: Gerry, I have a question. I see that we're only going until twelve o'clock today, or one o'clock.

CHAIR PARSKY: Yes, we're going to try, over the two-day period, we're going to try to do these discussions between now and lunch, about 12:45, try to get through those.

We'll have a public-comment period, as we have always, at the end of this session. But let's make it a give-and-take; and we'll try to complete this, this workshop by 12:45.

COMMISSIONER COGAN: Great.

CHAIR PARSKY: Okay, the first discussion -- not necessarily narrowly focused on technology, but it's the general subject that we wanted to have input on -- and I will, before we're finished, ask the staff to summarize any written material that we may have received from other industries or industries that may be covered, or interested parties.

And, obviously, technology is an important component to California's future. And we are particularly sensitive, as we try to make recommendations that are consistent with the 21st century economy of California, to continue to foster technological development, research, and development. And so the impact of this tax, or proposed tax, and the impact in combination of the package of changes that we would recommend on technological development and companies that are at the forefront of that, is a very important component for us.

So if, first, we could ask David to introduce yourself and then give some comments, and then we'll treat this as an open give-and-take.

MR. GOLLAHER: Thank you very much.

My name's David Gollaher. I'm the president and CEO of the California Healthcare Institute, CHI. We are a statewide association for California's biomedical industry. We represent more than 270 companies, as well as academic research institutions, both public and private, from Stanford and Scripps and Salk, to the University of California, along with biotech, biopharmaceutical, medical device, and medical diagnostics companies throughout California.

I would like to make a couple of different kinds or different levels of comments.

The first is to provide some context for what the life-sciences industry represents to California's economy.

Most of you know that the biotech industry was born here just around the corner at UCSF. Genentech was the first biotech company in the world. And California is by far the global leader in biotechnology and in biomedical R & D. So it's a real crown jewel in the national economy and of particular importance to California's economy.

And three of the world's greatest clusters, in fact -- the Bay Area, San Diego, and Orange County -- are three of the top four clusters of biomedical activity in the world.

In 2007 -- CHI, our organization, produces an annual report on the scope and scale of the life-sciences industry and its economic output. And we found in 2007, that revenues amounted to about $75 billion, taking everything into account. There are about a thousand products right now in the product pipeline, when you look up and down the 2,000 or so companies from large to small in California. The industry employs directly about

271,000 people in California. And if you take the multiplier effect into account, looking at construction, support services, and all the inputs for the industry, it multiplies out to about a million jobs all together in California.

The total wages and salaries paid in the industry in the year 2007 were over $20 billion. And the average wage in the industry is about $75,000 a year.

Beyond that, as you all well know, the industry makes enormous contributions to human health that are hard to calculate with respect to their economic impact but are, nonetheless, real.

Gilead Sciences, for example, has, during this generation, turned HIV, which was a death sentence when the infection was first discovered, into a chronic disease that can now be managed one pill, once a day. And people infected with HIV can live a normal life and continue as working adults through a normal life span.

So on the level of principle, one thing that I would like to point out is that any tax policy, any change in tax policy should reflect the unique characteristics of the biomedical industry across it. And I would point out a couple of things to take into account: One is that this industry is enormously capital-intensive. And its capital structure is different even from most other high-tech industries. The average biotech company, for example, takes 12 to 15 years to get its first product to market and employs more than a billion dollars of invested capital. So it's an enormously long, complex cycle time and long product development.

Moreover, the key driver for the industry is research and development. And biotech and biopharmaceuticals invest about half of all their revenues back into R & D. So incorporating the principle that encouraging more R & D is a good thing and is likely to build the industry and create more jobs is one of the key principles that we would recommend the Commission consider.

Now, I'd like to turn to the business net-receipts tax. We had the opportunity to talk to a number of our members on conference calls and to survey them, and to share some of the Commission's recommendations with them and get specific input. And I don't want to go into exhaustive detail but, rather, to raise a few of the top-line issues and questions that our members have, and reflect some of their concerns.

I think we all realize that this is not a fine-tuned specific proposal at this point. But the questions that our members had in the first instance is:

How broad the proposed tax would be, will it subject entities, such as check-the-box partnerships and so forth to the net-receipts tax, which entities will be covered and which will be excluded.

Second, will taxpayers be able to fully utilize their tax assets under the new tax regimen, and what restrictions and limitations would those be? So, for example, one of the important issues for development-stage companies is the net operating loss carryforward. A company that takes 12 to 15 years to get to market has substantial assets with respect to carrying those losses forward. And how they would be treated under the net-receipts tax is a critical issue for development-stage companies -- less important or perhaps unimportant for companies that have revenues subject to current taxation.

An additional question: Will there be a single mandatory filing method for all entities, or will the taxpayers be allowed to choose among filing methods? And this could be a question either for the transitional period or for the period when full phase-in of the new tax system has been implemented.

Obviously, the question of rates is paramount. And I think that, for larger companies -- the Amgens of the world, for example -- even a change of a couple of basis points in the base rate has enormous consequences.

So the first question or desire, I think, on the part of our membership would be to get more refinement on some of these issues, particularly the base rate, and to get more definition around those to produce some certainty of rate and impact so that their CFOs and treasurers could do the appropriate models for their shareholders.

A second set of issues would –- and I've talked a little bit about start-ups and development-stage companies, and I'd like to push that out just a bit further. I think from a policy perspective, that the state of California would want to continue to attract start-ups and development-stage companies and to retain those companies as they develop manufacturing capability. One of the facts of life that we've seen and the most important areas of impact on the life-sciences industry in California has been that when companies reach a certain stage of development, they choose to move offshore -- to Singapore or to other states in which manufacturing is less expensive than it is in California.

Genentech, for example, chose recently to build a new manufacturing facility in Oregon versus California. And that was based on the calculation of the single sales factor.

In order to take into account the impact on manufacturing as well as research and development, I think that the Commission would want to model both the impact of the net-receipts tax on both kinds of activities, and to have some understanding of the burden -- the tax burden on R & D-type operations, compared to high throughput manufacturing operations.

The last area that I want to address is the impact of the net-receipts tax on research and development. So currently, as you know, there is a federal R & D tax credit, there is also a state R & D tax credit. Both of those have been subject to pressure during the budget negotiations over the past couple of years in California. Both for planning purposes and for financial stability, it would be a good thing for those tax credits to be well-defined so the companies can do the appropriate modeling.

So the question for the Commission that I think that our members would be most interested in is the treatment of research and development cost under the net-receipts tax and what would be excluded and what would be subject to the tax for business purposes.

I think I will end there. I’ve probably used more than my allotted time; but I’d be glad to entertain any questions from the Commission.

CHAIR PARSKY: John, do you want to start?

COMMISSIONER COGAN: Do you want to hear from --

CHAIR PARSKY: Yes, I think, Bill, if you would make some comments.

Then I think we'd kind of like to just have an exchange over what impact -- or what kind of reaction you would have if rates were left at this one level or another, phased in, how it would impact your views if the corporate tax were eliminated. All of that, I think would be helpful to us. And to some, you may want to wait and come back and let us know about.

But, Bill, why don't you introduce yourself and then go ahead and we'll do that.

MR. BARRETT: Okay, I'm Bill Barrett. I'm vice president of Tax and Trade at Applied Materials. Applied, if you don't know, they make the machines that make semiconductors, historically. That was branched out into machines that make flat-panel displays for TVs and laptops.

And most recently, the last couple of years, we are now branching off into the solar area. Again, big machines making big panels or semiconductors.

I just wanted to -- you know, the materials that came by over the last couple of weeks generally got better and better, more detail and from the tax guy, it got better and better. So when I put together some of these earlier comments, it was with one of the earlier iterations of that. So I had some general comments on the state of the economy, if you'll suffer through that. And I'd just like to make a couple comments there.

I think we all know, and I think it's reflected in the reports that are coming out through this Commission, that both federal and state liabilities are on the balance sheet, are really not sustainable. It's the same situation at a federal level, the same situation for companies. You know, losses and increasing liabilities are simply not sustainable in this environment. Companies will do what they have to do to reduce the liability side of the balance sheet to stay in business.

We all know that they restructure. "*Restructure*" is basically a euphemism for, in many cases, going offshore, setting up operations in lower-tax areas.

Again, liabilities -- tax liabilities are simply one additional liability on a balance sheet. So if that increases, that puts pressure on companies to restructure.

I truly believe corporations at the end of the day do not pay income tax -- corporate income tax. I think it's passed on, primarily in the form of layoffs, if necessary.

So, again, I think it's important, at least from my perspective, to keep in mind that tax is just one liability on a balance sheet and it needs to be managed.

I also believe that the U.S. and California is an important crossroads because fiscal policy will have a direct impact on whether California asset values grow to absorb all the debt that is being incurred.

The comments by Warren Buffett last week, I think are very instructive in that regard. And I'd like to just quote Warren. This is in *The New York Times* last week in the editorial page.

Warren says,

> *"I want to emphasize that there is nothing evil or destructive in an increase in debt that is proportional to an increase in income or assets. As the resources of individuals, corporations, and countries grow, each can handle more debt. The United States remains, by far, the most prosperous country on earth and its debt-carrying capacity will grow in the future, just as it has in the past. Our immediate problem is to get our country back on its feet and flourishing -- 'whatever it takes' still makes sense. But once recovery is gained, however, Congress must end the rise in the*

debt-to-GDP ratio and keep our growth and obligations in line with our growth and resources. Unchecked greenback/dollar emissions will certainly cause the purchasing power of the currency to melt. The dollar's destiny lies with Congress."

So, again, I think those comments apply at the federal level as far as the California level.

In essence, what he is saying is, it's okay to have debt, as long as you have growth on the asset side of the balance sheet. So fiscal policy in California I think has to take that approach going forward.

So the first iteration of the report, a few comments on that.

The business net-receipts tax must consider the following key elements. Again, I think you've noted in the stuff I saw, that it is to be a replacement -- intended to be a replacement for the income tax. I think that's very important.

Defining cost of sales -- and David alluded to this -- is very important. Texas went through a version of this a couple of years ago. And what we found there was that, without R & D expenditures, including wages in the cost of sales, that the Texas gross receipts tax would have been a much worse situation for us. So we pushed really hard for them to put that into the cost of sales, and that reduced the net receipts, and it got us to a level that was roughly comparable to what we were paying in the past. So, again, the R & D, what you do with that is very important.

And importantly also, R & D support, it's supplies and it's wages. I think in the most recent iteration of the report, I think there's an intent to not allow a deduction for wages.

I actually did a paper on this, it was published in Tax Notes on February 16th. And it was an analysis of the subtraction method VAT at the federal level. And what I found was that in order to eliminate the winners -- or mitigate the winners-and-losers issue for wage-intensive and capital-intensive companies, you have to have either a deduction or a credit, wage credit, in order to equalize companies.

You know, I attempted to put myself in the shoes of a software company VP of tax and, again, modeled wage-intensive versus capital-intensive the impact at the federal level, and you really have to do something in that regard. Otherwise, you're going to have some big losers without a credit or a wage deduction for wage-intensive companies.

The other thing to think about -- and we are a worldwide unitary filer at Applied Materials, so I'm not that familiar with water's-edge type of calculations. But the thing to think about, too, is the border-adjusted aspects of a business net-receipts tax. And what I mean by that is the inputs. If you've got a situation where a foreign company that doesn't file worldwide unitary, is doing business in California, and it transfers product into California, into the California tax net, the federal tax net at the transfer price, you can see what can happen. The cost of sales could be elevated, reducing net receipts. That foreign competitor, for the California company, might have an advantage. Again, I haven't worked out the analysis on that, but I think you need to think about that long and hard.

I mentioned the R & D expenditures and cost of sales. Very important -- or a credit, if you want to keep the credit for California. That's another way to do it.

I mentioned the credit or deduction for wages. Very important for wage-intensive companies.

The other important thing that I found, at least at the federal level, was that low-margin companies, low net-margin companies, the bottomline percent being relatively low compared to a company like Applied, historically, which is at 20 percent net margins. Once you get down into those levels, a tax on net receipts of gross income can be pretty high. And, again, you've got a winners-and-losers issue.

So what I found, again, at the federal level was, you needed to cap it. You needed to cap the tax at 40 percent at the federal level. What it turns out to be at a state level, I don't know. But without that cap, then you're going to have some pretty high taxes for some companies with a profile of a low net margin.

Okay, now, a few other comments based on the most recent iteration of the report. What I noted in the recent iteration was that you intend to include treasury gains and losses and passive income at 100 percent. I mean, there are companies have done this. Treasury operations are pretty mobile. It's pretty easy for a company to move its operations outside the state. So that's what will happen to large companies. You know, they're not going to be taxed at 100 percent if they can move it to Nevada.

Using unitary business groups does eliminate the gains that could occur with intercompany -- of transfer pricing. So, again, I think the focus should be the unitary. I think the worldwide unitary, the fact that you eliminate intercompany transactions, deals with this border-adjusted potential issue. But companies that are foreign-based and do not file worldwide unitary may have an advantage, vis-à-vis California companies.

We talked about the wages and the salaries element. You really need to take a look at that from a winners-and-losers perspective.

And the cap. I worked with your examples. There was two examples in the back. And just –- this is very quick, this is last night -- but it seemed to me if you applied a 2 percent wage credit to the wages in those examples, it came out roughly equivalent to what the company might pay under the existing system. So there really needs to be more modeling than that.

So those are my comments.

CHAIR PARSKY: Why don't we start with some comments or questions?

John, do you want to start off?

COMMISSIONER COGAN: Let me find the button.

Yes, thank you, both, very much for taking the time to appear before us. I appreciate your thoughts and comments as we move forward.

I do have a couple of questions, mostly around the R & D credit. But let me start with David, and something you said, David.

Capital-intensive industries and high-margin industries, such as biotech, will benefit, it seems to me, from the BNRT relative to the current relative corporate income tax. On the other hand, if the industry loses NOLs, the industries lose R & D credits, then, to some extent, they're disadvantaged by the movement to the BNRT. And so we have these trade-offs, and industries sort of can't have it all, if you will.

So one option that at least one commissioner has mentioned to me, would be to retain the current R & D credit. But the current R & D credit -- it's a dangerous road for a commission to go down. Because ideally, we'd like to have no special treatment, no special deductions, no special credits. And once you take a step with one credit, then you should expect similar demands by a lot of other claimants on the State Treasury. So that's a big, worrisome thing. But we recognize the importance of high-tech and biotech for California's economy.

So one idea might be to have a partial R & D credit, which I'd like to ask you about. And the partial R & D credit would recognize that under a BNRT, we would have either complete expensing of capital or a very, very short depreciation period relative to the current code. And if we provided a BNRT credit or an R & D credit on top of that, you would, in effect, maybe reducing the price of capital to below zero.

And so how would you all feel about something like a revised R & D credit that just incorporated labor expenses?

MR. GOLLAHER: Well, if I think about the structure -– well, let's just take the biotech industry as an example. It's really divided in an interesting way between a few large, highly profitable companies and many, many smaller unprofitable companies. And the revenues into the unprofitable companies that are hoping to -- in three years or five years or seven years -- get a first product to market and earn product revenues, the income stream for those companies is to pay workers that are the main cost of doing business is royalty -- advances on future royalties through licensing deals, they would not be affected by any change in the R & D tax credit.

COMMISSIONER COGAN: Right.

MR. GOLLAHER: Right. So this whole flock of companies that are, in effect, the future, would not be influenced. They would care a lot about both the duration and the terms and conditions around the net operating loss and the carry-forward. And they would be even more interested if it were fungible. In other words, if you were able to sell it at a discount to a taxpayer or sell it back to the state at some kind of discount.

So those would be of great interest because, in the current system, many of those companies lose those tax credits; they expire before they're ever useful.

COMMISSIONER COGAN: Right, right.

MR. GOLLAHER: But the R & D tax credit and the way that that would be managed and discounted would be of great interest to the few large taxpayers. So Roche, Genentech, Biogen Idec, and so forth, Gilead, would care a lot about that.

COMMISSIONER COGAN: Right, right.

CHAIR PARSKY: But how do you think those companies would react to what John was suggesting?

MR. GOLLAHER: Well, I'd be guessing because I think they'd have to do the modeling. I mean, they'd look at their current cost of capital and look at his discounted model and do the comparison. And so I can't do that in my head and based on guesswork.

CHAIR PARSKY: I think it would be helpful to us if you got back to us with the reaction to something like --

MR. GOLLAHER: No, we'd be happy to. And I'm sure their tax people and CFOs would be interested in doing the modeling.

COMMISSIONER COGAN: Right. And I know our specifics haven't been out there that long, and I'm sure more specifics are going to have to be forthcoming from us in order for you to be able to do that kind of modeling.

MR. GOLLAHER: Sure.

COMMISSIONER COGAN: So we'll be getting that out hopefully very, very quickly.

Bill, can I comment on something you said?

MR. BARRETT: Yes.

COMMISSIONER COGAN: You talked about deductibility of labor expenses, or credit for labor expenses, which the BNRT, as we are now contemplating it, would not provide. And it seems to me that if one were to allow a deduction for labor expenses, then we are taking what we think of as more like a value-added tax and taking it back to being something like a corporate income tax.

MR. BARRETT: Yes.

COMMISSIONER COGAN: Right. And so it seems to me that the argument that's -- and I believe it's the argument that you made -- it's not really one of economic efficiency, it's one of incidence. What your concern is that if we were to lop off that deduction for labor expenses right now, that it would result in tremendous dislocations, both short-term and long-term.

MR. BARRETT: I believe it would, right.

COMMISSIONER COGAN: And we can deal with the short-term with a phase-in, I would believe; but I'm not sure we can deal with the long-term consequences.

MR. BARRETT: I think you're right.

And I think maybe -- that's why in pure economic-speak, I think a subtraction method VAT does make a lot of sense. But that's an academic view. And I think once you're on the ground and you're having that discussion with a CFO, that tax rate goes up, that's immediate, that is a short-term issue that you really have to address. And maybe that's why the flat tax evolved into what it was at the federal level, because I believe the flat tax does allow for some deduction or credit for wages.

But in my modeling -- again, this was at the federal level -- it was just pretty clear, I was, again, trying to be the Oracle VP of tax versus Applied Materials VP of tax; and there was a big difference. And so taking what I thought could work for Silicon Valley at the federal level, taking it for a software company, with that sort of big difference in tax rate, I knew it wouldn't go anywhere.

COMMISSIONER COGAN: Uh-huh. In some sense, if we think about the BNRT as extending a retail sales tax to services, then what you would say is any such tax would have severe consequences for labor-intensive industries.

You make the same case against a sales tax --

MR. BARRETT: Yes, I'm kind of about smart enough to make the connection of sales tax on services versus what we're talking about here at the corporate level. But taxing services, I think what I heard from some colleagues –- they have companies -- other states are actually backing away from that model, taxing services. And, you know, at the margin, I suspect there will be certain services that people will back off on from a consumer standpoint because of the tax. And some certain services are mobile.

COMMISSIONER COGAN: Right.

MR. BARRETT: If I want to use an accountant in Nevada, I may go to that accountant in Nevada versus somebody in California. So, you know, that's a big step and a lot of the potential consequences if you started taxing services.

COMMISSIONER COGAN: Right.

MR. GOLLAHER: So, John, just to pick up on that, because currently, medical services, physician services and so forth are not taxed. Under the model, as I read it, services provided by a for-profit hospital or a for-profit physicians group, for example, would be taxed. But those provided by not-for-profits would not be taxed; is that correct?

So one thing I would expect, a long time in my history, I was an operating officer at Scripps Clinic and Research Foundation which was a nonprofit, the nature of those kinds of organizations -- let me just talk about physicians organizations for a second -- is that whether they're profit or not-profit, the real operating cost are the physicians' incomes.

So what you would see is an almost 99 percent migration to not-for-profit models immediately. I mean, that's what I would recommend as a consultant to any group of professionals, which is to organize as a not-for-profit and make it a dollar a year of retained earnings. Because otherwise, you would be subject to the tax, and your services would be subject to the tax.

COMMISSIONER COGAN: Right. And the extent to which that is going to occur depends upon the level of the tax rate.

MR. GOLLAHER: Yes.

COMMISSIONER COGAN: If the tax rate is small, then we'd expect that incentive to reorganize, given the cost of reorganization and so forth, it's going to be small.

MR. GOLLAHER: Exactly, no, I agree with that.

COMMISSIONER COGAN: But then one of the dangers that people worry about with a BNRT, is that a rate might start out small and then creep up, as it has in Europe -- right, Bill?

MR. GOLLAHER: Yes, that's the experience on that.

MR. BARRETT: In Japan. Japan instituted one way back when they had their real-estate crisis, and it was supposed to be a one- or two-year thing. And now it's crept up. It's still with us 20 years later.

COMMISSIONER COGAN: Right, right.

I have one more question, actually. This is related to -- more generally to health care, David.

If we didn't allow a labor-expense deduction, then there is a question of how we think about health insurance. I mean, most economists think about health insurance as compensation. And so one would not allow a deduction for one's health-insurance expenses. Yet one can think also that a purchased health-insurance plan or for a self-insured company, the payment of health-care expenses might be another type of a non-labor expense, or non-compensation expense. And, therefore, we could make it deductible.

Have you any thoughts on the different treatments for health insurance from a public-policy standpoint?

MR. GOLLAHER: You know, that's a great

question. And that question is, of course, circling at the federal level, too, with respect to the deductibility from personal income and corporate income taxes for health insurance.

I mean, on the level of theory, I don't like the deduction any more than you do, because I think it provides perverse incentives for overspending.

COMMISSIONER COGAN: Right.

MR. GOLLAHER: And, you know, it's a bad idea. But it's sort of baked into the current system.

Unless there were a substantial change at the federal level of tax treatment for insurance and insurance-like expenses, it would seem difficult to implement something different at the state level. The tail wagging the dog.

COMMISSIONER COGAN: Right, right. Good.

CHAIR PARSKY: One other thing I think in doing your analysis that you should bear in mind is the interrelationship between this tax and the federal tax, and the deductibility of the payment of this tax. So it's really to accompany the net after-tax impact, combined, that ought to be looked at.

And we certainly haven't determined the rate levels. But what has been discussed is an extensive phase-in, not beginning until the 2011-2012 period, and then a phase-in over a five-year period from then as the corporate tax and any changes in the personal income tax and the sales and use tax decline, this tax might increase from what might be a 1 percent level to a 3½ or so percent level, in that kind of range.

MR. GOLLAHER: One concern that we've heard reflected is that as you extend the phase-in, you also extend the administrative burden of people who are trying to manage the phase-in and manage inconsistent tax systems to the degree that the federal and state taxes are inconsistent.

MR. BARRETT: In that regard, you may want to think about allowing for companies to adopt it sooner. I mean, it was an election. It was an election.

CHAIR PARSKY: It was an election?

MR. BARRETT: Yes. Because you're right, the administration is just one more level of administration.

COMMISSIONER COGAN: Right.

MR. BARRETT: And it's tough at year-end trying to get all this stuff put together.

COMMISSIONER COGAN: Right. And you're going to have to file a federal return, anyway. And so if you allowed elections, people would tend towards the current sort of system.

MR. GOLLAHER: And although it may seem

de minimis to some companies, particularly complex operations, the audit burden increases to the degree of the complexity.

COMMISSIONER COGAN: No wonder Ernst & Young liked this so much.

CHAIR PARSKY: The other thing we'd like you to think a little bit about is in connection with start-up companies, what's contemplated in the proposal is that there would be an exemption, if you will, from this tax at up to $500,000 of gross receipts.

Is that an appropriate level? I mean, you were particularly concerned about small businesses and start-up companies wanting to continue to foster both, and the magnitude of business at the small-business level in California, it might amount to anywhere from 85 to 90 percent of all the businesses are really deemed small businesses.

And would this level of exemption really apply to most of them?

MR. GOLLAHER: So this is an important point, and we've just had some experience with the definition of "*small business*" at the federal level around the issue of SBIRs and who qualifies for SBIR funding, okay.

Most small businesses are, in fact, small and the half-million-dollar threshold might work for them.

However, if you look at biotechnology, I think there's a unique problem because of the capital-formation issue. You can be a biotech that needs to raise $20 million or $30 million and still have a dozen employees and be quite a small business. So we could help you think through what kinds of criteria could be used but that wouldn't be prejudiced against extremely capital-intensive businesses that are, nonetheless, new, take a long time to get to market, have few employees, and are small, though capital-rich.

CHAIR PARSKY: It would be very helpful to us in trying to craft something that didn't violate the overall concepts of what a business net-receipts tax is but, at the same time, recognized with what was going on in California and the need to appropriately encourage small business development and companies that, as you say, would require capital in its initial stages. So commentary along those lines would be very helpful to us.

MR. GOLLAHER: We have a number of venture capital firms that are members of our group. And we can speak with them in terms of their views.

COMMISSIONER EDLEY: Well, it's a little perverse, but could you think about our definition of smallness being framed in terms of profit under federal tax purposes?

MR. GOLLAHER: Well, again --

COMMISSIONER EDLEY: And, I take it, again, you're concerned with companies -- I'm sorry to interrupt -- but you're concerned with companies, for example, that are still in a mode of accumulating NOLs.

MR. GOLLAHER: Right.

COMMISSIONER EDLEY: Don't have anything that's gotten to market yet, so they wouldn't be showing profit --

MR. GOLLAHER: Correct.

COMMISSIONER EDLEY: -- on a federal return?

MR. GOLLAHER: Right.

COMMISSIONER EDLEY: So a combination of small -- small/start-up, small and/or start-up, right, where you think of "start-up" with reference to their profitability.

MR. GOLLAHER: But what's interesting -- this is a very useful discussion because the classic definitions of "*small business*" don't really apply to some of the new kinds of businesses that we're seeing.

COMMISSIONER EDLEY: Exactly.

MR. GOLLAHER: And I'm familiar with the ones in life sciences, but there may well be ones in other areas of technology in which the classic definitions don't work very well, either. So rethinking the matrix would be a good exercise.

COMMISSIONER EDLEY: Maybe capitalization would be another thing.

MR. BARRETT: And, Chris, you're sort of going down the route that I was concerned about, with developing a cap, a cap on the tax. And if you lose money, then obviously the cap is no tax. So looking at --

CHAIR PARSKY: This whole area of how small business -- how the tax is structured in a way to not be an impediment to start-up businesses, small businesses, cutting across a number of industries. This is very important to us. And so coming back with some real input there would be very helpful.

COMMISSIONER COGAN: Yes, one of the problems that I've had with the gross sales measure, is that it sort of creates a notch in the tax code. Once the gross sales measure is $500,000, you don't pay any taxes until you reach that threshold.

Once you've crossed that threshold, then you're liable for as much as taxes on the net income of $500,000, right, if you have no costs or all your costs are labor. And so you create this notch in the tax code when you have such a standard.

COMMISSIONER EDLEY: I don't think that's called a "notch," I think that's called a "planning opportunity."

MR. GOLLAHER: But what we see all the time is companies that still haven't got their first product to market, but also have some other product or service that they can sell, because they're doing anything they can to bring revenue on board. So they're licensing, they're looking at contract manufacturing potential. So they have some manufacturing capacity for prototype drugs, but they're also doing some contract manufacturing. They would be reluctant to do that if that put them into a category that then required a different tax treatment for their operations.

COMMISSIONER COGAN: Right.

Say, June or Bob, in Michigan, was there any other criteria applied to start-ups? Is there any sort of special treatment of start-ups in the development of that code?

MS. HAAS: You essentially have a filing threshold of Michigan receipts. And the concept is the fact that you are over the gross-receipts threshold doesn't necessarily mean you have tax liability, depending upon your mix of where you're investing. So, for example, if one had a very labor-intensive start-up company that had more than, in this case, it would be $500,000 of California gross receipts, but they had lots of depreciable capital assets that were purchased, that then would be deductions from the gross receipts, you could end up with essentially a very low or no tax in the concept of having not labor intensive, but capital-intensive with very few labor people, you could still have a very low tax on that entity, even though they are technically over the gross-receipts threshold.

COMMISSIONER BARRALES: Chairman Parsky, can I ask a question? Kind of a question.

Staff and other presenters have talked about other states, other models. From your perspective, who is doing a good job? Or what are examples of encouraging development of small start-ups, biotech and tech companies, in attracting technology-related jobs and companies? What are some examples of that?

MR. GOLLAHER: Singapore.

I'm only half facetious.

But it's interesting, you know, if you go to the International Bio Conference that happens once a year, and you go to the trade floor, which is acres and acres, most of the display space is taken by foreign countries, trade missions, and other states that come to California or come to wherever the show is to attract business. And the pitch is usually tax, other economic incentives, tax holidays, and so forth. And then lower cost of doing business, and then human capital, what kinds of university connections and what kinds of workforce and so forth is available.

So states that do it well, North Carolina would be a case in point, in which there's been a coordinated business plan at Triangle Park between the state university system; the private university, Duke; and the state itself to package a set of incentives that include certain tax discounts, phase-ins, so forth, tax credits, for creating employment, for creating jobs.

And so you can model that kind of package. Very difficult for California to do in its current fiscal environment. But if you had to look at one state, my view would be you'd look at North Carolina, maybe you'd look at Maryland.

CHAIR PARSKY: Any others?

MR. BARRETT: Yes, I mean, we follow our customers. So if an Intel invests in Oregon or New Mexico or wherever, that's where we go to serve the customer. And I don't know the details in the Intel situation, but I do know that the states are very interested in tracking that big investment for a fab, to go along the lines of what Dave was describing.

COMMISSIONER BARRALES: So where in the states are your customers going these days?

MR. BARRETT: Actually, they're moving out of the United States more and more. I think the Feds have a much bigger issue. They have a huge issue. They need to attract investment in the United States, or it's going to be bad around here.

CHAIR PARSKY: Alan, any questions or thoughts?

MR. AUERBACH: No.

CHAIR PARSKY: Thank you, both, very much. This was extremely helpful to us.

Please, over the course of the next couple of weeks, please have a direct interchange with our staff, with Alan, with any of the people here in terms of trying to model up, with some suggested changes.

One other thing I should have said in the introduction, this is a process that will have one life, if you will, at the commission level and then another life at the legislative level.

The Legislature -- the Governor has said that he will call a special session of the Legislature to deal with the recommendations, and ultimately to either accept them as a package or not, but there will be a legislative process. There should be and there will be.

We just want to have as much possible input as we can in trying to craft some recommendations that make sense, as far as California is concerned.

Thank you both very much for doing this.

Next, we have, I think, Bill Dombrowski.

Is Bill here?

You're going to provide something? Okay.

If you could just introduce yourself -- and are you here to talk a little bit about retailers? Is that --

MR. CHASE: No, I'm David Chase with the Governor's Office. I'm just reading the letter on their behalf.

CHAIR PARSKY: Okay. And, David, you've done a very good job at helping us organize this. I'm just joking with you a little bit.

MR. CHASE: Thank you.

Again, this is from the California Retailers Association.

It starts:

"Dear Chairman Parksy:

"The California Retailers Association appreciates the time and hard work the Commission on the 21st Century Economy has devoted over recent months to hearing and considering various issues concerning California's tax structure. We must, however, respectfully express our strong concerns and opposition to a business net-receipts tax.

"Our concerns start with the BNRT rates being discussed. Rates ranging from 2.7 to 3.3 percent have been discussed. By comparison, Texas has different rates for different industries, with retailers subject to a rate of 0.5 percent.

"Assuming BNRT rates near 3 percent would mean retailers would pay combined taxes, substantially in excess of what we pay now.

"The BNRT also does not recognize or provide a deduction for the significant expenses represented by compensation and benefits. As a result, the tax will penalize California-based businesses that provide competitive wages and benefits, including health care. It would be ironic if the business tax structure in California would be changed to discourage employers from offering health care, while at the same time, the Legislature tries to mandate expansion of employer-based health care.

"There are other concerns we have with the BNRT. How will this tax affect specific economic sectors? Which industries will see their liabilities increase relative to proposed tax cuts, and which will pay less? How will

these changes affect these industries, these industries' inclinations to do business in California? How will the BNRT proposal affect California job creation and retention since, in effect, it appears to be a tax on employees? Will the BNRT provide an incentive for businesses to reduce California payrolls, including for California-headquartered in favor of outsourcing or relocation? How will the BNRT affect California's competitiveness? Specifically, with respect to domestically produced goods and services, exported at a new higher price, and with respect to those same goods and services offered at lower prices by other states and countries? Will the BNRT result in increased costs of doing business in California as it pushes up the cost of goods and services for vital California industries?

"The California Retailers Association is a trade association representing major California department stores, mass merchandisers, supermarkets, chain drug and convenience stores, as well as specialty retailers, such as auto, book, and home-improvement stores. Our members have more

than 9,000 stores in California and account for more than $100 billion in sales annually.

"Sincerely, Bill Dombrowski, President and CEO."

CHAIR PARSKY: Maybe we can talk a little bit about the impact of this tax on the retail industry generally. Maybe start a little bit on -- June, kind of the worry or concern Michigan may have had about this industry based on your experience and recollection, what reaction did the policy makers of Michigan have to this industry?

MS. HAAS: In general, anytime you discuss a tax that has a very broad base as a gross receipts or a value-added tax, there is a concern raised -- and it certainly was in Michigan -- that the low-margin industries, such as retailers, particularly grocers, will be negatively impacted by it.

The concern in Michigan, to a great extent, because there was a deduction for inventory, was substantially mitigated, because as you look at the carrying costs for that particular segment -- and I'll turn it over to Bob if he wants to make further comments -- a lot of their concern is, they're getting large amounts of receipts, but they have huge amounts of carrying costs, their inventory. Once you take the --

with the inventory deduction under a purchase system of other firms, then it's really limiting it more towards labor and profit, which is the value-added. And that, to a great extent, alleviated the concern that was expressed in Michigan for the move to a broader gross receipts-type tax.

CHAIR PARSKY: Bob?

MR. CLINE: I would agree with that summary. And it is a reminder that a value-added tax concept involves that base being determined by total revenue minus purchases from other firms. And that will include inventory, machinery and equipment, buildings -- whatever that purchase might be -- and paper clips.

It is important to discuss what form that subtraction will take and the relative size and timing of those subtractions for capital or inventory purchases. And I know that's an issue that's being considered by the Commission.

CHAIR PARSKY: Maybe I think it would be good to discuss a little bit that last subject, how we are struggling with the concept of whether or not those items that would warrant a deduction and would certainly be well received, I would think, by retailers or others, should they be immediately expensed as purchased, or should they be expensed over time, maybe much shorter time, than any depreciation schedule that would exist. And if it is over time, should it be afforded an interest factor.

And maybe, Alan, you could describe the issue that we are struggling with affecting that.

MR. AUERBACH: Thank you.

The issue of timing, I think, would relate only to durable goods. So in the case of retailers, the cost of goods sold would be immediately expensed. I don't think there's any question about that.

COMMISSIONER EDLEY: What about the interest costs related to the inventory?

MR. AUERBACH: I'm sorry?

COMMISSIONER EDLEY: Interest costs related to the inventory.

MR. AUERBACH: This, as under a sales tax for a typical retailer, there wouldn't be any interest deduction.

COMMISSIONER EDLEY: Deduction?

MR. AUERBACH: The only -- the issue of timing would relate to capital expenditures. And there, the question would be whether the deduction would be taken immediately as it would under a true subtraction method value-added tax, for example, or whether it would be partially deducted in the year of purchase with remaining deductions taken over some short period with an interest factor added to the basis of the future deductions.

The reasoning for the possibility of carrying these deductions out over time rather than immediately relate to two factors: One, having to do with the question of whether companies undertaking very large capital investments would not have a positive tax base, and then the issue of carry-forwards would come up.

Also, the problem of dealing with the apportionment factor, and the fact that this would be a tax assessed using a sales factor, much as the current -- the new corporate income tax would have an option to do that. And the problem of fluctuations in the tax base among different years associated with large capital purchases is raised by that. And by having capital deductions smoothed out over time rather than occurring in the year of purchase, that might lessen the problems associated with the apportionment factor in different years.

But the intent would be to allow companies the full value of the capital purchases as a deduction because of allowing interest on deducted bases, so that whether the deduction would be taken immediately or taken over a period of years, the full value of the deduction would be the same. It just has to do with other factors that might make it easier to do it over time rather than immediately.

I just wanted to say one thing. I'm sorry that the gentleman who wrote the statement isn't here. It talked about the possible problem of discouraging employment in California. This would be based on the sales apportionment factor. So the question, I think, would have to do more with sales in California rather than employment in California.

A national company, for example -- a company with national sales that happens to produce in California would not be especially disadvantaged by this tax, because the tax would only apply to -- based on sales in California, not on production in California.

CHAIR PARSKY: I think that's a critically important part of this analysis. And I hope that the companies involved here will look at that, as well as the deductibility of inventory, which I think retailers ought to do the calculations around in comparing the impact of this form of tax versus what exists now.

Other comments about this industry?

John?

COMMISSIONER COGAN: Yes, I've been hearing the same things from a lot of firms, that the business net-receipts tax is more like a tax on compensation than it is like a retail sales tax. And it seems to me that it is more like a retail sales tax than it is a tax on compensation. And Alan's points are very well taken.

You know, for a retailer, there is an issue, though, because it is low margin and high labor costs. So we do have to worry about it. But it seems to me that we need to have a much clearer picture about the incidence of this tax and why it would not fall so much on labor.

I mean, after all, if we just consider this tax in isolation from everything else we're doing, it seems like one could make a case, if you're a retailer, that this is going to disadvantage retailers. But at the same time, if it's coupled with a proposal that eliminates the retail sales tax in California, then all of a sudden you have to stop and say, "Hey, wait a second. Maybe in combination, these policies will not be so disadvantageous to retail."

So it's clear, though, that we need to do a lot more in the way of modeling if we're going to assuage the concerns of the industry.

COMMISSIONER EDLEY: Gerry, I need some help here with -- my intuition is a little tangled here because it just feels -- I mean, Alan, particularly, maybe you could help me out. Because it just feels to me like the interest costs associated with inventory management are --

it just feels conceptually different to me, from other forms of interest. And you probably want to know why I feel that way.

CHAIR PARSKY: Well, you're concerned about the way in which inventory is financed and how that relates to this form of tax?

COMMISSIONER EDLEY: Yes. Well, I guess for inventory -- I mean, there are sectors where these sort of -- let's take an auto dealership --

COMMISSIONER BARRALES: Right.

COMMISSIONER EDLEY: -- where I think there's a similar --

COMMISSIONER COGAN: You think about it just as a cost of doing business, in effect, since the norm is to finance it with debt; right?

COMMISSIONER EDLEY: Yes, right. Exactly. And it's almost as though you could -- if the manufacturer, the auto manufacturer could fold the cost of the financing into the wholesale price that they give to the dealers, it's just a question of who does the financing.

CHAIR PARSKY: I couldn't think of a better state to focus that question on than Michigan. So why don't you --

COMMISSIONER EDLEY: They're not selling many cars there, so…

Let's take it back a few years.

MS. HAAS: Not surprisingly, when -- under both the single business tax and the new Michigan business tax, there is a special deduction and/or credit for what's known as "*floor-plan interest*," which is interest that is accumulated to carry vehicle inventory. And I can provide those sections under both the SBT and the MBT to the Commission to consider.

But that was -- other than the auto dealers, I don't think we had or there were any other exceptions for interest. But that was a special provision.

COMMISSIONER EDLEY: So you agree, in New York, that would mean schmata didn't just write -- the rag trade would be in here talking about the way they do things.

CHAIR PARSKY: Well, we had a presentation from the retailers. Now, we want to keep this at a very high level.

MR. AUERBACH: Excuse me --

CHAIR PARSKY: Alan?

MR. AUERBACH: I just wanted to say, this touches -- I don't think there is anybody talking today from the financial industry; is that right?

COMMISSIONER EDLEY: Yes, right.

MR. AUERBACH: Because this definitely touches on the treatment of the financial industry, whether you would think about giving such a deduction would relate to how you end up treating the financial industry. Because there's two sides to the transaction here. And without getting into too much detail, you could conceive of a system where you would allow a deduction for interest. And not just for inventory, interest for carrying inventories, but also interest more generally. And that would relate to what you're doing to the companies that are providing the loans.

COMMISSIONER EDLEY: Okay, well, I'll sleep on this some more.

CHAIR PARSKY: Okay, let's go on to -- next, David, you're going to take on reading here? Okay.

This is from the Silicon Valley Leadership Group?

MR. CHASE: Okay, this one is a little bit longer, so bear with me here.

As the Chairman said, this is from the Silicon Valley Leadership Group.

"On behalf of the Silicon Valley Leadership Group, I am writing regarding recent discussions by the 21st Century Commission on the New Economy in preparation for the issuance of a final report on September 20. The more than 300

member companies of the leadership group recognize the economic circumstances you and your colleagues are dealing with in your consideration of a revised state tax structure. We have previously communicated to the Governor and the Legislature that without tax and budget reform, California will remain vulnerable to future economic difficulties.

"The Leadership Group has yet to formulate specific positions on any of the proposed plans under consideration by the Commission, given that many of the details are not yet developed or known. Nonetheless, we respectfully ask that you consider the following general comments and suggestions in your ongoing deliberations.

"First, although short-term revenue increases have regrettably been necessary to address the current budget crisis, such increased costs will hamper California's economic recovery and long-term health. To mitigate potential harm and to regain our tax base as quickly as possible, we urge that any reform proposals be benchmarked in the context of their impact on jobs and California's competitiveness across both established

industries and promising new sectors, including those related to green technology."

COMMISSIONER EDLEY: Well, that's a great idea. Why didn't we think about that?

MR. CHASE: *"In the past, we have recommended the following to meet those goals, and believe that these issues also have relevance to the proposals now under consideration by the Commission.*

"Single sales apportionment factor: 22 states utilize single-sales-factor apportionment, including states adjacent to and most competitive with California. States such as Texas now have alternative corporate tax systems not based on net income.

"R & D tax credit: It is critical that California remain competitive as a site for U.S. research and innovations, jobs, and economic growth, that such research fosters. Recent actions taken by state government to address our economic crisis have limited the ability of the current credit to produce its optimal favorable effect. It is vital that California return to encouraging research here to the greatest possible extent, even if structural changes

occur to the tax system.

"Double taxation of productive assets: California, unlike virtually every other state, has double-taxed productive assets used in both manufacturing and research. Academics, economists, and businesses all agree that taxing both business inputs and outputs constitutes inappropriate tax and economic policy. This practice should be avoided under any new tax structure.

"Second, the leadership group has had a long-standing position opposing split-roll property taxation, including split-rate proposals and other proposing changes of ownership to trigger reassessments of commercial property.

"We believe such changes are undesirable due to the inevitable increased tax burdens which would fall squarely on employers, as well as increased administrative burdens on taxpayers and government alike.

"If there are identified abuses of the current change-of-ownership rules, any revision should be limited to addressing such abuses, not altering the overall system to implement a

split roll.

"Third, the Commission's charter appears to propose revenue-neutral recommendations rather than to raise additional revenue. However, there have been some discussions of new sources of revenue by members of the Commission. If and when added revenue may be considered, we suggest that revenue enhancements be both limited and strategic. In this regard, we believe any revenue enhancements should be shared broadly rather than falling disproportionately on any one sector. A reinstatement of the vehicle license fee should be among the first considered.

"In addition, revenue increases and/or spending cuts will likely only temporarily address the State's fiscal problems, and meaningful budget reform will be needed as well.

"We urge the following:

"A two-year budget. This should include provisions for mid-course corrections and multiyear forecasts to help elected officials analyze the downstream effects of policy decisions.

"A more robust and secure reserve fund.

Even with the revision of the State's revenue structure, the State must institute revisions to smooth revenues and spending by setting money aside in flush times, neither spending it nor refunding, to provide a cushion when revenues fall.

"Fourth, with respect to the proposed business net-receipts tax, the Leadership Group has no formal position at this time. We believe the general comments below raise important issues to be considered as a BNRT proposal is refined and is subject to further consideration.

"If the Commission were to ultimately recommend one, we offer the following comments, although, as cited below, additional specific comments could emerge as more details of a BNRT become known.

"Changing to a net or gross receipts regimen will have a substantial impact on California business. Within the economic recession, importantly, our current corporate tax system allows for losses incurred during an accounting period to be carried over for use as soon as possible in a period of profit. This reflects the fact that yearly accounting periods

are not an accurate reflection of business economic circumstances. A fair and equitable measure needs to extend over a longer time period or businesses with similar economic outcomes over time would be treated disparately in terms of their tax burdens.

"A BNRT not being based upon profitability has the potential to severely hurt California business when they can least afford it and when cash flow is critical, when they have no profits at all.

"Accordingly, a BNRT should retain some method to avoid any unfair outcome. The Commission should also take into account the potential federal impact of an alternative tax system such as the BNRT.

"The enemy of a good business decision is uncertainty. Evidently, the proposed BNRT rate has already been subject to an increase over one previously mentioned. The acceptability of the BNRT will depend, in significant part, upon a business calculating what would be eliminated, the corporate income tax and state sales tax, and what would replace it, the BNRT.

"So the BNRT rate is critical to that

determination. Also, the BNRT rate should remain at a predictable level. In the future, susceptibility to arbitrary rate manipulation or increases should be avoided.

"Moreover, taxes replaced should, to the greatest extent possible, not reemerge later.

"Sourcing issues are critical within the context of a BNRT, and foreign income, dividends, royalties, et cetera, should be excluded from the base. The tax should be imposed on the basis of a true water's edge.

"As mentioned above, single-sales factor apportionment should be employed to calculate taxable net receipts. To revert to doing otherwise would be to return California to a method that penalized California jobs and capital investments and, ironically, rewarded the same if in other states.

"Also as mentioned above, it is important that BNRT preserve a measure targeted at the ongoing conduct and growth of research in California. Virtually every other state, including many of those with alternative tax systems, maintains a provision of some type to encourage new and added in-state research.

Virtually all economists agree that absent government aid, the private sector would underinvest in research.

“Thus, competition for research among other states and other countries is intense. A revised tax system should not place California in a lesser position. The BNRT should continue to include a provision designed to encourage research in California. Notably, in the recent past, legislative efforts have been made not only to retain our current 15 percent credit, but to also increase the rate to make sure that our lead is maintained, even as other states are moving to enhance their research credits and incentives.

“Also, as cited above, a BNRT should avoid the double taxation of productive assets our current system has unfortunately included. It appears that the BNRT would do so through the elimination of the state sales tax and the BNRT exclusion of business purchases from its base. However, the initial proposal to expense capital asset investments has apparently now been altered to, instead, employ a depreciation system similar to the federal modified

accelerated cost recovery system, which could expose some productive assets to continuing double taxation.

"In addition, the local sales tax share, presumably, would continue to tax both business inputs and outputs, and produce double taxation in the future unless the local sales tax was changed as well.

"In a transition to a BNRT system, it would be crucial that tax attributes from the prior tax system not be lost. For example, unutilized credits and losses carried over, and unclaimed depreciation of assets previously acquired should be contemplated and be accommodated under a new tax system. If not, the economics and receptivity of the new system will be adversely affected.

"We appreciate the opportunity to share our thoughts with you. Thank you in advance for your consideration and service in leading the Commission.

"Sincerely, Carl Guardino, President and CEO."

CHAIR PARSKY: Thank you.

We won't level any commentary on you, since you're the reader.

MR. CHASE: Thank you.

COMMISSIONER EDLEY: Well, was he forced to be the reader?

MR. CHASE: Yes.

CHAIR PARSKY: I know you're going to read another statement afterwards.

MR. CHASE: Yes.

CHAIR PARSKY: So you can stay, it's perfectly okay.

But let's put aside commentary about split roll, revenue neutrality, vehicle license fee, budget suggestions, and the reserve fund, none of which really address the purpose of this workshop.

Am I right in saying that single-sales-factor commentary from this statement, the double taxation with the exception, perhaps, of the local sales impact, and -- are addressed, really, in the proposal on the table?

What is raised again, however, is this -- the concept of immediate expensing versus expensing over time. I think that remains a troublesome issue that we really need to focus in on, as well as how we're going to deal with the R & D question raised again and then the losses, net losses. Those three things, at least, in that statement kind of came out, to me, as things that are important, again.

Any dialogue that we want to have further, without reaching any conclusion, but just dialogue further along this side.

And, Carl, I haven't asked you to comment yet, but we might get you engaged in this process.

On any of those subjects, what would you say without necessarily being a strong or medium advocate?

MR. JOSEPH: Well, I think the comments about companies having losses is, to me, just a reflection of the switch from an income base, to a base that's broader than an income basis.

And, you know, the idea that they should be able to carry it over, we have talked about if you do have a year where the purchases for the BNRT base are more than the receipts, you could have a carryover there. But I don't think that's what these comments are getting to. I think they're getting to more of an issue of almost ability to pay: You know, we're in a loss year and now you want us to pay this tax. I mean, I certainly understand the comment. I just don't know that it really is receptive or addressing the idea of value-added. You know, there can be value-added, even though no net income is produced due to expense. So I think that's just kind of inherent in the system.

The choice is that you are going to have a lower rate and a broader base. And, yes, companies that have a net income loss perhaps for federal purposes, may well pay the BNRT because they did add value. So I just think that's sort of fundamental in the choice that the Commission is looking at, that that could, in fact, happen.

As to the credit issue, that's certainly just a policy call for the Commission. Obviously, when you start interposing credits here, that starts to erode your base, which is one of the big sellers to me about the BNRT, is that you can have a big, broad base and a low rate. And when you start adding credits to it, that certainly can change that equation.

I mean, I do understand the argument about the credit increases investment in R & D and that that's a good thing for the economy as a whole. I just -- you know, that seems somewhat at odds with the idea of making this thing as broad as possible. I think some of the economists would probably have more to say on that than I.

CHAIR PARSKY: Bob?

MR. CLINE: Well, Carl made a very good point about a business net-receipts tax is a tax you might approximate by describing as a value-added tax. And you could have a -- you have a company that has quite a bit of value in terms of wages and salaries paid, interest paid, that is not making money in a particular year. It is not profitable. And you can understand the distinction between a profits tax and a value-added tax, and you can explain it, and you can describe it.

But the Michigan experience -- maybe June might want to comment on this -- the Michigan experience, they actually used two different value-added taxes -- the business activities tax, adopted back in 1953, and then the more recent single business tax, and now a modified gross receipts tax.

And I would say over the 45 to 50 years that Michigan used a variation of a value-added tax, year in and year out, there was continuous debate within the business community between the Legislature and the business community about the issue of profitability and how it related to the value-added tax.

And it tended -- the ebb and flow almost reflected the economic cycle. In the good years, when everybody was making a lot of profits, they seemed to be willing to live with the value-added tax. In years when profits were down, there was a growing support to switch to a corporate income tax.

But I guess my comment is, it’s a continuous challenge to adopt a new state business entity tax, be able to describe what it is, so that you can, in a sense, defend the tax base, and explain why it looks the way it does. And it's an ongoing challenge. Maybe it's also true for the corporate income tax, but…

MS. HAAS: Yes, I think Bob's observations are absolutely correct. I don't know whether you shared with them, when you have a value-added tax versus a profits tax, when profits go up, the tax does not go up as quickly as a net income tax would; and when profits go down, the tax does not go down as quickly as it would with a net income tax.

And the business community has uniformly expressed unhappiness with paying tax at a similar level when they are unprofitable as to when they are profitable during bad economic times. And that has uniformly been true in Michigan under all of their value-added tax-type regimes. And it is that nature of the entity of tax.

COMMISSIONER COGAN: One of the items mentioned was the allocation of interstate sales, the single sales factor. And one of the proposals that I saw in one of the documents we've received recently, was the possibility of using a five-year average of the state sales relative to worldwide sales or national sales as the apportionment factor versus using one year.

Phil, can you maybe walk us through how you see the pros and cons of those two alternatives? And maybe, Carl, when your people have some thoughts on one versus the other as well.

MR. SPILBERG: We did look at, as an alternative, apportioning revenues to the State using an average of five years -- of course, five years is an arbitrary number, you can choose as many as you want -- and compared it to other methods.

The advantage of using an average, is that changes from year to year are smaller. And to the extent that they're either –- that there are large sales that occur in or out of state, that the effect of those sales fall on the tax base are smaller. So basically, you have a more steady apportionment over time.

The disadvantage is that it can at times create basically a wrong apportionment because you have to take into account that your apportionment is against a tax base. So there could be changes to the tax base. You could have a firm that basically is a new firm that creates complications in how you properly calculate that average. And you can have a firm that, in essence, leaves the state in the mid -- well, and if you're averaging, the question is, what do you do when the firm leaves the state, in terms of recapturing whatever tax would need to be allocated.

COMMISSIONER COGAN: One additional question: So as I think we've previously discussed, if a company buys a piece of equipment in-state, it gets to deduct that right now. If that piece of equipment generates sales primarily outside the state, then the apportionment to the sales is going to be less in California. And, as a consequence, you may not capture through your tax system the value-added of that asset; right?

MR. SPILBERG: *(Nodding head.)*

COMMISSIONER COGAN: And so if I have an averaging scheme, then it seems to me that I'm capturing more of that value-added of that piece of equipment; is that right?

MR. SPILBERG: Yes.

COMMISSIONER COGAN: So that would be another advantage?

MR. SPILBERG: Yes.

COMMISSIONER COGAN: On the other hand, you have an administrative burden, especially on small firms of a five-year moving average; right?

MR. SPILBERG: Right. And just the complications with new firms and firms that basically cease doing business in your state is going to cause a problem for you.

COMMISSIONER COGAN: Right. Thanks.

CHAIR PARSKY: Carl?

MR. JOSEPH: I think that the idea of trying to smooth out the factor is a fine idea, in that there can be spikes up and down over the years that can cause things to change more than they probably should.

I guess my biggest concern on the averaging is that it's the sort of idea that gets frayed around the edges. From a constitutional perspective, you could end up with some rather odd results where, if you have a taxpayer that's on their way out of the state and is doing very little business in California but used to do a lot, you could end up with a sales factor maybe in their last year or their last couple of years which is quite a bit higher than is actually what's going on in the state. And at some level, that starts to worry me that you're ending up with a system that doesn't really relate to the benefits received in the state during the year in which the tax is imposed, but is really related to benefits received years earlier.

You know, if things are kind of moving along normally year to year, that's probably not much of a problem. But when people come in and people leave or businesses drastically change, that averaging starts to worry me more about whether or not it is reasonably related to the way that they're earning their business in the state.

CHAIR PARSKY: Other comments?

COMMISSIONER EDLEY: Well, I guess my intuition would be a little bit different on the legal issue, just in terms of the reasonableness of an averaging scheme strikes me as pretty compelling. So I take bet, I guess, but then again…

MR. JOSEPH: Well, it's true that there are not very many decisions that talk about this concept of external consistency, with how related the activities need to be. I mean, there's --

COMMISSIONER EDLEY: And over what accounting period is the issue.

MR. JOSEPH: I mean, that's true. Typically, we look at things -- court cases are decided on individual years. But here, you would essentially be making --

COMMISSIONER EDLEY: That's right.

MR. JOSEPH: -- an economic argument that that is not really enough. And that's kind of a -- I can't think of a case off the top of my head where that really has been argued. But nonetheless, I understand what you're saying.

CHAIR PARSKY: Okay, I think what we might do now is to take about a ten-minute break, and then we'll come back. And we've got one more statement to read from the construction industry, and then we have a small business professional services group, and then we'll let the public make some comments.

And I hope that all public comments will be constrained to the proposed business net-receipts tax. That's the purpose here. And there may be some questions of the public commentators, too.

About ten minutes. Let's take a break.

(Recess taken from 10:42 a.m. to 11:01 a.m.)

MR. CHASE: Okay, the next statement is from Doug Barnhart, who is chairman of J. Reese Construction.

And he writes,

> *"I would certainly like to participate, but would not be in California for the workshop dates.*
>
> *"California does not have a revenue problem in general, but it does have a spending-priority problem that is enhanced by the current tax structure. Its tax structure needs to be revised to reward job creation in the state as well as productive behavior.*
>
> *"Of the proposed changes that I am aware of, the elimination of the state corporate tax and the reduction of personal tax rates are the two I think would do the most good. The general*

rule in construction is that it is much easier for a firm headquartered in Nevada, Utah, Texas, or Arizona to come west than for a California firm to travel east. This is due to the California corporate tax structure which is the highest in the west. In addition, many construction firms hold an S-corporation status. California levies a 1.5 percent corporate tax on S corporations in addition to the personal income tax paid by the company owners. It is a competitive disadvantage.

"The State needs to encourage firm ownership to remain in the state rather than operate from an out-of-state headquarters. In addition, the State needs to support California companies doing work outside of the state.

"At Barnhardt, most of the firms I competed against on large California projects were not headquartered in a California. In fact, some were foreign-owned, which was really disturbing when the project was funded by public money.

"With regard to sales tax, it is not a problem for contractors, in that they simply pass the cost on to the customer, including the state and federal government on public projects.

In this regard, it is really a question of ultimate cost for the final bill payer, namely, the public.

"I question in an era that has seen material shortages, if the government should have to pay less for materials than the private sector. I believe such a dual policy would create a potential for abuse as materials can move from job site to job site.

"Some contractors do perform work on both private and public projects. In many ways, the sales tax is a good way to obtain tax contributions from everyone as it is paid at the point of sale. It is very simple and difficult to avoid, which works.

"As a counterpoint, I suspect that some firms purchase materials and equipment from outside the state and, in doing so, attempt to avoid paying sales tax.

"I guess if you eliminate the sales tax, some of those orders potentially could go to California firms.

"There is a resale license that can be used to obtain sales tax credits, but I know of very few construction firms that use the license

which supports my basic point, in that it is a pass-through tax.

"The resale license should be eliminated for construction firms, in my opinion.

"I don't know much about the proposed net-receipts tax; but, on the surface, it does not appear to be a good solution for construction firms. General contractors or at least building contractors subcontract at least 80 percent of the value of a project. It would appear that the net-receipts tax would result in the double-taxing of construction projects.

"I do not know enough about the net-receipts tax to comment. I do not claim to have any specific knowledge regarding tax structures. But I did create my company with 100 percent internal growth, and have a very good idea of what it takes and how some take advantage of the system."

CHAIR PARSKY: Alan, maybe I think one basic, perhaps misunderstanding, is the interrelationship between contractor and subcontractor under this proposed tax.

MR. AUERBACH: Yes, I think the natural treatment, assuming the subcontractor is really a separate entity, would be that the subcontractor services would be a normal deductible expense to the contractor; and then the subcontractor would be subject to tax according to same system. So I don't see any issue of double-taxation arising under this tax.

CHAIR PARSKY: Bob?

MR. CLINE: If I could comment, follow up on Alan's statement.

It's a good way to differentiate, to think about answering that question of, is there pyramiding or double-taxation. That's going to tell you whether or not this proposal is a gross-receipts tax, like the Washington B&O tax, and the Ohio cap tax, or is it a value-added tax. And when you have that subtraction for purchases of both services and products from other firms, you know it's not a gross-receipts tax; it really is trying to tax the value-added, one time assigned to the firm that created that value.

COMMISSIONER COGAN: And to the extent that we would be getting rid of the retail sales tax, we would be avoiding some pyramiding that is in the current law. And so the elimination of the retail sales tax would seem to be in accordance with fixing some of the problems that he has. So a net gain.

CHAIR PARSKY: Any further comment from Michigan of the impact on the tax on the construction industry?

MS. HAAS: Michigan, when it moved from the single business tax to its current Michigan business tax, the subtraction for purchase from other firms is only for capital. And we had a specific issue with the construction industry that I think is addressed by the current structure of the business net-receipts tax, which was, there wasn't a subtraction for purchases -- labor purchases from other firms. And, in fact, one of the few exceptions for a labor deduction is for the construction industry because of the perception of double-taxation.

You don't seem to have that -- that really doesn't exist in the current structure of the Michigan -- of your business net-receipts tax structure for California. So the fix that Michigan had to impose is already inherent in your structure.

COMMISSIONER COGAN: Is there an issue in towns close to the border, where you have a small construction industry, let's say, around Lake Tahoe. If they use a subcontractor inside the state, then that subcontractor has to pay the BNRT. But if they went across the border in Nevada and hired a subcontractor from Nevada, then that firm would not have to pay the BNRT and, hence, that subcontractor could sell his purchases -- or sell his services to the main contractor at a lower price.

MR. AUERBACH: I think the question would be whether there would be a different tax treatment.

It would be, if the sale occurred in the same place, that is, if the purchase of the subcontractor's services was, in both cases, deemed to occur in Nevada or in both cases deemed to have occurred in California, that I don't think it would make any difference.

COMMISSIONER EDLEY: Unless the sub is small.

MR. AUERBACH: Yes, but if the sub is small, then the sub doesn't pay taxes either way.

COMMISSIONER EDLEY: No matter where it is?

MR. AUERBACH: Right.

COMMISSIONER COGAN: Right, and actually that's a good point. So to some extent --

MR. AUERBACH: A Nevada subcontractor -- say, the project is in California, it's a construction project on the California side of Lake Tahoe. If it's a large Nevada company, the Nevada company would now have sales in California and be subject to tax according to the sales apportionment, in the same way that a California subcontractor would.

COMMISSIONER EDLEY: I guess what I was thinking of is the Nevada company, if the Nevada subcontractor had California sales below the threshold, right, we wouldn't go after them in California?

MR. JOSEPH: Well, keep in mind, it's not just sales. If they had payroll that was assigned here, because those guys were actually doing construction on a project in the state, building a building in Lake Tahoe --

COMMISSIONER EDLEY: So the whole economic nexus would be –– right.

MR. JOSEPH: Well, the new standard that you all have picked up, the new standard starting in 2011, includes $50,000 worth of payroll that's assignable to the state as well.

So if they were actually building a building in California of some size contract -- $50,000 worth of payroll, at least -- they'd be in regardless of whether the sale was $500,000 or not. Because the standard is, $500,000 of sales or $50,000 of payroll or $50,000 of property.

COMMISSIONER EDLEY: Okay, that gives us the nexus.

MR. JOSEPH: Yes, sir.

COMMISSIONER EDLEY: But in terms of sort of the zero-bracket amount, if you will --

MR. JOSEPH: Yes.

COMMISSIONER EDLEY: If the zero-bracket amount is still below whatever our threshold is --

MR. JOSEPH: Yes, that's true. And that's really something I haven't really seen fleshed out, as to whether that's pre-apportioned, post-apportioned. You know, how you want to determine that size for purposes of an interstate taxpayer. So that is an open question, at least.

COMMISSIONER EDLEY: That's interesting.

CHAIR PARSKY: I guess this relates to the broader question, not just the subcontractors, one sitting in California, one sitting up -- but the broader question is, are we incentivizing, in one way or other the purchase of services outside of California.

COMMISSIONER COGAN: Right.

CHAIR PARSKY: And the objective, I guess here, is, if the same purchase was done in California, the purchaser would be able to deduct those services that he is purchasing, and the recipient would have a tax, clearly, in California.

And the objective here would be to be able to capture both sides of the equation if the purchase was out of state; but it is an apportionment issue as to how much of that is captured based on a variety of factors.

Is that what's really on the table here?

COMMISSIONER COGAN: I think the general issue is still very much on the table.

I'm not sure about the specific, Gerry. You still have an issue of where a -- let's say a construction firm in Lake Tahoe, just to keep the example, is now not employing subcontractors but has his own employees, and those employees are not a deductible expense, their salaries are not a deductible expense in the BNRT. If that general contractor laid off his workers and hired a subcontractor in California, there would be no net economic advantage for doing so, because that subcontractor in California would have to pay the BNRT and then load that on to the cost, so that's neutral.

But if the general contractor went over to Nevada and hired a firm in Nevada, if that subcontractor in Nevada did not have to pay any BNRT, then you'd see there's an economic advantage doing so.

Now, Carl, your point is that if the work is performed in California by that subcontractor and the work involves a payroll of greater than $25,000, under the proposal, then that would create an economic nexus in California and that subcontractor would then be subject to the BNRT, eliminating the advantage one would have from laying off employees and outsourcing; right?

MR. JOSEPH: Yes.

COMMISSIONER EDLEY: Yes, well, what you could -- it strikes me that what you could do is for the California firm, you could make the Nevada subcontract non-deductible, but then give them a credit for being any

California BNRT being paid by the Nevada firm.

COMMISSIONER COGAN: I don't think you could do that because it's a type of service. And you'd be saying that, gee, the purchase of a service from a subcontractor if they're in California is deductible but in Nevada it's not.

I think that what you want to do is recognize that there might be an economic incentive, and then try to minimize it.

And Carl's point is that for any transaction of an appreciable size, at least involving this example of construction, if the work involving labor is $25,000 or more, there is no economic advantage to outsourcing.

COMMISSIONER EDLEY: But then the problem is that -- but then you might -- are you going to get into a situation in which the zero-bracket amount for California firms is higher than the zero-bracket amount for Nevada firms? You can't do that. Do you see what I'm saying? I mean, if the $25,000 gives you the nexus but our threshold for actually having liability for California firms is $500,000 --

COMMISSIONER COGAN: Good point.

COMMISSIONER EDLEY: -- so that's why I was thinking that --

COMMISSIONER COGAN: I see.

COMMISSIONER EDLEY: What essentially I want to say is, you can only take a deduction for any firm if they have paid for any sub, California or Nevada. You can only take a deduction if they have paid -- if they're a BNRT taxpayer. Otherwise, you can just get a credit.

MS. HAAS: There really should be no issue here. There should be -- there is no tax incentive to hiring a Nevada firm over a California firm for a construction project in California.

Either a Nevada or a California firm, when they come in to construct, has nexus with the state of California. They are both subject to the California tax. The fact that one is in Nevada or California doesn't provide an advantage because they have to come into California to do the construction project.

So now the question becomes, are they subject to -- do they meet the filing threshold.

COMMISSIONER EDLEY: Right.

MS. HAAS: Well, that depends on the size of the company. And if you hire a small California company, they don't file. If you hire a small Nevada company, they don't file. But it has nothing to do with the state in which they're originally organized or their business is headquartered. So I don't think there's an issue.

COMMISSIONER COGAN: Would the same apply to legal services from a Texas firm or a New York firm versus in-house?

COMMISSIONER EDLEY: Wait a minute. We're not going to tax lawyers; are we?

MS. HAAS: Of course not.

CHAIR PARSKY: We're not taxing law-school deans, we're taxing lawyers.

COMMISSIONER COGAN: June?

MS. HAAS: When you come into the state to conduct business activity as a matter of constitutional law, you have nexus with the state.

COMMISSIONER COGAN: So if we've got a New York law firm that doesn't send any lawyers in to California but issues advice and so forth from New York but never sets foot -- no employee sets foot in California -- I'm trying to separate the issues here.

MS. HAAS: Yes, yes, okay, so you have an issue of, one, physical presence in the state; two, is the new economic presence standard, which is not in place yet. It comes in, what, 2010. So now the question becomes then, at that point you have the economic presence standard, as I understand it, is more than $500,000 worth of sales --

COMMISSIONER EDLEY: Sales, right.

MS. HAAS: -- into the state, a sales source into the state, and you have to look to that.

MR. CLINE: This was an issue that was debated extensively in Ohio when they adopted their gross-receipts tax. I know it’s not a value-added tax. But they had the same questions about whether or not this tax would put the service providers within the state of Ohio at a competitive disadvantage with those in Michigan. And that’s why they were very -- so the debate ended up saying, if you’re going to have a tax like this -- that is, either gross receipts or value-added -- to have that level, competitive playing field, you have to assert economic nexus. That’s the key issue. And Michigan, Ohio, and Texas are asserting economic nexus for their alternative tax bases. I think they’re fairly confident they’ll win that legal battle at some point, but it’s still playing out within the courts. But it was a concern in Ohio, in particular.

Contrast that with the sales tax. And in all three of those states, there was the discussion that current law seems to protect out-of-state sellers of goods and services into a state for purposes of sales taxes if they don’t have a physical presence. And that’s why the catalog sellers and the Internet sellers have a competitive advantage if they aren’t taxpayers. But these new systems are thought of in terms of economic nexus at the business entity level is doable and can be defended and doesn't require a physical presence in the state. So it's a very important part of this whole discussion.

The belief is that this interstate service competitiveness is really not an issue as long as you can maintain economic nexus for taxpayers, whether they're 100 percent California or coming in from out of state.

CHAIR PARSKY: Any other -- Carl, any thoughts on this subject?

MR. JOSEPH: No, I think that's true. I mean, that was the subject of the memo that we provided to you last week –-

CHAIR PARSKY: Right.

MR. JOSEPH: -- was an analysis of that idea about how strong is the position on economic presence and what are the courts likely to do with that. But it is an important point of this because, in essence, when you talk about the 21st century economy, you're talking about an economy that is not tied to property the way it used to be. And that economic presence is quite possible, nowadays, without any physical presence in the state at all.

So I think that that is, to me, one of the more important things to keep in mind in the idea of what is the economy like now versus what was it like when we started this tax however many years ago we started taxing corporate income, so…

CHAIR PARSKY: Well, and we certainly want to be cognizant of -- or, say, be concerned about creating any incentives or disincentives, if you will, for economic growth and job creation within the state of California. And if we can maintain this concept, it seems to me that we're going a long way to do that.

MR. JOSEPH: No, I agree. I do think that the idea of where you want to draw the line about who is small enough to not pay the tax is an interesting question when you're talking about wholly in-state taxpayers and interstate taxpayers using apportionment. So that is something that I don't know that I've seen any recommendations on from the Commission yet. But that could be a little bit tricky, because you could have a very large firm that's out of state that has a very small presence in California, and maybe you want to exempt them, maybe you don't. I mean, that's a call.

COMMISSIONER EDLEY: Yes, you could have a different exemption amount.

COMMISSIONER COGAN: Yes.

CHAIR PARSKY: And that wouldn't impact the memo you wrote in terms of --

MR. JOSEPH: No.

CHAIR PARSKY: -- differentiating between an out-of-state firm and an in-state firm?

MR. JOSEPH: No, I don't think so. I think that if you're going to go -- well, hmm, I'd have to really think about that a little bit.

COMMISSIONER EDLEY: If you had, for example, a two hundred -- if, for in-state firms, you had a $500,000 exemption, and for any firms using apportionment, be they California-domiciled or elsewhere, you had a $250,000 one, for example, on the theory that they're big enough, it doesn't -- they can handle more administrative burden. Even though --

MR. JOSEPH: Yes, that's a good question.

Any thoughts down here on that?

I'd have to think about that. Because in a way, anytime anything looks different based upon whether you do business within or without, that starts to raise at least some fundamental red flags of, "Wait a second. You're treating somebody who is within and without different than somebody wholly within."

But it well may be that there's a justification to do that. And we'd have to think about that. I'm not prepared to answer that.

MS. HAAS: So are your choices California gross receipts or apportioned gross receipts for that cutoff threshold then? So whether it's just California receipts or it's apportioned?

COMMISSIONER EDLEY: Right.

MS. HAAS: And so apportioned then, whether you're California or non-California, it's business.

MR. JOSEPH: Yes, for instance, if you had a California company that had $501,000 worth of gross receipts, they'd be subject to the BNRT with this sort of spike or step. But if you had a company that had receipts everywhere of well over a million, but they're apportioned receipts to California were, you know, $499,000, they wouldn't pay. So it kind of comes down to, is it an ability-to-pay question, or is it just a question of a zero rate below a certain amount of receipts, and the rate changes at $500,000. I mean, that's something that we need to talk about.

COMMISSIONER EDLEY: And the truth of it is, right, is that we have a binary policy consideration. One is smallness, but the other is administrative burden. And if we're talking about the multistate corporation with significant sales, smallness isn't the issue. The only question is, at what point is it reasonable to impose the administrative burden, which could easily be a different number.

MR. JOSEPH: Sure.

COMMISSIONER COGAN: Now, Carl, you didn't address in your memo, as I recall, the issue of the legality of a lower threshold, other than $500,000.

MR. JOSEPH: No, that's true. We were only addressing the fundamental question of whether or not you could, in fact, impose the tax.

Whether or not you choose to let people pay a zero rate or exempt them from the tax, we did not address that.

You know, you have everybody in the pile now, and now you have to determine which ones you want to tax and which ones you don't based upon other considerations, be they economics -- they're too small, we don't want them to have to pay or it's too much of an administrative burden. At least you have them in the base to make that choice. That's what the memo was designed to do, was tell you that you can have them in the base.

COMMISSIONER COGAN: Right. You know, we have a trade-off between the rate and the base. And I'm wondering how sensitive the rate might be to an alteration in the base? That is, if instead of having a $500,000 threshold, we had a $1 million threshold or a $250,000 threshold, how much would either of those two changes affect the revenue-neutral rate of the BNRT?

Mark, is --

CHAIR PARSKY: Revenue-neutral compared to what?

COMMISSIONER COGAN: Revenue-neutral compared to the $500,000.

CHAIR PARSKY: Oh, I see.

COMMISSIONER COGAN: What I think right now, we have a going-in proposal, if you will, that has a $500,000 threshold.

CHAIR PARSKY: Right.

COMMISSIONER COGAN: And that would imply, when all the work is done, a particular BNRT rate. Let's call that 3 percent, just for the heck of it, for the whole system to be revenue-neutral.

What I'm asking is, if we were to, let's say, lower that threshold to $250,000 and thereby expand the tax base, how much of a rate reduction to achieve the same amount of revenues could we get from that change? Or, on the other hand, if we were to increase it to a million.

MR. IBELE: And we haven't looked at that. We could certainly do that. One of the reasons we haven't is because it's sort of influx as to what the level is going to be.

I think it would also be helpful to get probably a better handle from small business as to what is the compliance, what is the cost of something like this? What is the administrative burden?

I think one thing to keep in mind in talking about -- we've sort of talked about small business, and I think it's important to keep in mind that we want to -- we want to provide this exemption for small business; but we also are talking about a tax which is based on benefits and not ability to pay. So we have to be careful about confusing these two things.

So with a big company, with receipts overall of in excess of $1 million and gross receipts in California of $499,000, why shouldn't their benefits, if they're received in California, reflect it in that $499,000, why shouldn't they pay the tax? So I don't know if there's a way to get at the exemption being related to the business size itself as opposed to some other measure.

CHAIR PARSKY: Well, Bob, when you did the analysis of the base that might be available, albeit that these are estimates, and you have an overall base of in the range of a trillion or a trillion one, did you have any assumptions in that base about the amount of exemption?

MR. CLINE: We did. And let me preface my statement by, certainly the revenue estimates don't drive the policy. It's the other way around.

CHAIR PARSKY: We gathered that, but I just was curious -- I mean, it gets to John's question a little bit, but not --

MR. CLINE: In anticipation of John's question.

COMMISSIONER COGAN: What world are you living in?

MR. CLINE: Exactly.

In anticipation of John's question, we did do one alternative level of exemption. We did look at $250,000 as opposed to $500,000.

The preliminary number -- and it's not a number that Mark and Phil have blessed or really have looked at in detail, but that --

CHAIR PARSKY: You may never get a blessing from both of them.

MR. CLINE: Okay.

CHAIR PARSKY: You may just have to go for one. It's okay, though.

MR. CLINE: But our initial estimate was that moving from $250,000 to $500,000 as the filing threshold would reduce the tax base by approximately 5 percent. It's not a big number, but it's not zero. We were first initial pass-through --

CHAIR PARSKY: Well, it depends whether you consider 5 percent real money or not. But that's up to you.

MR. CLINE: So that, as a starting point, you could say, well, then you'd have to increase the rate by 5 percent to keep it revenue-neutral.

COMMISSIONER EDLEY: Right. 0.15 percent –– points. 0.15 points.

CHAIR PARSKY: Or said another way, you'd lower the rate if you went down?

MR. CLINE: Excuse me, certainly. You could lower the rate by roughly 5 percent.

COMMISSIONER COGAN: And I'm sure the margin, the margin of error in the estimates is much greater than 5 percent.

MR. CLINE: No comment.

CHAIR PARSKY: But said another way, I guess, at the $500,000 level, if you applied a 1 percent rate, you'd achieve approximately $11 billion. Approximately. If you lowered that to $250,000, you could get the same level of revenue at 5 percent less than the 1 percent rate; is that what you're saying?

COMMISSIONER EDLEY: Otherwise known as 0.95.

CHAIR PARSKY: Otherwise known as 0.95? That's what the dean -- is that okay?

COMMISSIONER BARRALES: Yes, thank you.

CHAIR PARSKY: All right, okay.

Are there any other comments before we move on?

(No response)

CHAIR PARSKY: Okay, where's David? Is he still in the room? Oh, yes, here he is.

You can stay there and contribute to this.

Okay, so we now have small business professional services. Two people have been kind enough to come forward.

And we really appreciate both of you being willing to appear in person.

Marty, do you want to start us off here?

MR. KELLER: Sure. Thank you, Mr. Chairman.

I begged David to read my statement for me, but he said that was one too many, so…

First of all, I'd like to introduce myself. I'm Marty Keller. I'm the small business advocate for the state of California. My job is to help the state's three and a half million small businesses deal with state government.

CHAIR PARSKY: We don't consider ourselves state government, but that's okay. You'll help us for sure.

MR. KELLER: Exactly.

I focus on economic growth issues, regulatory challenges, and state procurement opportunities. And in my capacity, I've been appointed by the Governor to represent small businesses in such bodies as his Economic Stimulus Task Force and the Green Collar Jobs Council.

And as part of the stimulus, I've been participating in a number of outreach events that have been co-produced by business matchmaking in state small business development centers. And these have been attended by hundreds of businesses around the state. And there's a whole series of them slated for next month. And all of those have already been subscribed.

And we will be in Escondido at the end of September, Mr. Barrales.

And the businesses are there because they're hurting and they're looking for ways to enhance and grow their businesses, to see whether there are any opportunities from the federal stimulus that can help stimulate their businesses. In fact, just before I left the office this morning, I got a call from a Silicon Valley company looking for some venture capital under the thought that perhaps in the stimulus package, there might be some hidden venture capital that he couldn't find out.

And I say this because I just want to point out to you, as you consider this, the comment earlier about policy will drive the revenue decisions rather than the other way around is obviously very critical to small businesses. And so in the two years that I've been on this job, there are really two concerns that come out over and over and over again. And you've addressed both of them already, and I'm not telling you anything you don't already know.

One is the perception that the regulatory burden is excessive. And the other one is, that has developed to a critical state since last September, is the restriction and access to capital, both working capital, financing, and equally as importantly, investment capital. So this obviously has immense bearing on what happens in the deliberations that the Commission makes and ultimately the policymakers of the state to determine how small businesses -- concerns about these issues will be addressed with respect to tax structure.

I also want to point out that last November, the Governor hosted the first Governor's Conference on Small Business and Entrepreneurship. And small-business delegates who attended there actually addressed, to create a series of recommendations for dealing with state policy, and they did have a couple that I want to point out.

One did address the regulatory burden on -- the Legislature actually has a bill before it that addresses many of the concerns that small businesses raise that has been authored by State Senator Rod Wright.

And the second one is actually a very modest proposal with respect to taxes, and it's ironic in light of what happened subsequently with the appointment of the Commission and their desire to take on the whole structure. When I tell you what they recommended, you'll probably smile. But they simply recommended that the State should basically eliminate the minimum franchise tax. And they were actually willing to work with the Legislature on a revenue-neutral way to do that. And they presented some ways that we thought would make sense. Because they were sensitive to the revenue challenge, but they thought that the minimum franchise tax was a burden to small businesses.

So just in that context, I'll let you know some of the outreach that we have been doing and some of the feedback that we've been getting even before the Commission was appointed and you began your work.

So now we're looking at the business net-receipts tax. And most small businesses, of course, aren't acquainted with this issue, and they are being presented with this just as you are. We're going to be hearing from Mr. Greenstreet in a minute about a particular response that a particular small business may have. I also note, there are members of the audience representing organizations that I've worked with on all of these issues.

So what I want to just point out as the advocate, my job is to listen to and report back to policymakers what the small businesses are concerned about.

I think it's important that they take a good look -- a good, hard look at the BNRT, particularly within the basket of all the other reforms that you are taking a look at.

And I want to acknowledge that you've been -- in the public comments you've made, after each of the presentations that David so professionally read to you, you've been looking at how, really, the question is, how do all these things blend together?

But if the BNRT does what it's promised, if it broadens the tax base, if it improves tax-competitiveness and stabilizes tax revenue, then that could contribute to the easing of the regulatory burden, at least as far as taxes are concerned, particularly with the exemption that you've just spent some time talking about.

But more importantly, I think the achievement of these goals should contribute to economic growth by creating a more even playing field and reducing some of the costs that small burdens carry under the current system. The issue of turnaround of the state's economy is a thing that small businesses single-mindedly care about right now.

And the most recent data that we have about the state's small business, which, unfortunately, is from 2006 data provided by the Small Business Administration in Washington, said that there were roughly 3.4 million small businesses in California, defined for state purposes as firms that employ a hundred or fewer. And of those 3.4 million, 2.6 million were sole proprietorships. So that represents -- that means that, roughly, 800,000 firms, according to SBA data, are employer firms.

Now, the Department of Finance estimates that over 90 percent of these businesses had less than $500,000 in gross receipts. Sole proprietorships, according to IRS data, average less than $60,000 in gross receipts. So it appears that a significant majority of small businesses will, under the current proposal, be exempt from paying the tax at all.

But, again, if all of the benefits that would be part of the package, including the flattening of the tax rates, the lowering of the overall rates and the increasing the tax-competitiveness factor accrue as a result of this as being part of the package, then the key issue of the economy expanding as a result of this, is the critical issue that small businesses will want to consider as they take a look at this proposal.

The devil’s in the details, I understand that. But, again, the principle that I believe you are wrestling with here is one that small businesses would welcome.

And I want to offer the services of my office. We maintain a very extensive network of small businesses. We communicate regularly with small business groups. We communicate regularly with individual small businesses who have concerns about these issues. I’d be happy to share with them any of the publications or proposals that you’re making, so that you can get more direct and more robust feedback from them.

Small businesses can be a really significant partner in the work that you’re doing. And if they understand this and they can make comments on this in a way that accrue to making this work for everybody, I think that you could really move this ball ahead quite a distance.

Obviously, small businesses are enormously varied in terms of what they do, who they are, what they produce, how they relate to the international, not just the interstate, but the international economy. And all those things need to be taken into consideration as you take a look at this.

But I think that the concept that, again, as part of this overall broad basket of policies that would make it easier for small businesses to compete in the economy and make sure that the competitiveness factor is maintained for all of them, as best you can, again, listening to your previous colloquy, I recognize that's going to be a challenge. But I think that, again, when you achieve that, that this could really benefit the small business sector of our economy.

After all, 98 percent of firms are small. 98 percent of firms in the state of California have a hundred or fewer employees. And they contribute to, roughly, half of all the employment in the state. So it is a critical sector of our economy, even in its complexity.

And, again, I think Joe will just give us a little bit of an example of that complexity and the challenges that are before us.

But I thank you for the opportunity just to give you some opening comments as the advocate for small businesses in the state. And again, to reiterate my offer to help you disseminate this information to small businesses and get feedback from them.

CHAIR PARSKY: Thank you very much.

We'll come back.

I think, Joe, why don't you make your comments first, and then we'll come back?

MR. GREENSTREET: Thank you. Okay, I'm Joe Greenstreet, and I am a small business owner. And I wish to thank the Chairman and the Commission for allowing me to be here, as well as David Chase, who has been very helpful in disseminating information to me in a short notice.

CHAIR PARSKY: Not too many compliments about David. You know, it's okay, though.

MR. GREENSTREET: Well, okay. Thank you.

That's all I've got to say about you, David. Sorry.

My firm provides accounting services and tax services to a number of small businesses in Nevada County as well as Sacramento County, and so forth and so our clientele varies to a great extent. Some are service, of course; others, retail and small manufacturer, and so on and so forth.

And I'm going to share with you today just one example. I have a case study that I've brought with me.

And, David, I assume you've passed this out to the members?

MR. CHASE: We have copies.

MR. GREENSTREET: Okay. And so what I did in my case study is, I took an actual business in our community, and I used real numbers. Of course, this is anonymous. The business owner gave me permission but would rather not have his name disclosed at this point in time. But this is a dinner house in our community. It's been in business for some 30 years. Well-established. And in 2008, did $1.4 million in sales.

Now, I want to emphasize, if I may, for just a moment, that for years, the accounting industry has been shying away from the C corp as a form of doing business. We have been filing elections with the Internal Revenue Service and the State of California to file as S corporations. And that's because the individual tax rates in recent years are actually, in many cases, smaller than those at the C-corp level.

But in reading the information from your Web site and the information that David provided me and so forth, I couldn't get a handle around PIT and what you were doing to it. There's apparently going to be some sort of a trade-off here. So I restricted my case study to a C corporation.

One comment, however, in the information that I was reading from your Web site. For those pass-through entities, I understand that they will be paying the business net-receipts tax at the entity level; and then as the income is passed through to them individually, there was some mention of a deduction on the personal side to somewhat compensate for this tax that they're paying at the entity level.

And I would like to express that I think a deduction is somewhat of a disservice, in that I think there should be a tax credit for those taxes that are being paid at the entity level. And so I wanted to make that comment.

And in my research of the BNRT, I assume that you've all got this little handout that I did. And the biggest issue on this spreadsheet -- you know, us accountants love to do spreadsheets, I could have given you 50, but I tried to sum it up in this one.

The first column there is the 2008 actual numbers. And the first item is the inventory, the product that is purchased for resale to the diners that come to the restaurant. And it's my understanding that the BNRT does not take into consideration inventory fluctuation. It's simply what you purchase during that calendar or fiscal year.

Am I correct in assuming that?

CHAIR PARSKY: *(Nodding head.)*

COMMISSIONER COGAN: *(Nodding head.)*

MR. GREENSTREET: Okay, so the business owner does, in fact, have some flexibility. If it's December 1st and he sees the BNRT tax coming at him, he would, I would assume, rather go out and acquire inventory than send the money to the State of California.

(Commissioner Hauck entered the meeting room.)

MR. GREENSTREET: So there is some flexibility there. It's almost on the equivalent of being on a cash method of accounting.

I like that, okay.

The next item, salaries and wages --

CHAIR PARSKY: Keep going. That's all right.

MR. GREENSTREET: Salaries and wages --

COMMISSIONER COGAN: The boys down to my right from the FTB, they don't like that.

MR. GREENSTREET: Okay.

CHAIR PARSKY: This is an anonymous company, and so don't worry about it.

MR. GREENSTREET: Okay, that's right. It is anonymous.

Salaries and wages were $546,000. And under your proposal, what I've heard here this morning, and it sounds like you're sticking to it, they're not going to allow labor as a cost of goods sold or as considered to be a purchase.

And so I just got a couple of observations regarding that. For years and years and years, we've had this controversy, employee versus independent contractors.

And I can assure you, there's going to be employees become independent contractors under the BNRT system.

Now, you may say they can't do that. Well, it's being done, or we wouldn't have had this controversy for many, many years.

As a matter of fact, in 1988, Congress enjoined the IRS from enforcing rules upon small business in determining who is an employee and who is an independent contractor, because Congress said, "We're going to get back to you on that, and we're going to fix the problem."

Nothing's been done.

Now, the Employment Development Department has a checklist of 30 questions that they ask of the taxpayer during an audit to determine whether or not they are an independent contractor or an employee. So I think they're just opening up a door that's going to create problems.

Down below, about three items down, I don't know the answer to this, but I assumed, if you're not going to allow labor, you're not going to allow payroll taxes that the employer must pay on behalf of the employee.

Is that a correct statement?

COMMISSIONER COGAN: No, I'm not -- no, it's not at this juncture. That's still very much an open question as to whether we would allow deductibility of other taxes or not. Payroll taxes in particular.

MR. GREENSTREET: I see, okay.

And so then my question, I think, has been answered this morning. Employee benefit programs also would not be allowed as a purchase under your definition; is that correct?

COMMISSIONER COGAN: You heard this morning my question to David Gollaher about health insurance?

MR. GREENSTREET: Yes.

COMMISSIONER COGAN: I guess I would say that the presumption of most people is that these are employee benefits, they're part of compensation, and, hence, they would not be deductible. But the Commission has not really spent much time thinking through that one. So it's still a little bit open. But you could tell the general leaning.

COMMISSIONER EDLEY: I mean, it's not value-added to –- I mean, you know, it's not value-added to the widget that's being produced or to the meal that's being produced.

MR. GREENSTREET: Well, you see that leads me to the next question, and that is, what about workmen's compensation insurance? Is that also not considered a purchase under the BNRT?

Okay. However, outside services, as I mentioned, will be deductible as a purchase. And so, again, there is going to be some outsourcing to individuals or companies who are not going to be paying the BNRT because of the threshold that is presently at a half million dollars and there's going to be employees displaced as a result of that.

Now, down at the very bottom, I have assumed here a rate of 3 percent. I think that's somewhere in the ballpark.

This business incurred a net operating loss in 2008 of $58,000.

When I make the adjustments to the income and calculate a 3 percent BNRT tax, I come up with a $17,419 liability. Now, that's a lot of money when your company has lost money.

Now, this company, I'm very familiar with -- I've been their accountant for twenty-some-odd years. And they lost money because they have the cream-of-the-crop of the employees in our small community -- restaurant workers -- whom they wanted to retain during a period of time when the business was down, because they have the faith that the business is going to return to its former revenue.

And so as a consequence, they're being penalized by being loyal to their employees and retaining them, even at the risk of incurring a loss and reducing their retained earnings or their savings in order to weather the recession.

Now, this is real world. I'm not making this up.

Okay, and so to summarize, and then I'll be glad to answer any questions, I think the BNRT, as Marty has said, if it would accomplish everything that he described, I think it would be a wonderful thing. But I think it's also -- I don't see it that way. I see it as being an accountant's retirement plan.

I'm surprised we don't have 150 CPAs up here giving you all the encouragement in the world. Because, folks, we've got federal accounting rules, we've got GAAP, we've got tax, we've got California, we've got depreciation systems now that are not in conformity. And, you know, we're talking about creating under the BNRT another depreciation system based upon 50 percent of the life used on the federal level using MACRS.

Come on, folks. This is going to cost the small business community tons of money.

Now, I like that; but I can't, in all good conscience, sit here and say, for my own benefit, I think this thing is good. I think compliance is going to be a nightmare. I think it's going to be costly. And I think it's, in this particular economic climate, it's just premature to even consider doing something of this nature.

So if I haven't offended, again, I want to thank you for allowing me to make my remarks.

Thank you.

CHAIR PARSKY: You certainly haven't offended. But let me ask you just a couple of basic questions.

If you looked at this business over a five-year period starting in 2003 to 2008, what would this look like?

MR. GREENSTREET: This business, I can tell you in 2003, 2004, 2005, their annual revenues were around $1.8 million.

CHAIR PARSKY: So were they continuing to operate at a loss throughout the whole period?

MR. GREENSTREET: No. They were profitable up until the two most recent fiscal years, yes.

CHAIR PARSKY: So the inter- -- the comparison over those profitable years might be different?

MR. GREENSTREET: That's correct.

CHAIR PARSKY: Okay. Second -- and, again, we haven't emphasized this, but I think it is important to take into account that the $17,000 liability would be deductible at the federal level?

MR. GREENSTREET: We'd have to make that assumption, yes.

CHAIR PARSKY: And, therefore, the after-tax consequences to this firm is less than recited here; right?

MR. GREENSTREET: No, that wouldn't be the case in the current year, because when a company has got a loss, to have an additional deduction does no benefit.

CHAIR PARSKY: No, no. I meant in terms of the impact, it would be less than $17,000 if you took into account a deduction at the federal level, 35 percent or so less.

MR. GREENSTREET: Uh-huh. Well, there was no tax paid at the federal or state level. And so you would be increasing the net operating loss carryforward at the federal level.

CHAIR PARSKY: Right.

MR. GREENSTREET: And eventually, they hopefully would take advantage of that.

CHAIR PARSKY: At some point between 2003 and 2008, they were not operating at a loss?

MR. GREENSTREET: That's correct, yes.

CHAIR PARSKY: Okay.

MR. GREENSTREET: Now, there was comments this morning about net operating losses, and that's something that the Commission has really got to struggle with. Because since 2005, we've got companies that have been operating at a loss for two to three years. And they have this accumulative carryover that needs to be dealt with.

The other issue is assets owned prior to the BNRT, what are we going to do with those assets? And so, really, you've got your work cut out for you, I can tell you that.

CHAIR PARSKY: John?

COMMISSIONER COGAN: Joe, thanks. You know, examples like this are really actually very, very helpful. And so I appreciate it. Yes, it's really -- I appreciate the thought and time you put into it.

The way I'd respond is, okay, so this company, under the current tax code, pays nothing. Under the BNRT, it would pay $17,000.

MR. GREENSTREET: That's correct.

COMMISSIONER COGAN: And the difference, primarily, is a consequence of labor expenses not being deductible under the BNRT, primarily?

MR. GREENSTREET: That's correct. Labor and the associated costs.

COMMISSIONER COGAN: Yes. And so in this example, wages and salaries are $546,000; right?

MR. GREENSTREET: Correct.

COMMISSIONER COGAN: So the way I'd respond is, this proposal, our proposal, would be coupled with income tax rate reductions that would result in somewhere around a 25 percent or 20 percent reduction in the typical personal income taxpayer's personal tax liability.

So for the employees that are still getting paid $546,000, those employees would -- 20 percent, if you use 20 percent, would receive a net tax break of $100,000. And, yes, this firm would incur a cost to the State of $17,000, but the employees of this company would get a tax reduction of a total of $100,000. And I haven't counted in that also some of the purchase services, of music services and so forth.

So when we think globally about this tax --

MR. GREENSTREET: Well, I would have loved to have done that. I did read everything I could read. And to go full circle in this case study is what's needed. If we're going to adjust personal income tax rates -- you know, when this commission -- I'd love to take this same example, when you're done with your decision-making process, and take it full circle, into the personal return. What is the impact personally, and does that offset the -- but I didn't have enough information to do that.

CHAIR PARSKY: That's a very appropriate comment. And as we said at the beginning, it is important to see it as a package.

Just so you know -- we won't get into the details -- but what the Commission has asked the staff and what will be discussed is, if we are going to adjust the current personal income tax system to have the general fund become less reliant on personal income taxes and become more simplified, if you will, we need to do it in a way that reduces the tax burden for all AGI brackets, not just some.

So John is right, we haven't come forward with a proposal yet, but I think you can operate under the assumption that if we come forward with one, it would have a reduction for all AGI brackets. And that needs to be taken into account the way John is talking about it.

MR. GREENSTREET: And what kind of assurance do we have, though, as the tax-paying public that if you're going to reduce personal income tax rates to whatever at the state level -- you know, we have a Legislature that -- you know, you guys have already commented on the activities of the Legislature. But is that rate going to be frozen at that level? Is it going to be indexed? You know, what prevents the state from raising the rate?

COMMISSIONER EDLEY: That's what elections are for.

MR. GREENSTREET: And then we're right back, we're no better off than we were.

CHAIR PARSKY: Well, but, again, I think you have to step back. What the Commission was asked to do, was to come up with a proposal, as a package, for reform. And what the Legislature has agreed to, is they will vote on the package once they go through their process of hearings and so forth, as a whole.

Now, you can't guarantee what elected officials will do going forward, except that the citizens of California elect the elected officials.

MR. GREENSTREET: Over and over and over and over.

CHAIR PARSKY: And I don't think there's a way in which we, as a commission, could get really any more commitment than that -- whatever the reform proposals are that will be looked at as a package, they will be examined as we're trying to examine them as much as possible beforehand.

So you're right, rates or new proposals could come up in the future, and they could come up whether the Commission existed or not, and whether the Commission made recommendations or not. So I think you have to kind of see it in that context.

MR. GREENSTREET: Okay, thank you.

COMMISSIONER COGAN: Gerry, actually, Phil just mentioned one other thing with respect to the example that you can take back to your client. The sales tax now applies to your -- under current law, and the sales are $1.4 million. So I'm not sure, 5 percent of $1.4 million is another $60,000 or so, I think; is that right? $70,000?

MR. GREENSTREET: Correct.

COMMISSIONER COGAN: And that would not be applied under the BNRT.

MR. GREENSTREET: Well, but the business collects the sales tax from the consumer. The business has the expense of administrating the sales tax.

COMMISSIONER COGAN: Right. So you've not included the tax and gross receipts here?

MR. GREENSTREET: No.

COMMISSIONER COGAN: Okay, great, great.

Let me ask you a question regarding incidence and disruption to the system. Bill Barrett this morning mentioned a very good point, that anytime you significantly change a tax code, you're going to have winners and losers.

MR. GREENSTREET: Yes.

COMMISSIONER COGAN: All right. And one of the big obstacles to enacting any reform is that very fact. And so mitigating somehow the extent of winners and losers has to be part of any tax-policy consideration.

So some of my colleagues might just wince at the following. But Bill also mentioned that maybe one way to mitigate the consequences of a BNRT is to make a portion of labor expenses tax-deductible for the purposes of the BNRT.

And so I'm wondering, for some firms, how important do you think that might be for some of your members, Marty and Joe, for the businesses that you deal with in the acceptability of the BNRT?

And one point I want to qualify: You weren't certain from our description of the BNRT as to whether, let's say, a law firm would have to pay a BNRT or a pass-through firm would have to pay a tax on their business operations, and whether they'd be able to deduct that against their personal income taxes.

Right now, under the way we're thinking about it, the answer to that question is no.

MR. GREENSTREET: No.

COMMISSIONER COGAN: Right. So you pay it, let's call it the 3 percent BNRT; and then you'd, in addition, have to count the income that's passed through to you as an individual on your personal income taxes. And so that is another sort of policy decision that creates economic losers, perhaps.

MR. GREENSTREET: Yes.

COMMISSIONER COGAN: Although there is the reduction in the personal income tax rates -- as Gerry said, across the board.

MR. GREENSTREET: That's very alarming.

The information I read as of yesterday was that there would be a deduction at the personal level.

Now, you're saying that that's no longer a consideration?

COMMISSIONER COGAN: No, we were certainly considering it as a deduction during a phase-in period.

MR. GREENSTREET: I see.

COMMISSIONER COGAN: Ultimately, we were thinking that there would be no deduction for a BNRT tax against your personal income tax.

MR. GREENSTREET: I see.

COMMISSIONER COGAN: And so it has raised the question, does that represent double taxation? And so people are naturally concerned.

And so I'm just wondering, A, how large the concern will be.

And Bill, I thought, had an interesting idea. If the concerns are too great, that a good idea about maybe having some portion of the labor compensation to be tax-deductible.

MR. GREENSTREET: Well, I'd respond to that by saying, I'd like to see it all deductible. But there are certain industries -- and I can't fathom designing a system with the BNRT that's going to be one system for car dealers and another system for construction and another system for retailers. Talk about a retirement plan for accountants.

So there is going to have to be some sort of uniform rules that's going to have to apply to everyone. But I can tell you, service industries are going to be hurt by this, there is no question. I think of personnel agencies, I think of -- you know, out here in our agricultural areas we have such companies that they don't do anything other than their contractors for workers. If you need 50 farm workers, you call this contractor and he sends them out.

And so it's going to be painful for an awful lot of folks. Restaurants, extremely labor-intensive, as well as many others.

You've got a tough sell ahead of you.

COMMISSIONER COGAN: Uh-huh.

CHAIR PARSKY: Well, I want to go back to deductibility just for a minute, to make sure that we understand where the payment of this tax would not be deductible.

Let's start -- assume for the moment that there's a tax paid by a pass-through entity, a law firm, a business. Is the tax not deductible at the federal income level?

MR. SPILBERG: Well, it's -- the way -- as long as it's a pass-through firm, the way that Gerry described it, then basically what happens is that it's an income after tax that is basically passed through to the income tax return.

And in this particular case, what you would have, is that it would be, in fact, indirectly, in a sense, that the tax would be deductible against your income. So that would be true for a pass-through firm, both against the federal income tax and also against the California income tax.

COMMISSIONER COGAN: But the income itself -- the income would be taxed at the BNRT level?

MR. SPILBERG: Yes ––

COMMISSIONER COGAN: The income would be personal income tax level?

MR. SPILBERG: That's right, the income would be taxed at -- the net receipts would be taxed at the BNRT level. And then the firm would, in essence, pass through its net receipts after tax to the personal income tax return. So indirectly, the BNRT is deductible.

COMMISSIONER BARRALES: Phil, could you explain that in the context of these numbers here? Can you pull that from here?

MR. SPILBERG: Right. Yes, this is a C corp, so we would not have any pass-through over here to the individual income tax return. But in the normal circumstance what you would have is, you would have -- if this was a pass-through, then that firm would have had a loss of $58,000. And in addition to that, it would have paid the tax of $17,000. So, in essence, its pass-through to the income tax return would be basically $58,000 -- $59,000 plus the $17,000.

MR. GREENSTREET: Well, that would be true at the federal level, provided the BNRT tax is deductible. At the federal, I don’t see any reason why it wouldn’t be.

MR. SPILBERG: Yes, right.

MR. GREENSTREET: But at the state level, it would be the same?

MR. SPILBERG: It’s the same. It would be the same. It would be the same treatment again at the state level.

COMMISSIONER EDLEY: For the personal income tax, for the California PIT, what the individual would get from this pass-through is a loss totaling the $58,000 plus $17,000.

MR. GREENSTREET: So you’re saying, on

California, I'm going to be able to pass through now $75,000?

CHAIR PARSKY: Yes.

COMMISSIONER EDLEY: Yes.

MR. GREENSTREET: No. The BNRT tax is not going to increase -- not going to go into my state return at the entity level as a deduction.

COMMISSIONER EDLEY: Well, that would be great. If you want to do it that way, there's no profit.

I mean, the question is, what's the profit of the pass-through entity?

MR. GREENSTREET: Pardon me?

COMMISSIONER EDLEY: What's the profit of the pass-through entity?

MR. GREENSTREET: For California purposes, under existing Revenue and Tax Code, it would be $58,000, whether you paid the $17,000 or not. At the federal level, $17,000 BNRT tax would be deductible. And so you would have a $75,000 pass-through at the federal level.

MR. SPILBERG: You can look at this as though this $17,000 was similar to a sales tax. So if you had, under your personal income tax return for California, if you had a $58,000 loss and then in addition to that you paid $17,000 in sales tax for your business, both of those would be deductible.

MR. GREENSTREET: Sales tax is not deductible at the California or federal level. I’m sorry.

MR. SPILBERG: For the business?

MR. GREENSTREET: For the business or the individual on a pass-through.

CHAIR PARSKY: Let me just turn to the Franchise Tax Board to make a few comments.

MR. KUSIAK: I think the point that’s trying to be made --

MR. GREENSTREET: I didn’t know you were in the room, sorry.

CHAIR PARSKY: That’s right. You’re anonymous. Don’t worry about it. He doesn’t know you’re here.

Okay, go ahead.

MR. KUSIAK: Since we’re writing a new law in this context, whether it’s deductible or not is something to be determined by the ultimate recommendation. And if it’s deductible, it’s deductible in calculating the net income for California income tax purposes. And we can certainly make it deductible.

MR. GREENSTREET: Great.

MR. KUSIAK: I think what’s being described is that it would be deductible for purposes of computing the net income of the entity.

COMMISSIONER EDLEY: Exactly.

MR. KUSIAK: That's essentially what's being described.

We're not dealing with the existing income tax rules except to the extent they need to be modified.

COMMISSIONER EDLEY: But for exactly your point, we obviously want to mitigate the cascading of the tax.

MR. GREENSTREET: Hey, I'm all for it, if that's what you want to do.

CHAIR PARSKY: That's why you're here.

MR. GREENSTREET: Okay.

COMMISSIONER BARRALES: Mr. Chairman, and then let's assume this was an S corporation. What's the --

CHAIR PARSKY: That's it.

COMMISSIONER BARRALES: That's it?

So what's the difference between an S corp and a C corp under this scenario?

MR. GREENSTREET: The difference between -- an S corp is a pass-through. You pay the taxes at the individual level, predominantly. California does have a small tax rate of 1½ percent at the corporate level. But that's the main difference, is that you're passing the income through. The individual hopefully is paying taxes on that at a lower rate than they would if it was a C corporation.

So in summary, if I've got this right, you would have a $75,000 net operating loss at the federal and state level under what you're proposing.

MR. KUSIAK: That's correct. The other thing that --

MR. SPILBERG: Unless, if we're talking about the pass-through to the individual, that the individual has other income.

MR. GREENSTREET: Yes.

MR. SPILBERG: Right.

MR. KUSIAK: Well, the other thing to bear in mind is that also because the S corp is under the existing corporate income and franchise tax, assuming that tax were to be eliminated, that 1½ percent under current California law would no longer exist.

MR. GREENSTREET: And I would assume the $800 minimum would go away as well.

MR. KUSIAK: There's been no discussion of minimum in the context of this business net-receipts tax. But to the extent there is none, you're absolutely right.

COMMISSIONER EDLEY: I thought we were going to cut that to $795?

MR. KUSIAK: I'm sorry?

COMMISSIONER EDLEY: Never mind.

MR. GREENSTREET: You know, I would like to see the $800 go away. You've got one year grace when you start a business. And, you know, just talk -- just 30 seconds about starting a business. You know, in past recessions, do you know what people did when they became unemployed? They became self-employed. They went out in the garage and they moved things around and pretty soon, they're making furniture or they're designing software.

Well, folks, where do you think they got the money to do that? They got that from their home. A home equity loan.

Well, guess what? There's no equity in the home anymore. And as a consequence, you know, we've got a real problem here in helping people start their business and get it going. We haven't seen the influx of business start-ups in this recession that we have in past recessions because there's no source of revenue, there is no source of capital. And so the angel loans is the only thing.

So we have to look at BNRT. Does that enhance that person's ability to go out there in the garage and start building that piece of furniture that's unique? I don't know, I don't know. I think there's got to be a real serious consideration given to that.

CHAIR PARSKY: Well, it's very much at the heart of what this Commission is thinking about. So you're 100 percent right.

I think it would be useful, between now and September 10, if we took this example and any other concrete anonymous examples, and actually passed them through the package of changes that are being contemplated.

MR. GREENSTREET: Sure, I'd love to do that.

CHAIR PARSKY: So that we could actually show the rest of the Commission how a package of changes would measure up on the goals that were given to this Commission, a principal one of which is, are we promoting economic growth and job creation by these changes, potentially, or not?

So I'd like you to take this with our staff and apply some potential changes that we'll try to outline on the personal income tax side --

MR. GREENSTREET: Okay.

CHAIR PARSKY: -- as John outlined, and the deductibility that may occur both at the state level and at the federal level.

MR. GREENSTREET: I'd be happy to.

Where do I send the bill for my services?

COMMISSIONER COGAN: We'll send you a voucher.

CHAIR PARSKY: Since you have already gone on record saying that the accounting firms, or the accountants will like this tax --

MR. GREENSTREET: Yes, yes.

CHAIR PARSKY: -- I'm not -- I would like all accounting firms to comment to Joe about that. Because it is true that the tax would apply to accounting services in a way that perhaps the sales tax does not.

MR. GREENSTREET: Okay.

CHAIR PARSKY: So I'll let you be the recipient of those comments.

MR. GREENSTREET: That's fine. Thank you.

COMMISSIONER COGAN: Don't try to take a charitable deduction for the work that you do, though.

Actually, I have a question for Phil. The minimum franchise tax, how much revenue does that raise for the State?

MR. SPILBERG: It's a significant amount. It's certainly in the hundreds of millions of dollars.

COMMISSIONER COGAN: Hundreds of millions?

MR. SPILBERG: Yes.

COMMISSIONER COGAN: Wow. So each 1 percent on the BNRT is, let's say, roughly from what we know, somewhere around $10 billion to $12 billion in revenues. And so if this were a couple of hundred million, we'd be talking about two-tenths of a percent on the BNRT to make it revenue-neutral, to eliminate the franchise tax and to raise the BNRT rate a little bit?

MR. SPILBERG: Yes.

COMMISSIONER COGAN: Interesting.

CHAIR PARSKY: See what happens when you have such a large base. You know, a dollar here, a dollar there can be moved around pretty easily.

COMMISSIONER COGAN: The problem is, it goes both ways.

CHAIR PARSKY: Any other comments or questions?

(No response)

CHAIR PARSKY: Thank you, both, very much. This is extremely helpful.

MR. GREENSTREET: Thank you.

CHAIR PARSKY: And I would really appreciate it if you could continue to dialogue with us.

Okay, we have a public-comment period that we want to go through now.

I always pick up these blue slips with some trepidation since I might not be able to read the names properly. But we have four people.

I would just -- we'll receive obviously any written statements. But I would hope that the commentary would be confined to just the business net-receipts tax, that's what this working group is about.

Okay, Michele –– uh-oh. Is there anyone ––

You're Michele? But you've decided not to comment?

MS. PIELSTICKER: No.

CHAIR PARSKY: Okay. I'm sorry. Well, how do you pronounce your last name?

MS. PIELSTICKER: "Pielsticker."

CHAIR PARSKY: Pielsticker; is that right?

I don't mean to embarrass you. It's okay.

Kyla Christoffersen, is that correct?

MS. CHRISTOFFERSEN: Yes, it is.

CHAIR PARSKY: Oh, good.

MS. CHRISTOFFERSEN: Good afternoon, Mr. Chairman and Commissioners. We thank you for the opportunity to provide comment today.

My name is Kyla Christoffersen here on behalf of the California Chamber of Commerce. We have provided a letter, as you saw, with a number of initial questions from the business community regarding BNRT. And so today, I'm just going to highlight a few of the issues that we raised and go into them in greater detail.

First of all, with respect to the operational and transitional issues, much of what was discussed today, we do very much appreciate the preliminary overview that was released by the Commission, and did answer a number of questions regarding operational and transitional issues. However, there are many more details that still need to be addressed and many more questions that would need to be answered before companies can complete a full analysis of the impact of BNRT on their individual companies.

Two of the fundamental issues, clearly, are the rate and what specifically can be deducted.

The preliminary review document does not have any rate provided. And while there is some mention of what would be deductible, there is no specifics on that, so we do need more details, clearly.

With respect to rate, I want to emphasize a few points. First of all, you know, obviously, it's very important to the business community that we have the rates so that we can do the calculations necessary. Even as has been noted today, even with a low rate, businesses can have very significant liability under BNRT because the tax base is so broad. We understand, by just a very small percentage difference, it can mean millions in tax-liability difference.

We're also concerned about whether a lower rate is possible with what's being contemplated because there is still apparently going to be a personal income tax. And many small businesses do pay under the personal income tax system. And while there is a $500,000 exemption -- and I understand that's being looked at in terms of what the threshold will specifically be -- the $500,000 is gross receipts. And so that would be typically a very small business, and so we see that exemption as being a very small one.

Additionally, there’s still the local sales tax that’s in place and could be variable. And so any BNRT would have to be contemplated with respect to those.

We’re also very concerned with respect to rate. What will happen if the projected revenues don’t come in in order to offset, as contemplated, elimination of the corporate tax or the state portion of the sales tax. So if the revenues don’t come in at the projected levels, what happens to the rate then? Is there any guarantee to the business community that the rate will not thereafter be increased? If so, who would be responsible for establishing the rate or an increase?

We’re very concerned about a government agency being given that authority. And there has not been specific guidance provided with respect to who would set that rate.

Additionally, with the taxes that are being contemplated for elimination, is there any guarantee that some of those would not return, in part or whole?

And, you know, we’ve talked a lot about investment today, about the need for businesses to be able to plan. And so there has to be, clearly, an element of certainty with whatever is proposed. So that's why these questions concerning rate are extremely important.

Turning from the operational and transitional issues -- and, again, we've raised many of those questions in great detail on the document that we've provided with our statement from the business community coalition, so I want go into all of those, and many were covered today as well.

So I would like to turn now to macro-economic issues, which we think are extremely important. And we did lay out a number of those as well in the questions document that we provided.

And turning back to the founding charges that were stated in the Governor's Executive Order, several of the founding charges to the Commission, in terms of priorities and what needed to be achieved by this body, did regard the economy and California's economic health, the ability of California to successfully compete with other states and other nations, and specifically in terms of jobs and investments. And as we noted on our letter, we think that that is an extremely important priority, and we respectfully urge the Commission to give those charges as much weight as some of the other criteria that have been considered in looking at all of these issues.

With respect to analysis that businesses would need, we very much would request that there be some form of modeling, some form of analysis, both going forward, ten years going forward, as well as going backwards ten years. Because we would like to know what kind of revenue BNRT would have raised, both in the good times and the bad times. We think that's something important for businesses to be able to know.

Additionally, in terms of macro-economic issues, there's three in particular I want to highlight.

First of all, we would like to know and would like to ask the Commission whether it's good policy to achieve broadening of the tax base by creating essentially winners and losers. And I appreciated Mr. Cogan's pointing out that there would need to be perhaps some form of mitigation of that, because that's an important question. We question whether it's good policy to shift some of the tax burden from one set of industry sectors to another set of industry sectors.

Additionally, is it good policy to shift the tax burden to companies that are in a loss position? And there's been a lot of discussions today about whether there will be some form of net operating loss deduction that will be available. And, you know, it's concerning to companies that are in a loss position that they may yet have to pay taxes. And that has been acknowledged and covered, and we appreciate that.

And with respect to small businesses, I touched on sole proprietors, a number of businesses that do pay PIT. And so are they going to, since corporate tax would be eliminated but PIT staying in place, are many small businesses going to see a net overall increase in taxes? So these are all questions that we have in terms of how the base is being broadened.

Another economic impact that we're very concerned about is the incentivizing of outsourcing of labor. Because from what we can tell, the BNRT would be essentially a tax on employees. And there has been quite a bit of discussion today about would different payroll costs, such as workers' comp and health benefits, would those be deductible? It seems clear that compensation would not be deductible.

So it's very important to know whether the Commission has fully analyzed the impact on jobs in California.

And with respect to the research-and-development credit issue, it's important to note that most of that credit does go, right now, to labor. So in terms of our ability to compete with other states, most of them do have an R & D credit incentive, incentivizing R & D activity.

We think that's very important to look at as well.

A third economic factor that's very important in terms of our ability to compete with other states and nations would be whether our exports -- the goods produced here in California and exported to other nations and countries and states, rather -- whether those would be much higher because the assumption is that much of the increased taxes will be passed along to the consumer. And so if that follows, then are the cost of California goods and products that are exported going to be much higher, and how will that enable us to be able to compete with goods and products that are sold at lower cost by other states and countries?

So those are some of the issues that are very important. And like I said, we've laid out a number of other economic factors that we think would be really important to have considered. And we strongly urge the Commission to take sufficient time, all the time that is needed, to slowly and carefully assess the BNRT because, clearly, I think it's an understatement to say that it would be a dramatic change.

We would also respectfully urge the Commission not to cut off that analysis by the citing of any arbitrary deadlines. Because the bottom line is that we want to be able to, as the Chamber, provide the analysis that you do and the hopefully thorough vetting that you do and the modeling that you do; we want to be able to take that and share it with California businesses, and get their feedback and be able to share that with you in terms of what the consequences would be on California businesses. And that way, when the Commission does take a vote on BNRT, if it does, that the full consequences will be known.

We can't know those full consequences without all of the information that's been requested, not only by ourselves, the Chamber, but by the other individuals who testified today.

So we thank you again for this opportunity to comment.

CHAIR PARSKY: Thank you very much.

I think it would be very helpful to us -- the testimony you've given and the issues you've raised, I gather, continue to be the issues post-understanding, at least the outline, that has been presented.

And so I think it would help us if the letter that was submitted, you separated out issues that were answered in connection with the letter, from issues that remain unanswered or of matters of concern. And if your testimony reflects that differentiation, great. But I recognize that you hadn't seen -- or the Chamber had not seen the summary that was presented when the letter was submitted.

MS. CHRISTOFFERSEN: Yes.

CHAIR PARSKY: So that would help us if you could kind of recraft on the submission, to either expand on what you just said, or leave what you just said, for us to take into account.

MS. CHRISTOFFERSEN: Yes, we would be glad to do that. And just in a nutshell, we appreciated that the preliminary review did address a number of the operational and transitional issues. But we felt that there was not much on the macro-economic impacts.

CHAIR PARSKY: And also, you might take into account in a submission the dialogue that went on this morning. If you want to emphasize the importance, for instance, on deductibility, on other things that may have come out in this morning’s discussion, that would also help us.

MS. CHRISTOFFERSEN: Yes, we will address that.

CHAIR PARSKY: John?

COMMISSIONER COGAN: Just one thing. First of all, thanks for the list of questions. It was the most thorough of any set, I think, of comments we’ve received so far. And they did, in fact, raise a lot of questions in my own mind about how far we are along here.

And then your comment about deadlines, I think, is a very, very important one. I know for myself, I tend to think this is -- right now, this seems like a good way to go. But I wonder if we're far enough along, given the short, short deadline and how we should go about thinking about where we are compared to where we would have to be in order for some legislation to actually move. So that's a very, very good point.

Of all the things you mentioned, I only have one question about one of them. You said that in the context of determining the revenue estimates, that you all were concerned about using a government agency to do that estimating. At least that's what I thought I heard.

MS. CHRISTOFFERSEN: The rate setting.

COMMISSIONER COGAN: Oh, the rate setting?

MS. CHRISTOFFERSEN: Yes.

COMMISSIONER COGAN: As opposed to just calculating the revenues that would be necessary? I'm not really sure what the dividing line is here. That is, we would not have a government agency, I don't think, ever delegate to a government agency the idea of setting a tax rate.

MS. CHRISTOFFERSEN: That's comforting to hear.

COMMISSIONER COGAN: I think the Legislature has to be in charge of that one, so I don't think that was ever an issue.

CHAIR PARSKY: I hope that wasn't suggested by anything that was provided, because we aren't contemplating -- at least from the Commission's standpoint -- contemplating recommending that.

MS. CHRISTOFFERSEN: Okay, well, it just hadn't been clearly addressed, so we appreciate that.

COMMISSIONER COGAN: Okay, great.

And it's okay with the Chamber that in developing the recommended rate, that we use government agencies to estimate the revenue-neutral rate in our calculation; right? That's okay with --

MS. CHRISTOFFERSEN: We would, we're accustomed to that, and we welcome any revenue estimates from any government agencies.

COMMISSIONER COGAN: Thanks.

MS. CHRISTOFFERSEN: Thanks.

CHAIR PARSKY: Other comments or questions?

(No response)

CHAIR PARSKY: Thank you very much. We really appreciate it.

Next, Tony Fisher.

MR. FISHER: Thank you, Chairperson Parsky and Commissioners.

I am Tony Fisher, representing NUMMI. As you may know, NUMMI is the automobile assembly plant in Fremont, California, that employs about 4,700 team members and produces, on average, over 300,000 vehicles per year. Also, NUMMI has attracted to California 26 affiliated major parts-supplying companies that employ a total of approximately 3,200 additional team members.

We appreciate the opportunity to share with you our guiding tax principles regarding the business net-receipts tax proposal that has been put forth recently by members of the Commission.

In line with our presentation before you on March 10th, we are pleased to see a movement towards the economic competitive principle of not taxing business inputs, like providing a sales-tax exemption for manufacturing machinery and equipment. However, we see in the proposed business net-receipts tax, or BNRT, a movement away from an even-playing-field principle since most other states, to our knowledge, do not impose such a tax.

Also, NUMMI is concerned that a BNRT could create a burden for those businesses which are marginal year after year or in an annual loss position on a regular basis. For these reasons, NUMMI recommends that, one, a thorough economic impact analysis be performed; and, two, methods be incorporated to avoid unreasonable burdens before considering a business net-receipts tax in California.

Thank you for allowing me to give NUMMI's perspective. If you have any questions, I'd be pleased to answer them.

CHAIR PARSKY: All right. Thank you very much.

Any questions?

COMMISSIONER EDLEY: Interesting.

CHAIR PARSKY: Thank you.

We appreciate it. Thank you very much.

Next is Michael Jacob.

MR. JACOB: Good afternoon, Commissioners. I appreciate the opportunity and the workshop. It's a good idea.

I represent Pacific Merchant Shipping Association, and we are a West Coast organization representing marine terminal operators and ocean carriers operating at all of the California's public ports, primarily in the container trade. And we have a couple of questions and some suggestions that are specific, but I'd be remiss if I didn't open with the comment. I'd hate to brand myself as a loser, but in the context of the discussion, we have a lot of concerns about the business net-receipts tax in general on our industry.

We have a proud history as the highest-paid, blue-collar, unionized workforce employer in North America with our longshore labor force, and a payroll in California of well over a billion dollars, not including all of the additional benefits, in terms of the consideration of our expenses. So that's certainly a concern for us going forward. We don't have a formal position at this time, and we'll probably be developing that shortly.

And the receipt of the overview is actually helpful in communicating with our members who had lots of additional questions when we posed this to them. So we'll probably be providing you a formal position soon with some additional comments, generally.

But specifically, we have a question for you and, again, as I said, a specific potential response. In the preliminary overview, it was made very clear that purchases from all other firms are to be deductible. And the definition of "purchases," it includes obviously rents.

In our industry and just some background, most of what we do in terms of our operations are through rented facilities. But they're not rented from other firms. Our leases are from public port agencies. And so we have a very large portfolio of possessory interests.

And in the property-tax realm, as our friends at the BOE know very well, we do not receive a benefit vis-à-vis folks that we'd be competing with that operate private terminals, because we pay a possessory-interest tax. So it's an equalization between what we pay in terms of our overall burden of operating, compared to folks that are renting facilities or leasing facilities from private landowners as opposed to public.

In this instance, if the idea was not to deduct purchases in the form of lease or rent expenses because it's not from a private firm, we would ask that we not be disadvantaged; just like we're not advantaged from operating in the context of a proprietary relationship just because that organization happens to be public that is leasing us the property, it does not mean that they're leasing in proprietary capacity. So if that's not clear, we'd ask you to make it clear. And if it's going to be made clear, we'd ask you to do it in a way that doesn't disadvantage someone from acting in a proprietary relationship with a public agency.

CHAIR PARSKY: Mark?

MR. IBELE: I think that's a very good point. I think we need to incorporate that as part of the -- if there's a statute that develops from this, its equivalency in treatment.

COMMISSIONER COGAN: Let me ask a question a little bit differently.

Is there any economic reason, Alan -- or Phil -- any economic reason for having a different tax treatment of rental from private businesses versus from public entities?

MR. AUERBACH: No.

CHAIR PARSKY: Phil?

MR. JACOB: We'd agree.

CHAIR PARSKY: You're not 100 percent ahead, so you're not a loser, for sure.

MR. JACOB: I appreciate it.

COMMISSIONER EDLEY: I don't see that there's any difference whether it's being done on a proprietary basis. That is to say, even if it's a below-market kind of rental arrangement, it still ought to be deductible.

COMMISSIONER BARRALES: It's still a business input; correct?

COMMISSIONER EDLEY: It's still a business. Exactly. So we're with you.

MR. JACOB: Thank you. I appreciate it.

CHAIR PARSKY: Thank you for raising it.

COMMISSIONER EDLEY: Wait a minute. You could talk about something else.

CHAIR PARSKY: No, no, he's ahead. Leave him alone.

Michael Shaw. I don’t think you submitted your name, but your card.

MR. SHAW: Yes, I’m Michael Shaw with the National Federation of Independent Business. And I appreciate the Chairman’s indulgence for my inability to follow the rules and fill out my slip. But I did want to thank you for the opportunity to be here today to talk about this new tax that has a lot of us -- the hairs on the back of our necks standing up.

We do appreciate the efforts of the Commission. Obviously, the commissioners and the staff who have been very helpful in helping to better understand what this proposal is going to look like, or may look like, because it has alleviated some of the concerns that we initially had.

There still remains a lot of issues, and I think some of it is questions that yet even the commissioners haven’t yet fully decided themselves. And so we do appreciate the additional effort here of the workshops. I think that will be very beneficial to answer any of these questions.

To be very brief, the small business issues include a lot of the larger business issues. But one of the primary concerns we have is the ability to pay. Obviously, in the current system, that’s effectively built in when you have an income tax. You don't earn an income, you don't pay a tax. Very simple.

With the business net-receipts tax, as has been described, obviously -- and we've talked about this earlier -- you could be in a scenario where you're losing money and still owing a tax. The question is, with what money are you going to pay said tax? Obviously, that is something that could dig a deeper hole for a small business. And that certainly is not good for the economy. One of the principles of the Commission being to improve the long-term sustainability, jobs, and creation and such.

Additionally, as -- and I apologize if this was clarified, I had stepped out of the room for a little bit -- but the $500,000 filing threshold, as had been described, the question we have there is, if we're talking about a filing threshold, are we then saying that the tax would apply in full or in part when you hit that $500,001? Or are we talking about an exemption, which would mean that starting with that $500,001 is when the tax starts to kick in? Because those are two very different scenarios. And effectively, what you're talking about is, if you're going with a filing threshold, where the full rates kicks in, you're talking about a $15,000 tax for earning one additional dollar. And I don't think that's what the Commission would like to see. I don't think --

it certainly does not fit with the principles that literally laid down the founding of this commission.

And finally, with all due respect to the good people that represent the larger businesses in California that do provide a lot of benefit to small businesses, restaurants, dry cleaners and all those things. So there is definitely a symbiotic relationship here.

The elimination of the corporate income tax but preservation in some form of the personal income tax do cause us quite a bit of consternation because you're now talking about a small business, simply by the fact that they are organized in one manner, is going to be paying potentially a higher tax than a business that's organized in a different manner for no other reason than that method of organization. So if you are filing under the corporate income tax system, you are going to be paying, effectively, just the business net-receipts tax. Income taxes are generated, obviously, through employees as income is passed through in terms of wages.

On the personal income tax side, you now have a small business owner who is paying the business net-receipts tax. And whether or not that's deductible or a credit against their adjusted gross income, they are then going to be paying the personal income tax rate as small as it might be, on top of that.

And so we think that that disadvantages smaller businesses which, according to our information, 80 percent of our membership file under the personal income tax system. That's a significant disadvantage to larger businesses, when they already suffer a lot of the issues of the economies of scale and so on and so forth.

But we do, again, greatly appreciate the efforts of the Commission, the leadership of Chairman Parsky on this and many other issues. Obviously, we do look forward to the proposals and opportunity to fully analyze those issues. Because we do realize that the -- you know, it's easy to focus on this one issue and how we think this may be a very bad thing for business in California. But it's another thing to focus on the whole package, which does include, and we would like to fully acknowledge that it does include some potential offsets.

What the whole package looks like is what we're going to be focused on. And we also do want to give due attention, though, to the specific elements and the impacts that those might have, not simply on tax liabilities but also on the economy and job-creation which is very important to our membership.

Thank you.

CHAIR PARSKY: Thank you very much.

Comments from anyone here?

Alan?

MR. AUERBACH: I want to ask you, you alluded to the concern about the ability to pay for a company that might not have any income but might be assessed a tax under this tax base.

Do you see that differently for a company with similar circumstances that would be collecting a sales tax under the current law for the goods that it sells? And so I'd like you to think of a comparison, two cases. So imagine you have a company, perhaps with no taxable income, or perhaps even a loss, that under current law, it's the goods that it sells are subject to the sales tax. And under this alternative system, the sales tax, or at least the state-level sales tax would no longer be there. Instead, they would be assessed a business net-receipts tax.

Do you see that the environment in which that company would be operating would be less -- of course, obviously, the amount of tax matters. But let's assume for the moment that it's roughly the same number of dollars of tax being paid under the sales tax in one case and under the business net-receipts tax in the other case. Do you see the operating environment as being less favorable in the case of the business net-receipts tax? Is that what you're saying?

COMMISSIONER EDLEY: Just to piggyback Alan’s point, in Europe, for example, companies pay the VAT whether or not they have profits.

MR. SHAW: Well, currently, the sales tax is effectively collected, not paid by the business. So the consumer is the one that is ultimately responsible for paying the sales and use tax. So the business is acting as the collecting agent, in that sense, and simply remitting it to --

MR. AUERBACH: So you’re saying that you think that the company would not be able to pass along the business net-receipts tax?

MR. SHAW: They very well likely would attempt to. Unfortunately -- and, again, this is one of the situations that differs between small and large businesses –- oftentimes, small businesses find it more difficult in terms of competitiveness to pass on those increased costs. Economies of scale and a number of other factors go into play there. But that would be another situation that could potentially advantage larger businesses versus the smaller entities.

MR. AUERBACH: And why would it advantage larger businesses relative to the smaller ones, given that they’d all be subject to the --

MR. SHAW: Well, economies of scale, obviously, allow larger businesses to purchase larger quantities of inventory and other things and potentially negotiate better prices on those goods and services. I mean, if you think of a Wal-Mart versus your average corner drugstore, or maybe we could go with another large chain drugstore versus a small corner drugstore, the price that the large chain pays for those goods and services can be negotiated to get a lower price.

MR. AUERBACH: Sure, no, I understand why a large business might have a cost advantage relative to a small business. I'm just trying to understand -- I mean, that's true under the current system; right? I'm just trying to --

MR. SHAW: Yes.

MR. AUERBACH: -- understand why a small business would be particularly disadvantaged by a shift -- what I'm focusing on here is the issue of trying to see through who is actually liable to pay the tax, as opposed to who is actually bearing the burden of the tax. And at least in cases of value-added taxes, it's a general sense that these things can be passed along to whatever extent sales taxes can be passed along to purchasers.

MR. SHAW: Well, I would answer this way. I think ultimately consumers are going to pay the tax. Any way you look at it, the costs are going to be passed on to consumers.

Now, does that in any way negatively affect the ability of a particular business based on their size to compete in that environment? We would argue that there's probably some impact. And I wouldn't necessarily say doing that is going to kill every small business, but I would say it's going to probably negatively affect those businesses where they compete against larger entities.

Now, that doesn't necessarily mean they'll go out of business. They may have to cut back on employees, they may have to find other ways to generate those cost savings. But I would say that it will get passed on to the consumers ultimately, but there may be some negative impacts to the businesses in that process.

CHAIR PARSKY: You might think in terms of not necessarily now, but as you think through this, think in terms the example Alan raised, where you have the same dollars: One reflected on the sales-tax side, another reflected on the BNRT side, and see whether or not -- on the assumption each is going to be passed on, whether or not -- how you react to that. Then take the second example where a small business may come under the exemption on the BNRT and the sales tax is removed, and what impact that might have.

MR. SHAW: We'd be happy to do that.

CHAIR PARSKY: I don't think we have any other public comment. I think that will conclude our first of two workshops. I hope everyone in the audience will pass on to the public at large the process that we are going through, and we really appreciate it.

We're going to do another workshop in Los Angeles on Friday, starting at nine o'clock. And we really appreciate all participation from everyone.

All of the people here will gather for lunch, and then we're going to do a little planning session for Friday's workshop.

Thank you all very much. Thanks for coming.

(The COTCE BNRT workshop concluded at 12:51 p.m.)

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REPORTER'S CERTIFICATE

I hereby certify:

That the foregoing proceedings were duly reported by me at the time and place herein specified; and

That the proceedings were reported by me, a duly certified shorthand reporter and a disinterested person, and was thereafter transcribed into typewriting; and

That the foregoing transcript is a record of the statements of all parties made at the time of the proceeding.

IN WITNESS WHEREOF, I have hereunto set my hand on the 30th day of August 2009.

DANIEL P. FELDHAUS
California CSR #6949
Registered Diplomate Reporter
Certified Realtime Reporter