STATE OF CALIFORNIA

COMMISSION ON THE 21st CENTURY ECONOMY

STATE OF CALIFORNIA

REVENUE & TAXATION

Commission BNRT Workshop

Friday, August 28, 2009
9:00 a.m. – 1:20 p.m.

University of California, Los Angeles
De Neve Plaza, Plaza Room
De Neve Commons
351 Charles E. Young Drive, West
Los Angeles, California

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COMMISSION ON THE 21ST CENTURY ECONOMY

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BNRT Workshop Panel

JUNE SUMMERS HAAS
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Franchise Tax Board

DOUG POWERS
Franchise Tax Board

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MARK IBELE
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MARGIE RAMIREZ WALKER

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Presenters

JIM BARNETT
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Edison International

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Tax Partner
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DAVID CHASE
Governor's Office

JIM EUPHRAT
Tax Manager
General Dynamics/National Steel & Shipbuilding Co.

RUSSELL GOLDSMITH
Chairman/CEO
City National Bank

MARTY KELLER
Director
Office of Small Business Advocate

A P P E A R A N C E S

Presenters

Continued

GREG LIPPE
Managing Partner
Lippe, Hellie, Hoffer & Allison LLP

ERIC MIETHKE
Motion Picture Association of America

MIKE ROCKENBACH
Chief Financial Officer
Emulex

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Public Testimony

MICHAEL D. SHAW
Legislator Director
National Federation of Independent Business

WILLIAM SPILLANE
Americans for Fair Taxation

CHRISS STREET
Treasurer-Tax Collector
County of Orange

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BE IT REMEMBERED that on Friday, August 28, 2009, commencing at the hour of 9:08 a.m., at University of California, Los Angeles - Covel Commons, 330 De Neve Drive, Los Angeles, 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: This forum is certainly recognizable for me given my involvement with University of California. I want to thank everyone for participating in this public workshop.

Just a few comments by way of introduction. As part of the process of the Commission established by Governor Schwarzenegger and Karen Bass and Darrell Steinberg, we have been considering a package of possible recommendations. At the last Commission meeting, we put forward an approach that we would take with respect to the recommendations we would make, divided up, really, into three sections that the report and recommendations will be structured around.

The first section will contain tax-law changes, revenue-related, that the Legislature can act on as their process unfolds, but that they can act on.

The second section would be tax-law changes, revenue-related. That may require an amendment or change to the State Constitution, or that might involve a voter initiative.

And the third section will be recommendations that commissioners will make that are for others to consider, areas of reform that may be revenue-related and may not be revenue-related, but that they're areas of reform that could – that, from the Commission's standpoint, others should consider.

That structure was agreed to by the Commission. It's been posted on our Web site, and it will serve as the framework for the recommendations that we will make under our deadline of September 20th.

We plan to have another full commission meeting on September 10th, here at UCLA, and then, if necessary, also on September 14th of the Commission.

And then we also put forward a package that all the commissioners wanted to still be part of the consideration. And there were a number of items on that package: Changes in the personal income tax, changes in the corporate income tax, changes in the state sales and use tax, and the possible establishment of a business net-receipts tax.

In addition to that, there was the proposal for a possible pollution tax on fuels, a split-roll property tax, a severance or royalty on expanded oil drilling, a rainy-day or reserve fund, and the possibility of recommending a forum or establishing a forum for settling tax disputes in California.

That package of recommendations, or that package, will serve as the basis for the ultimate recommendations. It could be that some items on that list wouldn’t be supported by enough commissioners and, therefore, would become part of Section 3, which, as I indicated, would be recommendations for others to consider as part of reform. And they could be parts of Sections 1 or 2.

Anything outside of that package could still be part of Section 3 but would not be part of Sections 1 or 2. That’s the structure.

Now, we’ve been looking extensively at a major change in the tax system around a new form of tax, and that’s the business net-receipts tax. And the Commission felt that because of the magnitude of this potential tax, the fact that it would be new to California, that more work really needed to be done by the Commission to understand the impact of such a tax on various taxpayers, parts of our community. And, therefore, it was recommended that we hold public workshops just around that tax. And I was able to get the voluntary contributions of John Cogan and Chris Edley, two commissioners to help conduct these workshops.

We have sought the expertise of the Franchise Tax Board, of the Legislative Counsel's office, of the Legislative Analyst's Office; and we also have, working with us, representatives from Ernst & Young that have done a lot of work in state taxation. And June Haas, who is here with us, who is a private practicing lawyer, but was very involved as commissioner in the state of Michigan, and very familiar with the approach taken by Michigan to a similar, although not exactly the same, form of tax.

We also have two commissioners here -- all commissioners are welcome -- Curt Pringle and Ruben Barrales -- to listen to this give-and-take impact of this tax.

These workshops are only oriented around this business net-receipts tax. However, I think it is very important that the community, as a whole, step back and understand the relationship between the changes that might be made in the other taxes and their impact on business, individuals, others in California. Because it is a package, and will be seen as a package. But the purpose here is for us to understand the reactions of people, to have an open give-and-take about it.

We would all urge that the people that would be presenting to us here, as the people that presented to us two days ago in San Francisco, orient their comments around this tax.

We may have some give-and-take about making sure people take into account adjustments that might be made in the other taxes. Inherent in the materials that we submitted for people to consider, was a clear transition period. This is not a tax that the Commission would recommend be put into effect all at once. Clearly, we would have in mind that it wouldn't -- if it was to be recommended -- begin until the fiscal year ending 2012, and then thereafter, phased in over a period as long as five years. Other taxes would be adjusted downward as this tax was adjusted upward. And so I want to keep reminding people to please bear that in mind.

And although any new tax, and certainly one of this size, might evoke an initial reaction of, "Oh, my goodness, let's not do anything that dramatic," the issues faced by the state are dramatic. And as people now see, many of the services that have been promised from the government of the state of California aren't being provided, or those services have had to be cut back, primarily because the anticipated revenues from going to the general fund have not been nearly as high as was anticipated.

So the volatile nature or the wide swings in the amount of revenues that are going to the general fund have caused real consternation in our state and in all of our communities.

So if this Commission can recommend for consideration ways in which that volatility or those wide swings can be adequately eased for the future, I think it will benefit all Californians.

With that introduction, any comments that any of my fellow commissioners might want to make?

John or Chris, Ruben?

COMMISSIONER BARRALES: No.

CHAIR PARSKY: Curt?

Then we will begin our panel with Russell Goldsmith.

Russell, I know, is here.

This is a little bit more formal than -- I know Russell quite well. He's a terrific chairman of a quality bank. I told him this would be kind of an informal discussion. It looks a little more formal than really it is.

But we really appreciate your coming forward, giving your comments about the impact or concerns you may have about this tax, and we'll have some give-and-take.

Thank you very much.

MR. GOLDSMITH: Thank you, Mr. Chairman, and thank you for including me here at this workshop. I appreciate the opportunity.

First, I want to commend the entire Commission for agreeing to a set of principles that I concur should guide tax reform: Establishing a 21st century tax structure for the state's 21st century economy; stabilizing state revenues and reducing volatility; promoting the long-term economic prosperity of the state and its citizens; improving California's ability to compete with other states and other nations for jobs and investments; reflecting principles of sound tax-policy principles like simplicity, competitiveness, efficiency, predictability, and ease of compliance and administration; and last, but not least, ensuring that our tax structure is fair and equitable.

With tax policy, these principles are an outstanding place to start. And in this context, I would like to address two things this morning. One is the proposed business net-receipts tax, and whether or not it should be applied to banks. I'd also like to briefly emphasize the importance of establishing a fair and equitable tax system that promotes job-creation and economic growth throughout California and does not put our state at a competitive disadvantage.

Let me briefly tell you something about City

National Bank, which is a wholly owned subsidiary of City National Corporation. We're headquartered here in Los Angeles, listed on the New York Stock Exchange. We have been here since our founding, 55 years ago. And City National today is backed by nearly $18 billion in total assets. We're actually the second largest independent bank headquartered in the state of California. We provide banking, investment, and trust services to thousands -- tens of thousands of clients through 64 offices, mainly in Southern California and the San Francisco Bay Area, plus some offices in Nevada and New York City.

City National and its eight majority-owned investment affiliates also manage or administer close to $48 billion in client investment assets. And, again, most of those assets would be here in California.

Our company employs about 2,700 men and women, and nearly all of them live here in California.

We now pay corporate income tax at a rate of 11.84 percent to the state of California.

As we understand it, the Commission is proposing to phase out the current corporate income tax and replace it with a business net-receipts tax. Obviously, we don't have all the details. But as I understand it, I believe you have essentially four alternatives under consideration. And I'd like to comment on each of those.

The first is a net-receipts tax calculation which, under the proposed general rule, would exclude items such as interest income, interest expense, dividend income, and compensation costs. Our understanding is that this particular formula would exempt banks. And we agree that banks should be exempted. City National and virtually all banks earn most of their revenue from the loans made to businesses, entrepreneurs, and consumers.

If interest income and expense were excluded, those companies, including ours, would essentially operate tax-free. We might enjoy that and would appreciate the consideration, but I suspect that's not what you wanted to have happen, and I acknowledge that's not equitable.

So recognizing that banks would not and should not be taxed under the general rule, as I understand it, the Commission has proposed three alternative tax computations. One is a modified business net-receipts tax, presumably one that would include interest income and expense. A net income tax that excludes compensation expense. Or third, the net income tax that corporations pay under the current law. So let me try to talk about each of those.

The first alternative, a modified net-receipts tax, raises several concerns for us. For one thing --

and I'm not sure people fully appreciate this -- banks are fundamentally different from manufacturers and even other services companies. But a bank does, in fact, pay for the goods that it manufactures but in a way that most people don't recognize.

Our cost of goods -- any bank's cost of goods, since our goods are essentially money that we rent -- so any tax structure that tried to tax our gross receipts should have to factor out the cost of the goods that we, in effect, manufacture and then turn around and rent. So any fair receipts tax calculation for the banking industry would have to include both interest income and interest expense for their part of the cost of the commodity that, in some cases, we own our capital, but in most cases, goods that we're renting from our depositors.

It would also have to take in all of the costs that banks have to pay for money to rent. After all, a bank's inventory consists of cash; and we obtain it by borrowing the money, in effect, by paying for deposits and raising capital.

A net-receipts tax calculation for banks would also have to include other costs of our getting this money and renting it out, like the possibility that we've seen all too dramatically for real credit losses. That's a real cost of this product. You could call it waste, like on a factory floor, what you throw away. There is a waste factor in banking that is also a cost of our product.

Credit risk and credit loss is a cost of doing business for banks that should also logically be deducted from net receipts.

Failing to do all of that will make loans more expensive for the public, harder to get for the public. And, you know, if you pick up today’s *LA Times*, you realize the enormous stress the banking industry goes through periodically, and would be harmful to the banking system here in the state.

The second tax alternative cited by your Commission, as I understand it, would exclude deductions for compensation expense. This, I think, is troubling. It would make it more expensive to hire people. And I think that at a time when the state has 12 percent unemployment, as I know you’re all very much aware, it will put more pressure on companies that provide jobs to the public. A tax like this would, in effect, discriminate against companies that hire lots of people and penalize disproportionately all of the people-intensive, labor-intensive California companies and businesses, of which there are many, that are providing much-needed jobs to Californians.

A bank like ours, for example, does not succeed simply by buying and selling goods. We have succeeded at City National because we have a lot of people, they're highly skilled, they're highly compensated, and that, too, is a real cost of our product, knowing -- you know, selling a tomato in a grocery store is very different from deciding to lend somebody a million dollars to start up a grocery store, and so the personnel costs are integral to the costs of our product.

If a new tax system makes that more expensive and more difficult, it would be harder for us to grow, harder for us to lend money, harder to create jobs, and harder to compete with banks who keep a lot of their functions outside the state of California.

How exactly each of your options would affect City National and all the many banks in the state of California is something that we don't -- I don't entirely know until we see the tax rates that would be applied and how it interacts with the other taxes, as your chairman was describing a few minutes ago. But based on what we know, we continue to believe that the current income-tax system, because it taxes banks like ours and a lot of other businesses in proportion to their financial success, and is able to take into account the complex and subtle costs of our products, is a fairer, more comprehensible, and importantly, more competitive when you recognize that we're competing with 49 other states and a bunch of countries.

As you weigh various alternatives, I would ask you to give particular attention to establishing a tax system that promotes job creation and economic growth and does not hurt California's competitive position with other states.

This is a concern I've actually worked on over the last few years chairing the Los Angeles Economy and Jobs Committee, which Mayor Villaraigosa created.

California, as you are well aware, is the eighth largest economy on earth. Because, among many things, it is still the manufacturing center of the United States, the entertainment capital of the world, and our nation's trade gateway to Latin America and the Pacific Rim. And because it is the birthplace and the center of technology industries and the nation's leading producer of everything from agriculture and aerospace to biomed and toy design, all of these industries employ large numbers of men and women. They would be hurt by a business receipts tax that did not encourage employment but, instead, rewarded not hiring or even firing people.

In these perilous times, every job is precious and under pressure. California must protect and encourage employment, not penalize it.

I think this is especially true here in California, where we benefit enormously from our unique entrepreneurial culture that produces spectacularly innovative and globally competitive companies that we desperately need in the 21st century. Just to name a few obvious names: Apple, Facebook, Google.

California, as you know, attracts more venture capital than any other place on the planet. Northern California is the No. 1 recipient of venture capital. Southern California is the No. 2 recipient. Greater than Boston, greater than Texas. Maintaining that is critical for our state.

A lot of small start-up venture-capital-backed companies go through a number of lean, nonprofitable, unprofitable years. Biotech clients that we have in San Diego go for many years losing money. To be hit with a tax while they're losing money, trying to create drugs or technology that will benefit the public and help the economy is obviously an issue that needs to be considered. We don't want to risk losing California's receipt of venture-capital funding, nor do we want to lose these companies as they emerge from those incubation phases and create enormous tax revenue and jobs.

Let me give you one example. A few years ago, one of my children was in the same college class as Mark Zuckerberg. He dropped out; my kids graduated. Unfortunately, he created a lot more value than my kids did. But he had to leave Cambridge, Massachusetts, to find the right place to take Facebook and build it into what it has become today.

He chose California. He didn't have to come here. But, if you will, the soil of financial resources, intellectual capital, the tax climate -- it was an attractive mix and, obviously, has helped the state and his company.

But if you have a tax on unprofitable companies that employ lots of people, will the Zuckerbergs of the future bring the Facebooks of the future to California or will they be attracted to other places that don't have that tax?

I also would point out that while in the short run you might pick up some tax revenue from these money-losing companies that employ lots of people, it's also true that growing businesses produce more tax revenue for the state in the long run. It's the grow-the-pie theory rather than fighting over the slices of the pie.

Peter Weber has a report you may have seen, called, "*Growing California's Regional Economies*." And it concludes that a 1 percent increase in California's economic output would add between $2.5 billion and $5 billion in new tax revenue. Obviously, as businesses invest and hire more workers and become profitable, the tax base expands and our state receives more money.

Crafting tax reform, in my view, should be like practicing medicine. The first rule is to do no harm. I really do appreciate the fact that you've given me this opportunity to speak. And, obviously, many organizations have made many comments about which your important work is about.

I'd underscore four questions that have been raised that I think need to be addressed: How would the proposal affect the tax liabilities of California's leading industries? Would it negatively influence already negative perceptions about doing business in this state? Would a net-receipts tax encourage job creation or provide incentives to scale back employment or move jobs out of California? How would the tax affect prices and California's ability to compete with other states and other countries?

I'm confident that the answers to these and other questions will become clearer as your tax proposal continues to take shape and you focus on these complex issues and detail.

And I commend you for taking the time today and the other day to let people like myself share our thoughts with you.

I would just add that besides the business receipts tax -- and I know that's what you want to focus on -- I really do think looking at alternative taxes that don't hurt the state's competitive position would help ease the burden and move towards a goal of bringing down the corporate income tax and personal income tax makes sense.

One idea I like, and the chairman mentioned it a second ago as being on your list, is the oil-extraction tax. There's a business that cannot move out of California. And the fact that we don't have that tax and Alaska does and Texas does, I find it incomprehensible that we wouldn't have an oil-extraction tax that's competitive somewhere between the Texas and Alaska rates. And, obviously, the price of oil -- I mean, it's a red herring to say it's going to affect the consumers' cost at the pump. Oil prices are set in the global marketplace, and California should be getting its fair share. Alaska doesn't have an income tax. There's a reason for that.

I know it's controversial, but I do think -- and I pay that tax -- vehicle registration taxes are too low. They should be competitive. We can extract some more revenue there without hurting this economy.

And so those would be two that I would just mention.

For decades, California's economy has been the envy of the world. In many ways, it still is. But it's going to take a lot of work to sustain the prosperity of this state.

The talent and resources, industries, and entrepreneurs that set our state apart are as rich and compelling as they ever were. But I believe all of us must do more to foster a strong economy. And I appreciate the fact that that's what I believe this commission is trying to do.

We need a set of tax policies that are sound, fair, equitable, competitive, more stable, and designed to protect the jobs we have, and promote the job-creating investments that are critical in the 21^{st} century.

In particular, every economy, including California's, needs a strong banking system, as we've seen all too clearly in the last 18 months. The net-receipts tax is not the right method for banks to pay their fair share for California.

Thank you very much for listening to me. And if you want to discuss it further, I'm happy to do that.

CHAIR PARSKY: We would.

First of all, I want to thank you very much for that thoughtful presentation.

I'm going to ask the staff, the Franchise Tax Board -- don't get too nervous about the fact that the Franchise Tax Board is here. They're here as advisors.

MR. GOLDSMITH: I didn't bring my returns.

CHAIR PARSKY: They're advisors to this Commission, and they've done fabulous work for us here.

And I'll ask my fellow commissioners. One comment you made at the end, I'd be interested in your views, you mentioned the oil-extraction tax. If you coupled that with a willingness to allow expanded oil drilling, how would you feel?

MR. GOLDSMITH: You know, I think that -- and I preface it by saying, I'm no expert on oil drilling -- but, first of all, I think that the state has just agreed to expanded oil drilling without -- if you'll pardon the pun -- extracting an oil-extraction tax. It would seem to me, that's putting the horse before the cart. Why give the right for expanded oil drilling without getting an oil-extraction tax? So I think, in part, as I understand it, the state's already agreed to do that.

But assuming your question is, should there be more drilling, I think, based on what I know, there are enormous safeguards today that didn't exist back when we saw the oil spills in the Santa Barbara Channel. And I think we are at a time when we have to choose among a set of less palatable alternatives. This country needs to be energy-independent, it needs to have the ability to transition to an alternative energy era. And I think it would behoove the state, as the country simultaneously and the state, have policies that are in favor of and promote clean energy, I think if part of the price of getting revenue for oil extraction is greater drilling, prudently done, I would support that.

CHAIR PARSKY: Curt, would you like to ask questions?

COMMISSIONER PRINGLE: How did you know that? I didn't do anything to signal -- no, no, I just want to make sure we hear this in context.

What is -- for example, does our staff know any proposed extraction tax and the value of that based upon the current potential for drilling?

MR. GOLDSMITH: I can tell you, I read in the paper -- your staff probably has a better number -- but the 9.9 percent tax that was proposed would produce $800 million in tax revenue. And that was a couple months ago, when the price of oil was lower. So if you think oil is going to go back up over $100 a barrel one of these days, you know, I think the notion that you could raise a billion dollars -- Alaska has a 25 percent oil-extraction tax, which probably affords their governor the ability to say things our governor can't.

You know, a 9.9 percent --

CHAIR PARSKY: Maybe their former governor.

MR. GOLDSMITH: That's right. We haven't heard from the current governor.

COMMISSIONER PRINGLE: But I think that is a good mark. Let's say it is a billion dollars, Mr. Chairman. And I guess my challenge with that is, isn't it true that the BNRT, business net-receipts tax, is somewhat around $10 billion to $12 billion estimated in value for every one percentage point?

CHAIR PARSKY: Yes.

COMMISSIONER PRINGLE: And that we are talking about eliminating the corporate income tax, dramatically reducing the state sales tax, and dramatically reducing the personal income tax obligation, and to get into the range of twenty-five-some-billion dollars, $30 billion, of modifications of existing taxes.

To fill that gap, that is the challenge we're faced with. And seeing -- I think there is probably a diverse point of view on this panel about an oil-severance tax or extraction tax, even. But still, under that theory, you're talking about one, two, three billion dollars compared to kind of our task, is to see the shifting from some of the taxes that are the most volatile. It’s a twenty, thirty billion dollar puzzle. And that’s the depth by which we’re looking. And I think that defines some of my challenges with looking at some of those taxes that may not be necessarily as broad-based and valuable in the overall picture. Not that they might not be perfectly legitimate.

MR. GOLDSMITH: Well, I guess, to quote a famous Republican, Everett Dirksen, *“A billion here and a billion there, and before you know it, it’s real money*.” I think that what I’m suggesting is, the net-receipts tax probably does make some sense for certain parts of the economy that are not labor-intensive, where you’re not going to impact it. And, obviously, you’re calibrating the trade-off against the reductions. So if you look at law firms, you know: Is it personal income tax, or is it taxing a partnership? I appreciate the complexity of that.

But I think -- and, obviously, I feel strongly that some industries, like banks, like probably highly labor-intensive but moderately profitable businesses, that there are some drawbacks to this tax as I see it.

But I also think a way to ameliorate the problem is, as I suggest, to grow -- which is what I think you’re trying to do, by the way -- grow the tax-revenue pie. The net-receipts tax is obviously designed to bring a different type of revenue into the tax revenue pie for the state. I think that's a laudable goal. I do think it needs to be more stable but carefully defined. And I appreciate that you're trying to figure that out. But I think you don't have to put -- it's not an all-or-nothing fight. It doesn't have to be all to the net-receipts tax and zero corporate income tax and zero personal income tax. We're willing to pay a corporate income tax in lieu of being in the net-receipts tax.

But if you're trying to build a bigger, stabler pie for a state tax revenue, I'm suggesting whether it's the oil-extraction tax, whether it's increasing the vehicle-registration tax -- obviously, there are a number of other taxes that are under consideration that could ameliorate the balance that you need to get from both.

Also, you know -- and I haven't tried to address it, I'm sure the FTB would be better-suited for this -- there are things that could be done on the corporate income tax as well to bring the rate down but to close some of the things that reduce revenue.

So I don't envy you, the complexity of your task.

CHAIR PARSKY: Maybe focus some questions just on the impact of this tax and the justification for including banks in it.

Why don't you start -- yes, go ahead, John.

COMMISSIONER COGAN: Russell, thank you very much for your excellent testimony. It's nice to have someone of your expertise here to help us think through these issues.

MR. GOLDSMITH: Thank you.

COMMISSIONER COGAN: Let me try to explain the dilemma that I think we have. The BNRT seems to us, with its low rate and broad base, to be one that is certainly worth pursuing for California, and that's sort of why we're here. And if you approach tax policy from a 30,000-foot level, you say, "Ideally, we'd like to have one tax for all businesses, not two tax regimes." Two tax regimes will distort economic activity and slow economic growth.

If we left the banks out, we'd have banks under a regime of within 11.8 percent rate, I believe you said was the bank rate now.

MR. GOLDSMITH: Right.

COMMISSIONER COGAN: We'd have another regime side-by-side at, let's say, our BNRT rate would be around 3 to 4 percent.

Each tax regime would have different expenses that could be deducted. And that seems to me to be terribly distorting from an economic standpoint.

Whereas Chris Edley said last time, it's too many opportunities for tax planning. And so tax avoidance would become sort of the objective of many business decisions when it wouldn't be.

And so that's what we're concerned about, is having businesses with an opportunity, in effect, to choose between these two. And the banking sector, I believe many of its activities could be classified as financial and other -- or outside the financial. So that's our worry.

At the same time, when I think about the BNRT, it's like a value-added tax. And I ask myself, "How do we measure the value-added in the banking business?" And that's where I have a lot of trouble. What is the measure that we use?

And so one thing we've sort of hit on here is to say, "Look, let's try a measure that simply takes the banking business as a cash-flow business, and sort of says at the heart, 'Look, the value-added is the difference between what you have to pay to have access to credit markets and what you get in return by making that money available to the private sector.'"

So if you're able to get credit at 2 percent and you're able to earn a return of 5 percent on that money, why isn't that the amount of money that represents a good approximation of the value that your operations have added to productive activities?

And so maybe you could help me think through why that's not a good measure of value-added, since at some fundamental level it does seem to me to be reasonably an appropriate measure.

MR. GOLDSMITH: Well, I'll try.

And, by the way, I meant to say, 10.84 percent for the marginal rate.

You know, if the banking business were as simple as: What do we pay the depositor and what we get back from the borrower, then maybe there would be -- it would be a lot easier to find wisdom in the approach that you're taking. But the fact is, the cost of the money that we lend is a lot higher.

You know, pick up today's *LA Times* business section. I mean, you've got banks failing across this country under enormous stress. Having a receipts tax would be enormously burdensome. And, obviously, we've seen a number of bank failures already in California, which is not good for the state or the people who live here or its economy.

As I tried to suggest, the cost of the money that we lend is often -- I think has so many pieces that is so complicated, that it doesn't lend -- no pun intended -- it doesn't lend itself to the simple measurement of, say, our posted CD rate versus our lending rate. Every bank has multiple rates that they pay.

At our bank and a number of other banks, we have businesses that leave millions of dollars in our accounts, and we pay them nothing for it in terms of a rate, but we pay them through services. We provide free checking. We provide free online banking. Maybe we give them a preferential rate on loans because they're keeping large, compensating balances with us.

So to send a squadron from the Franchise Tax Board in and say, "What is the cost of the goods you're renting," it's not as simple as going down to Hertz Rent-a-Car and saying, "Okay, what did you pay for the Chevy, and what are you renting it out for?"

COMMISSIONER COGAN: Right.

MR. GOLDSMITH: It's much subtler than that.

You know, if you provided a driver in the car, you provided somebody to wash it every morning, you provided somebody to give you a neck massage while you're riding in the car. I mean, it's a complicated mosaic as to the cost of the goods. And the cost of doing business, as we're seeing painfully right now, are the losses and the reserves.

And so I think part of why the income tax is fairer for business is that it takes into account all those legitimate costs and gives the state, you know, a share when there are profits to be had.

I'm sure there are a number of other businesses where maybe it's a lot simpler and the net-receipts tax makes great sense.

Obviously, having multiple tax systems isn't theoretically the most desirable approach, but we're stuck with it. We have federalism; we have multiple taxes.

You know, I haven't studied it, but it would seem to me, you know, that one approach here would be to go with more -- expanding where the sales tax applies. And so you don't have to get into the question of the cost of goods.

The notion of missing the legitimate costs that a lot of businesses have to put that product forward, which is the issue with banks in particular, and the issue of making it more expensive to hire people in this state -- I mean, we see the ads from other states. If it's cheaper to have workers in Nevada or Arizona or Texas, as it is now, I fear this exacerbates it.

At least now, if you do business in California, which is a higher-cost state, you can deduct those legitimate costs that are inherent in doing business in California. And I would hate to see that change.

COMMISSIONER COGAN: You know, with respect to the FTB, I worry that if we have a dual system in place, then banks will find it in their economic tax interests to have non-banking activities, and to assign certain deductions to those non-banking activities, and certain receipts to the banking activities, to have a tax at a 3 to 4 percent rate rather than a 10.8 percent rate.

And, boy, I tell you, what I worry about is, that's an invitation to have the FTB very much in your business.

COMMISSIONER PRINGLE: Send a little squadron.

MR. GOLDSMITH: I appreciate the problem. I mean, the fact is, virtually every bank has non- -- when you say "non-bank," really, you should call it "non-lending activities."

COMMISSIONER COGAN: Right.

MR. GOLDSMITH: And, frankly, consumers and bankers want to do that. We provide investment advice, others provide insurance -- I mean, a range of things.

A simple approach to it might just be to say, principally, if you're a bank measured by, say, the majority of your revenue is interest income, then all of your activities to be subject to the existing corporate income tax, and not put the put the whole bank, if administratively that seems too challenging.

Obviously, filing two tax returns, segregating your business gets complicated.

I don't think it's as hard for the great bulk of our revenue. I mean, we have a very substantial wealth-management business, as I mentioned. It's pretty clear to us how much revenue is coming in from that business and how much is coming in from interest income. We're a public company; you can see it in our statements.

So, you know, would it be a little complicated? Yes, but I don't think it would actually be all that complicated.

And the truth is, in this state, most banks -- and there are hundreds, if not thousands of independent banks in the state of California, that are pretty much simple loan-and-deposit operations.

So I think it's doable either way.

(Commissioner Ito entered the meeting room.)

COMMISSIONER COGAN: Yes.

One final comment is, I share a lot of the concerns that people have about including the banking sector in. After all, you go over to Europe where they have the similar types of taxes to a BNRT, a value-added tax, and I think in virtually all of the European countries, the banking sector is set aside and not part of that value-added tax because of the issues that you've raised here.

And yet think about grand tax reform in California without having all of California industry in it, and it sort of makes you --

MR. GOLDSMITH: That's why I'd like to see an oil-extraction tax. Let's include the oil companies in this grand reform.

COMMISSIONER COGAN: I sort of share Curt's view. Tax reform is one thing. Having an oil-extraction tax that will offset 1 percent of any tax change that we would make, it's, like, irrelevant for tax reform. It might be good for raising revenues. But, again, if it's $800 million, it's 1 percent of the general fund revenue.

So I hear you on that, but I just think it's kind of irrelevant with respect to the fundamental question that we face, which is: How do we make our current tax system, a tax system that will promote economic growth for the state?

MR. GOLDSMITH: Well, I appreciate that.

I guess I would just say, instead of trying to have one massive, single-payer solution, you know, the net-receipts tax, one sizes fits all, I think the complexities of the industries and the complexity of the burdens that are already on the taxpayers of the state suggests that while a simple one or two, you know, silver bullets would be fabulous, I don't think that's the reality.

And so I appreciate that the oil-extraction tax is just a piece; but the vehicle-registration tax, as an example, then you don't have to increase it by another billion. Maybe you just increase it by $1 billion, not $2 billion. That can comes right out of the pocket of motorists.

I think it's a mosaic, a complex mosaic that has to have multiple parts. We live in a complicated world, and I appreciate your willingness to hear my views about one slice of it, the banking industry, that doesn't really fit into the net-receipts tax.

COMMISSIONER COGAN: All right, thanks very much.

MR. GOLDSMITH: Thank you.

CHAIR PARSKY: I'd just like to ask Carl -- Carl, do you want to ask some questions about whether this industry should be part of the system or not?

MR. JOSEPH: Well, one of the things that would change under what the Commission has proposed is, I think under our current system of where we're heading into single-factor apportionment, the provision for banks to remain on the equally weighted three-factor formula is still in the code.

And so in the proposal of the Commission, everybody goes to single sales, which would take away from banks, having to have a payroll factor in your apportionment formula.

And I'm just wondering if you have any opinion about how that encourages employment in California to get rid of that payroll factor for you all, versus having the payroll included under the BNRT, and whether you thought about the interplay of that at all.

MR. GOLDSMITH: I don't fully understand.

How would it work, in terms of it would reduce some payroll costs?

MR. JOSEPH: Yes. Well, for banks now, the apportionment is payroll, property, and sales -- single-weighted sales. And the Commission's proposal is to put everybody on single-factor sales apportionment. No more payroll-factor inclusion at all. And I'm wondering for a bank like you all, since you wouldn't have the payroll factor in your computation for your apportionment percentage for California, if the removal of that payroll factor at all, in your mind, offsets the inclusion of the payroll in the base for the BNRT, in that your apportionment factor should fall under this proposal versus what the current law would be?

MR. GOLDSMITH: I'd have to really take a look at the numbers with our tax guys and see what the trade-off is to give you an answer. And I'd be happy to take a look at that.

But one other point that I'd highlight that you're seeing, as I've said today, in a tough economic period like this, a huge cost of our product are the loan losses that we take. And so part of my problem with the net-receipts tax is the procyclicality of it in a tough economic environment.

So at a time like this, when companies are being urged -- banks are being urged to keep lending -- which, by the way, City National has kept lending, and City National -- for the record, we accepted all the IOUs from the State of California, for what that's worth to you. But obviously profit margins are thin -- thinner in this period. And, roughly, half the banks in the United States aren't even profitable. So I would be concerned -- one of my other concerns about the tax is that it will penalize banks at their most vulnerable moments in various economic cycles, and that would hurt lending.

CHAIR PARSKY: June, what was the approach taken in Michigan to the banking industry?

MS. HAAS: Under the single-business tax, which is an added -- value-added tax, the banking industry was subjected to essentially a net income tax. And so it was not included in the additive value-added tax base.

When Michigan most recently moved to its Michigan business tax, which is a net income tax and a modified gross-receipts tax, combined, the banking industry was actually sort of narrowed a little bit.

The definition of "*financial institution*" was limited to those that are regulated as financial institutions; whereas under the single business tax, they were looking at those that had financial-type assets. So they narrowed the group of entities that then were treated as financial institutions and they are subjected to a net capital tax, instead of the modified gross-receipts tax and business income tax. So that's the history of treating financials in Michigan.

CHAIR PARSKY: I think one of the biggest challenges that we face is the area we're talking about now. I think that one underlying objective of looking at the business net-receipts tax, is that as the economy of California has moved more and more toward a service economy, that sector is not part of the broad tax base reflective in the sales tax. And so one of the objectives is to include that sector in that base. That can be accomplished in more than one way. But it certainly would be accomplished under this business net-receipts tax.

How to deal with banks in that equation is a complicated subject. And we've been struggling with not having a complete answer; but how should this commission, if we decide to recommend consideration of this kind of change, what should we recommend considering about banks?

And, as John said, when you have institutions as yours, that has more than just lending but has other services that are provided, how does that fit into what might be a different scheme for a bank?

And you've identified, rightfully, the issues that we are struggling with, and that the Legislature would have to struggle with if they decided to proceed with this kind of change.

MR. GOLDSMITH: Well, as I understand it, you are trying -- which I think is commendable -- as the economy has shifted, to get the state kind of its fair share of revenue out of services businesses. And I think whether it's a net-receipts tax or some form of a sales tax, whether it's, you know, dry-cleaning or alcoholic beverages or consulting services of one sort or another, I think those are revenue-rich environments for the state that, as you point out, are essentially outside of the tax system.

But a bank typically -- I'm not aware of a bank that's not a corporation in the state of California. They are regulated, typically by two, three, four entities. There's enormous visibility. It's not like a partnership that, to your point, that can monkey around a little bit with, "Well, if we distribute more to the partners, then there's no profit at the partnership level." You know, there are virtually no banks -- there are probably a handful of little ones -- that are even owned by a small group of people. So I think the banking system, for a variety of reasons, is in the tax-revenue system for the State; it has unique properties, both in terms of figuring out the complexity of its costs and the challenges that it has in the business-cycle process, where -- and given the fundamental nature, as you're seeing in Washington, the essential quality of having a healthy banking system to foster the health of the economy.

So I think there are areas, whether it's oil extraction or it's dry-cleaning, where there is a legitimate opportunity for the State to get some revenue. I think the corporate income tax actually -- obviously, the rates could be lower, the definitions could be fairer.

But that's a whole other ongoing challenge. But I think it's a system that's proven to be reasonably equitable; and I suspect, in normal times, produces healthy revenues for the State of California.

COMMISSIONER PRINGLE: Mr. Chairman?

CHAIR PARSKY: Go ahead, Curt.

COMMISSIONER PRINGLE: Well, thanks.

I do want to respond because, as the son of a dry-cleaner --

CHAIR PARSKY: Who knew? That's the danger of examples we're using. That's all right.

COMMISSIONER PRINGLE: I actually think that you pointed out what may be missed in some of this discussion, is that there are a lot of people who pay taxes and different types of taxes, but there are some companies –- let me see, an unincorporated retail store pays not only -- their customers pay a retail sales tax on the commodity purchased, but also all of that corporate income tax is paid, as well as any corporate distribution to any of the principals in personal income tax.

I would say a dry-cleaner pays -- either they're incorporated, like my father was, or they're a sole proprietor, and they pay a personal income tax on all of that that's brought in. But they don't pay a sales tax, nor do you.

And, you know, talking about extending -- there's a couple advocates here to extend the sales tax and not even create this new BNRT. There's some advocates that say, extend it to all services. And I hear a lot in your words, that that is something that you would contemplate as being equitable.

So would you see there is equity in extending it to financial services, so the services that you provide your customers -- not necessarily the interest on their accounts -- but the services that if -- am I really hearing that you think that that would be an equitable way to address expansion of the sales tax, broaden the base of the sales tax, as you suggested, be it to dry-cleaners or to banks, that that is a commodity that's being purchased, is that service, just like goods. So is that something you see that would balance off, instead of a BNRT, extending all sales tax to services?

MR. GOLDSMITH: First, I want to applaud your father for being an entrepreneur. We're bringing on entrepreneurs at City National.

I used that because I thought it looked like a product, right, that you get something back, whether it's a bottle of liquor or a clean garment. I think it's different when you're lending money. That's not exactly a service and that's not exactly a product. And I think trying to put a sales tax on that really doesn't fit. That's why I think the corporate income tax has been an equitable solution to get the State some revenue.

I sympathize greatly with your discussion of the paying of tax at every level. I think it would be a lot better if we didn't have to have all these taxes. But, obviously, the State's got a revenue crisis. And the issue is trying to come up with a system that's competitive with other states, that doesn't further damage our image as a place to do business.

And I think the "Do no harm" is a huge issue. You know, you pick up *TIME* magazine, you pick up any number of places. The image of this state as a place to bring your business is under enormous pressure. And I think you want to find -- which is why I go back to, you want a mosaic of incremental change that doesn't send the wrong signal to the businesses, the entrepreneurs. We can't drive jobs out of the state. We've got to attract jobs. We have a lot of tremendous capabilities and resources. And I think incrementally changing this in a way that seems equitable and that doesn't put us at a competitive disadvantage with other states is critically important.

I know of any number of jobs, as I'm sure you do -- and I know the Chairman has businesses scattered around -- you know, businesses that are moving from Santa Monica to Austin, Texas, with terrific jobs because they view Texas as business-friendly, and they view Santa Monica and California as hostile to people who make money.

So finding a balance where California doesn't look like it's hostile to entrepreneurs, hostile to economic growth and job creation, I think is fundamental.

COMMISSIONER PRINGLE: I do have one other question. I won't get into the fact that I believe dry-cleaners have more regulatory agencies overseeing them than banks -- and I think I can prove it.

MR. GOLDSMITH: I'll defer.

COMMISSIONER PRINGLE: But, in fact, I would like to make sure I understand the distinction -- and maybe, Mark, you can help me. All businesses in California aren't treated equal. There are, for example, insurance companies don't pay a bank and corp tax rate; is that correct?

MR. IBELE: Yes, they pay the gross premiums tax.

COMMISSIONER PRINGLE: So describe, one, what you perceive as the rationale for the Legislature creating a separate tax structure for insurance companies. And I want to hear it as a comparative to the thought about financial institutions.

MR. IBELE: Well, I think it goes -- it probably goes back to the 1930s when we first had the corporation income tax. And I think the rationale was, it was difficult to capture the activities -- it was difficult to put insurance companies in the same sort of box, or conceive of them in the same way as other types of companies. And perhaps it was easier to administer. There may be some other issues associated with that.

COMMISSIONER PRINGLE: So it’s a strict gross premiums tax?

MR. IBELE: Gross premiums tax. It’s a 2 percent rate on gross premiums.

COMMISSIONER PRINGLE: 2 percent on all premium purchases or premium values?

MR. IBELE: Premium payments. Gross premiums received by the insurance, by the insurer.

COMMISSIONER PRINGLE: I see.

And that is not in any contemplative sense a part of our package; is that correct?

MR. IBELE: It’s been brought up, but it’s not part of the package. It’s been discussed just briefly.

CHAIR PARSKY: Carl, not to say that you were there in the 1930s, however, any comments about the history there?

MR. POWERS: I don't know exactly when it came in, but it's actually in the Constitution. So the gross premiums tax is in the Constitution, and requires a constitutional amendment to actually change it.

COMMISSIONER EDLEY: But there's nothing about dry-cleaners?

MR. POWERS: Not that I'm aware of.

CHAIR PARSKY: Not in the Constitution.

MR. JOSEPH: I would point out that we have had problems with that in the sense that insurance companies and insurance activities are often parts of corporate groups that file the corporate income tax return. And because the insurance companies do not pay the corporate income tax return, they have been a bit of an issue for purposes of tax planning, to the point that not too many years ago, the Legislature put in a pretty complex set of rules to deal with the problem of companies putting intangible assets and things into insurance companies, to essentially avoid the corporate tax on those assets if they had been held and sold by somebody who was paying the corporate tax.

So even that variation has caused some issues. And so I think there is some concern about exacerbating that by essentially doing it again.

CHAIR PARSKY: Jennifer, do you have --

COMMISSIONER ITO: No.

CHAIR PARSKY: Chris?

COMMISSIONER EDLEY: Two, I think, quick questions.

The first: How should we think about venture capital firms? Anything special spring to mind?

MR. GOLDSMITH: Well, I think, first and foremost, I go back to my “Do no harm.” Venture capital is the lifeblood of so much job-creation and critical to this state’s future when you consider what’s happening, you know, with auto plants and so forth.

As I think about it, some of them are -- many of them are partnerships. So really, in that sense, it looks like law firms. I think they’re under assault at the federal level. I talked to a friend and client of mine who is a venture-capital firm -- and I’m sure Mr. Parsky can give you great insight into this whole field -- but, you know, there are these contemplated changes at the federal tax level, and that’s going to have an enormous impact on venture-capital firms.

I think for the State to further impact that business until it’s clear what’s going to happen at the federal level, you know, it might be prudent to wait.

CHAIR PARSKY: We might separate a little bit venture-capital firms from start-up businesses.

COMMISSIONER EDLEY: Right, that was my next question. Yes, exactly.

CHAIR PARSKY: Differentiate it a little bit there.

And as currently contemplated, there would be a minimum level of gross receipts, currently contemplated $500,000, which would take you outside of the business net-receipts tax.

We're quite concerned about the impact of this tax on small business in California and on, obviously, start-up businesses.

I don't know the exact statistics, but I know Phil has indicated something along the lines that maybe as many as 80 percent of the businesses in California might be deemed small business.

Is that about right, Phil -- or even higher?

MR. SPILBERG: Could be. Under the definition of $500,000, it could be even higher.

CHAIR PARSKY: It could be even higher?

All of those businesses, as contemplated, would come outside of the reach, if you will, of the business net-receipts tax.

COMMISSIONER EDLEY: Some of them would be filers, but they wouldn't have any liability.

CHAIR PARSKY: Liability.

COMMISSIONER EDLEY: No tax liability.

CHAIR PARSKY: Right.

MR. GOLDSMITH: I think the concern is -- and I think Facebook is -- and I have no affiliation with Facebook -- I don't even use Facebook, but --

COMMISSIONER EDLEY: What is it?

MR. GOLDSMITH: What is Facebook?

COMMISSIONER EDLEY: Never mind.

CHAIR PARSKY: The Boalt Law School is sometimes a little bit removed from day-to-day activity, but that's okay.

MR. GOLDSMITH: Ask your students, how many of them have a page in Facebook. It's a social phenomenon that started at Harvard college and has spread around the globe, and --

COMMISSIONER EDLEY: Do we tax those?

I'm sorry.

CHAIR PARSKY: Anyone from Harvard college will get taxed as part of the system.

MR. GOLDSMITH: I'm against that.

But what would worry me about a gross-receipts tax, I believe -- I don't know this, but I believe Facebook may still not be profitable, and yet it employs an enormous number of people and is seen as having a very bright future, *à la* Google, *à la* Apple.

And so I recognize and respect the notion of carving out small business and the dry-cleaners of the world, who have the sole proprietorships. But what I would hate to see happen is the Mark Zuckerbergs of the future, who have a great company, need some venture capital, need the intellectual capital that we have in this state; but they have it in Texas, they have it in India, they have it in Massachusetts. And if they say, “Wait a minute, as soon as my company” -- I’m sure Facebook has far more than $500,000 in revenue. But let us assume, as I believe that it is still, quote, “pre-profit,” I would think a lot of entrepreneurs are going to say -- and VC funds in particular -- “I’m investing in this company not to get it to $500,000 in revenue, but to $500 million in revenue; and if I move it or start it or incubate it in California, I’m going to, in addition to absorbing and having to fund losses for three, five, ten years -- certainly biotech in San Diego, this is a big, big, issue -- and then it explodes with revenue and profitability, that’s when the State should reap its fair share of revenue; not when these fledgling companies are trying to make it.

And the scale of these enterprises, they can absorb $100 million in capital and have hundreds of millions in revenue.

Amazon, which isn't in California, but is a perfect example of that, it was losing money for a very long time and now is a phenomenal business.

That's another thing, and I haven't said this, but the whole issue of taxing Internet sales, so the State loses sales tax. The amount of sales that occur in California via the Internet is huge and is only going to get larger. It's a federal exemption issue, as I understand it. But that may be something that you want to take a look at.

CHAIR PARSKY: John?

COMMISSIONER COGAN: Carl, you mentioned that the banks are still under the three-factor apportionment for interstate sales. Could you indicate, what was the rationale for keeping them separate?

MR. JOSEPH: Well, yes, I certainly wasn't in the Legislature when they wrote the bill the way they did. But when we went from a three-factor formula to a double-weighted sales factor formula, which increased the emphasis on sales -- this was back in 1993 -- at that time, there were industries in the state that requested that they remain on the standard three-factor formula. Extractive industries were one. Banking and financial was another one.

And so at that time, those industries said, "Please don't make the formula more about the market, because our markets in California, for the most extent" -- at that point, you know, banks were more state as opposed to big, national things, I assume. So when the Legislature just recently went to allow an election to go to single-factor sales, no other factors at all, the way they wrote the bill was essentially if you could elect the double -- or "elect" -- if you were a double-weighted entity under the existing law, then you could elect to just use single-factor sales under the new law.

If you were an entity that was -- the average weight of the -- the normal three-factor formula, you would stay on that formula. And that leads me to assume that they believe that those industries who didn't want 50 percent of their factor to be sales back in 1993, would certainly not want 100 percent of their sales to be the factor. And so they were remaining on that equally weighted three-factor formula.

Your proposal here is a sales-factor proposal. And I'm just wondering whether or not that difference in any way compensates at all -- that getting rid of that payroll factor, which is often argued in literature to be a tax on payroll, essentially -- if that in any way subsumes some of the problems for the banks in the taxing of their employees' labor.

COMMISSIONER COGAN: Right. You know, it would be interesting if the decision was made to keep banks outside of a BNRT. If we went with a BNRT, it would be interesting to take a look at what the consequences would be of changing the law with respect to the interstate sales apportionment factor for banks.

COMMISSIONER EDLEY: Well, what about law firms? I take it, the issue with banks is that you're originating the loans all over the place, so your sales are all over the place, but the workforce is largely local. Well, the same would be true of a law firm or an accounting firm, right, is that they'd be --

COMMISSIONER COGAN: I didn't think we were thinking of a policy that would keep the law firms outside of the BNRT.

COMMISSIONER EDLEY: I know. But I'm trying to figure out, what would be the rationale?

Well, for the BNRT, yes, right.

COMMISSIONER COGAN: I'm just saying, assume that we made a decision that banks would be outside the BNRT.

COMMISSIONER EDLEY: Right, right.

COMMISSIONER COGAN: Then does it make sense for us to be thinking about the apportionment factor for banks, changing that?

COMMISSIONER EDLEY: Right.

MR. JOSEPH: Yes, I'm not aware of what happened as far as input from the banks on the sales-factor formula that went through the last time. You know, that was during the sort of budget process. And I don't know how much input there was from industry. I don't know whether or not that assumption, that they would not like a bigger sales factor and a smaller payroll factor, is necessarily true anymore. But certainly that's --

COMMISSIONER COGAN: That's what I'm wondering, yes.

COMMISSIONER EDLEY: I guess what I was getting at, John, is if the logic -- if the apportionment -- whatever the tax is, why doesn't the same apportionment logic follow for services like law and accounting, as for the service provided by a bank?

COMMISSIONER COGAN: Regardless? You're saying --

COMMISSIONER EDLEY: Right.

COMMISSIONER COGAN: -- regardless of whether we're in a BNRT or not?

COMMISSIONER EDLEY: Right.

COMMISSIONER COGAN: And that raises a question that we have talked a little bit about already, which is: What is the most appropriate apportionment factor within the BNRT?

COMMISSIONER EDLEY: Right.

COMMISSIONER COGAN: And is the same apportionment factor, the right factor for all?

And in the staff proposal we have so far, it’s a sales-apportionment factor.

COMMISSIONER EDLEY: We should let Russell get back to work.

COMMISSIONER COGAN: Yes, yes.

CHAIR PARSKY: Russell, we kept you a little longer because we have really struggled with how the BNRT should or shouldn’t apply to the banking industry. And so we really thank you very much. A very thoughtful presentation. And I think we will probably try to develop some examples, concretely, of how the existing system might affect the bank and how the proposed system and maybe some of your people in the tax area will take a look at those examples.

MR. GOLDSMITH: Well, I appreciate the opportunity to share my thoughts and have the dialogue. And, yes, we’d be happy to be helpful. We have some people who know more about tax and apportionment and some of these other sexy issues.

And so, yes, if there are some fact patterns or something you’d like us to say how we think it affects us, either way, I'm happy to have -- to ask somebody to do the homework and supply it to you. And I applaud what you guys are trying to do, as I said in my statement. Thanks very much.

CHAIR PARSKY: Thank you very much.

Let's move on to Technology, or another technology presentation.

Is Mike Rockenbach here?

MR. ROCKENBACH: Good morning.

CHAIR PARSKY: Please, Mike. I'm sorry to keep you a little longer, but we'll try to catch up.

MR. ROCKENBACH: No problem.

I don't really have any prepared remarks, so maybe that will speed it up a bit. But as way of an introduction, let me maybe give you a little background on myself and the company that I work for.

COMMISSIONER EDLEY: Okay, and then tell us what you think we should do to banks, now that Russell is gone.

MR. ROCKENBACH: Banks are our friends.

So my background is, born and raised in California. I've got a couple of kids that I've raised in California. I've worked here all my life.

The company I work for is Emulex Corporation. It's been around for quite a while as a technology company that's somewhat challenging. We've been a public company for about 30 years. I've worked there coming up on 18 years. I've been CFO of the company for about the last ten or 11 years. And so I've got a little bit of a background.

No background in tax, other than the experiences I get from filling out taxes and signing tax returns. But as I think of some of the earlier comments, when we have had to make decisions as a company, quite frankly, taxes is kind of -- well, not necessarily an afterthought, but kind of a result of the things that we're working on. It's very difficult, I think, as a technology company, to make the basis of your business decisions on accounting treatment, tax treatment, those types of things, because you've got to do the right thing for the business. And in technology, that really consists of innovation and growth.

And I think, as we've changed a lot over the years as a company, we've had our tough times, we've had our good times. We're in a position now where we're a fairly global company. I don't know that we're representative of all technology companies in California. In fact, quite frankly, I think we're probably not a good representation of all technology companies. For us, we manufacture high-speed components for big OEMs. So the guys we're selling to are HP, EMC, Dell. So big, global companies.

And, you know, our products are being integrated into their products and then they're being sold to big data centers, where they're storing lots of information and accessing a lot of information.

So banks are our friends because they do a lot of transactions, and that's kind of the specialty of the products that we build.

You know, as a global company, we've been through a variety of changes. When I started at the company, we were a global company, we had 13 international subsidiaries. Went through a lot of changes, shrunk down a lot to just a single corporation, and we've been going the other way for the last ten years, maybe. And we're kind of back out at that growth and the extent of the -- you know, the current environment. But we're now that global company again.

We design all our own products. We partner with a lot of different people to help us build products and design products. We've done our own manufacturing in the past, but we don't today. We outsource that.

But because of the way that we do business, we're selling to these OEMs. And so ultimately, our net revenues, if you will, in the state of California are really dependent on where our customers are building product. So we don't ultimately sell a lot into California if our customers aren't building products in California.

So, being not a tax expert, I can't tell you if a receipts tax is better than an income tax. When I think about a receipts tax, you know, we've got several subsidiaries in Europe and so we've got a little bit of experience with value-added tax. You know, the challenge we have as a U.S. company and value-added taxes, it's in local currency, so you're exposed to currency gain/loss more than anything else with the value-added tax.

But, you know, when I think about it, when I think of a receipts tax -- and you talked about the example of a small start-up company -- under $500,000 in revenue wouldn't be taxed on the net receipts. But, you know, a net-receipts tax is kind of like -- you know, kind of an existence tax: "I'm here, therefore, I'm taxed."

And, now, the other side of that, though, is we're getting a lot of benefits; right? There's services that the State is providing because we're here. And so when you're in a start-up, I think that is a bit of a challenge, right, because you aren't generating a lot of revenue, even when you get -- from a technology company's perspective, even when you get past $500,000 in revenue, you may not be making a profit yet.

But, on the other hand, when you're profitable, you're generating income, and so that's more of a share-the-wealth type of tax; right? If I'm doing really well, I'm sharing more with you; and if I'm not doing so well, we're both suffering.

And what that does from the State's perspective in terms of delivering those services to us as a company and, you know, the citizens of the state, is that puts a lot more volatility in the revenue stream.

And I think, obviously, when you're using a profits-based tax -- and you can debate what "profit" is -- but when you're using a profit-based tax, it's probably got a more disproportionate impact on a relatively small change. And the reason I say that is if you -- you know, you look at gross domestic product, maybe it's coming down 10 percent this year, but profits are coming down 60 percent. So if I'm sharing the wealth with you, you're getting hit by 60 percent, when on the top line and the services that you have to provide maybe only got cut by 10 percent. So what that does, I think, by transferring from an income-tax base to a revenue-tax base, is it provides more stability in the State's revenue stream, which is good during the bad times.

And kind of the counter to that, though, is you don't get the upside during the good times. So I think it shifts directionally from the State or from the government to the individual corporations. In some respects, you're putting a little bit more instability on the company because we're going to pay taxes on our revenue base as opposed to our income base. So if we're less profitable, the tax is still the same. If we're more profitable, it's great because it's lower on a relative basis.

So when you get more stability in the State's income, you know, the onus is on the companies to take more responsibility when we've got the volatility on our side of the income. So I don't know that -- I think you've got an unenviable task.

I certainly appreciate --

COMMISSIONER EDLEY: Everybody agrees on that.

CHAIR PARSKY: That's a given.

COMMISSIONER EDLEY: Can we just put that in our report?

MR. ROCKENBACH: I probably should have started off with that, I guess. But, you know, I think it's hard for me or for a company to look at just a receipts tax independently. I don't know whether I feel good or bad about it -- in fact, I don't feel good or bad about it because, you know, for me as an officer in the company or an executive in the company that you're trying to run a business, that's just one of the variables you take into account. So you have to look at the sum of the parts. If you had a -- I don't know what numbers you're looking at -- or I don't think you've filled in the blanks on the numbers yet as you look at these things -- but if you have a 2 or 3 percent revenue tax but the income tax on individuals that we're employing is 30 percent, well, I have the same problem, it's just moved to a different line on my P&L.

I think that at a certain level, a receipts tax maybe benefits established companies a little bit more than a start-up company. But that doesn't mean there can't be other offsets that make it beneficial to be a start-up company. And so I think that's how we would look at it as a company. And I can't speak on behalf of all technology companies because a lot of them have different variables than we have.

But I think from a public company's perspective, or from any company's perspective, the things that help us are probably fairly broad. You know, a great school system that's generating a lot of very talented math, science majors and communication majors and a variety of skill-sets like that is going to help us as a company. So that's a service. So we're certainly willing to pay a little bit more in another bucket if we're going to get a little bit more in that bucket.

And I think it will be interesting to see how this plays out. As I say, I live here, and I fully intend to continue living here. But it's difficult to do these types of changes at all. And I think it's painful to do them as iterative changes. But that's not to say that the pain of doing a massive change is any less. But the thing that I think helps us at a broad base is simplicity, to the extent we can.

The more cumbersome it is to figure out what the tax rate is, the more expense there is to us as a company. So, again, I kind of have to look at it from all the variables, not just one.

And I think there's a lot of value in a receipts-type tax. If it reduces some of the volatility and lets you continue as a state and, as an economy, to be able to invest through the tougher times, but you're not necessarily, like I say, going to get all upside of the better times, but that's okay. The government is there as a service and, you know, support provider as opposed to, you know, the entrepreneurship is on the company side. And an environment that encourages that and supports that, I think, is the biggest driver to success for companies.

CHAIR PARSKY: Thank you.

John?

COMMISSIONER COGAN: Thanks, Mike, for taking the time to come here.

A couple points you said.

We don’t get the benefit under a BNRT or a more stable revenue flow, that we don’t get the upside when the economy booms. But I think, from what I’ve seen of the way the State has dealt with, or spent on the upside, what they’ve done is just created a budget that’s a disaster for California programs when the downturn hits. And that’s what we’re seeing now. And so the benefits of having a stable revenue source is really -- I think really, really important for the State.

The second point is that you said that part of the reason for your success is that you make decisions based upon economics, not on how to game the tax code. One of the benefits of a broad-based tax system that has a low rate, is that further encourages people to make their decisions based on sound economics and not on tax policy. And so that’s another reason for thinking about a broad-based, low-tax-rate kind of regime.

Let me ask you two questions. One is, when it comes to planning for a company such as yours, one of the provisions we have is an apportionment formula for assigning your tax liability based upon your in-state sales versus your out-of-state sales. And we've been playing with two options: Make that an annual calculation, so it's annual sales inside of California relative to the rest of the world. Another is a five-year averaging of that sales ratio.

Does it make a difference -- an appreciable difference for a company like yours in terms of tax planning or in terms of, more importantly, economics planning for your company, which way we would go? Do you see any important difference?

MR. ROCKENBACH: That's a great question.

I think if you're in a -- let me think about how that would affect us.

I think if you're growing pretty quickly, I would guess, you know, a five-year average look-back might be better for you.

COMMISSIONER COGAN: Uh-huh.

MR. ROCKENBACH: Because that would kind of lower it, you know, overall. That's my guess.

CHAIR PARSKY: Well, it might be helpful, maybe to take a look, post this discussion, at the actual experience of your company.

MR. ROCKENBACH: Yes.

CHAIR PARSKY: And without necessarily disclosing anything that's not publicly disclosed, maybe provide us with what impact it would have on your company if we went in one or the other of these directions.

MR. ROCKENBACH: Sure, I could take a look at that.

Yes, like I say, I think for us, it’s probably not representative of technology companies as a whole. It would depend on how much it changed within the state of California. I mean, we could have very dramatic changes elsewhere and, you know, they wouldn’t necessarily affect California as much.

I think new technology is going to tend to be on that curve of accelerating revenue growth. More established companies, maybe it’s not going to make as much of a difference if you’re growing 5 or 10 percent a year, there’s less volatility in your numbers. So whether it’s one year or five years might not make a big difference.

But from a start-up’s perspective, maybe five-year averaging would alleviate some of the other pressures you have, because you would see a little bit of a benefit, maybe as you’re kind of hitting an acceleration curve, where the tax would be a little bit lower because your averaging look-back is five years, or some subset of five years. So you would kind of get -- you would have a little bit of pain at the beginning, but you'd get some benefit as you kind of got into the market.

COMMISSIONER COGAN: Yes, unless you start selling first in California and then branch out; right?

MR. ROCKENBACH: That's true.

But, again, I think if you're selling first and only in California, there's -- if there's compensating things within the business that make it more efficient for you, that's not necessarily a penalty.

COMMISSIONER COGAN: Right.

Then does your company make use of the research-and-development tax credit? How important is that to your company?

MR. ROCKENBACH: We do use the research, the R & D credits. We also have benefitted -- this was for us, anyway, it was quite a few years ago -- but from net-loss carry-forwards -- net-loss carry-forwards, I think if you're a company that's done acquisitions -- we've done acquisitions in the past. There's some benefits from acquiring NOLs. You know, there's some limitations on how much you can use it.

But, again, I mean, those are things where, when we look at a company from a perspective of an acquisition, we're not making the decision based on whether we're going to get these losses that I can absorb or not, because we're looking at it just purely from innovation and technology.

COMMISSIONER COGAN: Right.

MR. ROCKENBACH: And what we look at -- and now we're probably a fairly normal company -- these things are really just a make-or-buy decision for us. So we're trying to look forward in the market, directionally, where things are going and where we need to be; and then our decision comes down to, do we have the time and the wherewithal to do it internally, or is there somebody out there, as the case of the start-up or somebody funded by venture capital, that can go do that, or is already doing that? And an acquisition makes more sense. And then, you know, whether you have an NOL or not comes into play after you make that decision. So I mean, they tend to be very business-driven decisions. And I think the taxes either are a little bit of a drag on that or they complement that decision.

COMMISSIONER COGAN: Great, got it.

Thanks very much.

CHAIR PARSKY: Ruben?

COMMISSIONER BARRALES: So you're agnostic right now on the business net-receipts tax.

Is there any tax system that would give you heartburn immediately? I mean, is there a proposal or an idea that would cost jobs at any lengths or be considered harmful?

MR. ROCKENBACH: I can’t think of any specific ones.

You know, I think -- we’re a company -- well, because we sell to OEMs, we’re a company that has relatively fixed costs in a lot of ways. We don’t have a lot of variable costs. So when things slow down, spending is relatively confined. I mean, we’re like everybody else. We’ve assessed our spending and made changed in our spending over the last two years. But, you know, if our revenue is off 20 or 30 percent, you know, we’re maybe only able to cut expenses 10 or 15 percent. So I don’t think -- you know, on the other hand, as we grow, we’ve got a lot of leverage towards the upside.

So -- and I think there’s benefits from R & D tax credits. But, again, that’s only a big benefit to the extent that there is a penalty somewhere else. So if there aren’t R & D credits but overall taxes are lower, that’s a good thing for us.

CHAIR PARSKY: I think if you look at this -- I don’t know the details of your business at all, but I would urge you to look at this tax in the context of the way in which you grow. If you’re a very high-margin business and fixed costs are really under control, I think you could potentially really benefit from a substitute. But we'd like you to look at it.

MR. ROCKENBACH: Yes. Like I said, I think for an established company, I don't know -- I mean, like I say, you have to look at it in the context of all the changes you're making. But in general, as an established company, I don't know, maybe we would favor a receipts tax as opposed to an income tax because we're established. That might not necessarily work out for everybody else.

But, you know, what that does, I guess -- kind of the counter to -- would a receipts tax impact innovation within the state, it might -- maybe it just changes the way you do innovation in the state. And I guess I'm probably pointing it out to people that already know, but there's a lot of things that can come into impacts on whether start-ups work or not. Tax is only one piece of it. And, you know, you can debate on how big of a piece that is.

But if a receipts tax, at a very broad, macro level, favors established companies versus start-ups, that's not necessarily a bad thing. If companies have the wherewithal within the state and the ability to draw on an educated workforce, a strong workforce, to deliver better innovation, it just shifts the burden from being -- it shifts the burden back to more of a make from a buy.

So we would have less of a burden as we're profitable. We can make more investments in research and development to expand our business as opposed to looking at it and saying, "Well, we have to go buy somebody that's more innovative in that particular area than us because there is a guy out there that was a start-up and did that." So it might just shift the way things happened as opposed to being a big negative or a big positive. It's kind of, like I say, within just the concept of a receipts tax, that's a hard variable to look at. But you do have to look at these things as an all-inclusive approach, I think.

CHAIR PARSKY: Thank you very much. We really appreciate your contribution.

MR. ROCKENBACH: Thanks.

CHAIR PARSKY: Next, Motion Picture Association.

COMMISSIONER EDLEY: Gerry, while he's coming up, can I make two quick points?

One is, I think John made a point about how, when in the current system, when receipts go down for the State, we get into a mess. Because when receipts were high, we started doing all the spending. Well, I just wanted to set the record straight from a left perspective here --

CHAIR PARSKY: You're on my right. He's on my left.

COMMISSIONER EDLEY: When things get out of whack on the downside, speaking generally, there are three explanations.

One may be that there were commitments made to expenditures that can't be continued.

Another may be that there are discretionary programs that the Legislature refuses to cut.

And the third may be that, when times were good, the Legislature cut taxes.

And it's all three of those things, it's not just one of them. And so I think the expenditure issue that gets us into trouble is when they've made a commitment to some kind of program that they're not willing to trim back. And as we've certainly seen in this round, wherever there's been a discretionary program to get cut -- with the exception of prisons and so forth -- they've cut it. But certainly, I would agree that on the entitlement side, you run into much more difficult problems.

But it's also, I think we've seen both in Sacramento and in Washington, a tendency when times are good to cut revenues which also contributes to the problem.

COMMISSIONER COGAN: I certainly would not disagree with that at all. The point is, what we want to try to do is get a tax code that prevents what we're seeing now, which is these deep, wrenching cuts in certain programs that were expanded before merely because the Legislature took a temporary increase in revenue and treated it as a permanent increase.

COMMISSIONER EDLEY: That's right. I'd certainly agree with that.

The second thing I want to say is, I think it's important for us to remember that in trying to figure out how we think about start-ups and the seeming unfairness of forcing a company to pay a BNRT if they don't have profits, it's not paying the BNRT as compared to not paying any taxes, because you don't have profits to be taxed if, in fact, we're going to expand the sales tax as an alternative. So it may be they have no profits, but they've got a sales-tax liability as well. So that's the comparison.

Now, that wouldn't apply in the case of, say, a biotech start-up where there's a long pipeline and you actually have no sales of anything.

COMMISSIONER COGAN: Right.

COMMISSIONER EDLEY: But something like that.

CHAIR PARSKY: Something like both.

COMMISSIONER EDLEY: Right. But for something like the Facebook example, Facebook is really big now, but they don't have any profits. If there's something there that would be folded, would be encompassed within sales, they would be paying a sales tax.

CHAIR PARSKY: Right.

COMMISSIONER EDLEY: And also, the bigger they get, I think our argument would be that with the bigger -- if they had gotten really big but still don't have any profits, if the rate is low enough -- 3 to 4 percent -- then that's kind of a cost that can be better, it seems to me, integrated into their business operations, into their structure -- their financial structure, because they're big enough. In that sense, it's not much different than if they faced cost increases in some other factor of production or they're paying more for their labor.

COMMISSIONER BARRALES: Dry-cleaning.

COMMISSIONER EDLEY: Or for their dry-cleaning, for that matter. Right.

So I think that that would be, that there's wiggle room. In other words, that there would be enough wiggle room. At some point you get big enough, that there's enough wiggle room that if the rate is small, you ought to be able to cope with it, I think, plan for it, or pass it along, whatever.

COMMISSIONER COGAN: Yes.

CHAIR PARSKY: Okay, Eric, we're going to move along, but we really appreciate your coming.

MR. MIETHKE: Thank you very much, Mr. Chairman.

I have submitted written testimony, so I won't read it, and I'll try and get you back on schedule by just summarizing as quickly as I can, answering what questions you may have.

CHAIR PARSKY: I know the level of your expertise, so I'm sure you can summarize well.

MR. MIETHKE: If it's anything like my family advises me, it shouldn't take long because I don't have much expertise in much of anything. Particularly, ask my 12-year-old, Sam.

At any rate, I appreciate the opportunity to come today on behalf of the MPAA. You've asked us to comment briefly on the business net-receipts proposal as we understand it, and perhaps offer just a few comments about the package, too, as we understand it.

I'll restrict it to the proposal to phase out the bank and corp tax and reduce sales and use tax rates. I did not believe any discussion of the flattening of the PIT was part of this, so we have no comments on that.

Some of the things I'll be saying is not different from what you've heard so far. To the degree that it's redundant today, I'll try to really skip over it, one of which is, of course, like everyone else, the more detail that we could have, the easier to be for us to give you a better idea of how this will have an effect on the industry.

Some of the major pieces that would be helpful to have as soon as possible would be, of course, information on the rates, the BNRT rate, and also the phase-out rates on bank and corp, and ultimately, too, what the Commission will be recommending for the sales and use tax rate. As you know, the state sales and use tax rate is federally made up of six different rates. And the decision on whether to eliminate some or all of them will have a fairly profound impact on some of these compensating taxes that will be used to offset the BNRT.

Certainly another big issue will be treatment and expensing of equipment, what happens with carryforward credits and NOLs. And certainly one question that all are interested in is, to the degree that part of this package is the reduction or elimination of these other taxes, what guarantees do we have that that will actually occur? Is the proposal to have that all preprogrammed as part of the original legislation, so that it doesn't become, in essence, at the end of the phase-out period discretionary on the part of the Legislature as to whether to eliminate the replacement taxes or not?

One thing I do want to stress, too, is that people tend to think of the motion-picture industry as being just that, and distinct and unique. But at least the studios that make up the Motion Picture Association of America, many of them are part of a much larger corporate conglomerate that are engaged in far-reaching activities, some completely unrelated to motion-picture production and distribution.

To that extent, this information is important because we will analyze this proposal not just in the individual context of our motion-picture operations, but the members will analyze it in terms of their overall corporate context. Because, again, this is based on, as I understand it -- as we understand it, your unitary group, as would be for bank and corp tax which, again, would include all these many, many diverse businesses within it. So the sooner we get the information, the better.

Now, based on what we do know, we do have a few matters that do concern us that we'd like to offer testimony on today. One is -- and I won't belabor it because others have -- and that is, there is a built-in incentive, to some degree, to outsource and offshore, which has been talked about to some degree. Because, of course, payments to your own employees are not deductible. Payments to a firm are.

We have worked very, very closely with our union partners in the industry to try and encourage the expansion of California production, discourage runaway production. And so certainly that would be something that we would be concerned about if, in fact, these incentives are out there.

We don't believe the fixes to that problem are necessarily easy. We do think there are constitutional issues involved, significant ones. And certainly to the degree that we bypass the legal constraints, as we saw in the 1980s, from the unitary-tax wars, worldwide combination, at some level, these issues become political ones with our foreign-trading partners as well. If they find themselves subject to this place called California's taxation, they begin to wonder, you know, how does that work, and complain to Washington who, in turn, turns around and threatens federal legislation. So all these things become problematic.

There has been commentary on start-ups. You know, the motion-picture industry is a very strong part of California's entrepreneurial spirit. And, indeed, a lot of start-ups and truly innovative companies occur in our industry.

The bane of all small businesses is capital preservation, formation, retention -- you name it, it's all about capital and, indeed, a tax that, at least on its face, would seem to apply whether profitable or not, where there's no deductions for interest payments on debt. And also there's one thing that I don't think anyone has touched on, current changes in the bank and corp law not only allow for NOL carryforward, but a two-year NOL carryback. And from what I could see from the materials that the Commission made available on BNRT, at least it didn't say that the NOL carried back would be continued on into this tax program. That's something I really would advise thinking about.

We are, to some degree, concerned about whether this would increase the cost of production in California. Now, it is true that whatever production company in California would pay to a firm would be deductible from its own BNRT. But the entities -- the multitude of small companies and others that perform all the subspecialties, ranging from lighting, cinematography, editing, special effects, sound effects, application makeup, these entities would all become subject to BNRT.

Currently, their services are not taxed under the sales-and-use tax law. And there's a debate, of course, even within our members as to whether you should view this as a sales tax or an income tax.

But nonetheless, the testimony that we have from E & Y, I believe at the first hearing where this was introduced, was that the bulk of this would be passed along in the form of higher prices. So presumably, even though we would be deducting those higher prices from our BNRT liability, those are still increased costs that we would have to bear.

Now, whether those would be significant or not, of course, is a function of what are the other offsetting considerations. And, indeed, even that service provider, whether the other offsetting provisions would offset the need to pass along the BNRT in the form of higher prices.

As you all know, the Governor and the Legislature has had a tremendous focus in this last year on the issue of lowering the cost of production in California. We have all worked together, and we're very, very pleased to see a production tax credit offered, finally, for shooting in California.

California has been in a very competitive situation with other states, like New Mexico, Connecticut, New York, Illinois, that have offered major tax incentives to come shoot there.

We appreciate California's recognition of that. We would like to shoot here. This is the industry's home.

We would certainly want to make sure that nothing about the BNRT is inconsistent with that and with that movement and on a public policy level.

I just want to say a couple of words about the income tax -- the current income tax -- and this goes more along the order of a transition from an income tax to a BNRT.

The income tax has actually been a pretty stable, relatively well-known commodity to the motion-picture industry. The regulation, actually -- the income tax regulation that applies to the motion-picture industry, frankly, is undergoing the first revision this year in -- what, Carl, 27 years?

MR. JOSEPH: A long time.

MR. MIETHKE: A long time.

So it is pretty well known. And we have had relatively few issues with it. So to the degree that there is movement away from it, we're moving from the known to the unknown. And there's always issues that arise and questions that arise in connection with that.

One of the major ones, of course, is the expensing versus capitalization of equipment. The motion-picture industry, both through its direct operations as making and producing motion pictures, as well as other things, like theme parks and other things with which you’re well familiar, buys a tremendous amount of high-value, high-dollar equipment every year.

The issue of whether that’s expensed or amortized is going to be one that’s really quite significant.

And as I noted earlier, these equipment purchases are still going to be subject to some portion of sales tax.

By my own rough calculation, under the most rosy scenario, we would be looking at a state sales tax rate of about 1.75 percent, and under a worst-case scenario -- and a worst-case scenario would be where the half-cent portion of the rate that’s for realignment, that took place when -- I think it was 1991, the Legislature handed off health and welfare responsibilities to the county, sent down a half cent of revenue in the realignment of that -- whether that, in fact, would be repealed or not. Assuming it isn’t, and realignment is in place, and you were to make a purchase in the highest tax jurisdiction in the state -- local jurisdiction, which is, I believe, Pico Rivera and Southgate -- that would be 4.75 percent, still existing after full phaseout. So you’re looking at quite a range of continuing potential sales-tax liability on major purchases of inputs.

Again, one of the reasons why, for many years, the industry has, like the rest of California industry, urged a sales-tax exemption on manufacturing capital inputs, certainly.

Just a few other passing comments. Although this has not been a major issue in our industry, we do note that the BNRT would carry over the existing business/nonbusiness income distinction. That has been somewhat problematic in the past. There's no easy answer for replacement. But having business/nonbusiness issues in two tax programs at the same time is certainly some level of concern.

We notice, too, from looking at your preliminary overview of net-receipts tax is that it contains numerous apportionment formulas that appear -- and, again, I haven't really had time to confirm with FTB -- but it would appear to continue what we call both interstate apportionment -- trying to figure out what portion of gross receipts or income is apportionable to California as opposed to other states -- and intrastate apportionment, meaning, once you've determined how much is allocable or apportioned to California, how much of those receipts, or how much of that income should be apportioned to each of the individual companies that are doing business in California.

That, in the past, has generated some problems, some technical problems -- and FTB, I'm sure, can brief you more in detail on that -- of the shifting of income by virtue of these formulas and also stranding of tax credits.

Now, I did not notice, really, any discussion of whether tax credits would spring anew and be in a business net-receipts tax regime, or whether we would just be using up credits earned under the bank and corporation tax. But to the degree that credits are almost a political reality at some point for -- someone's going to come up with something that the Legislature deems to be a creditable activity, that's at least something to keep your eyes on.

Finally, I just want to touch on a couple of transition issues. This has morphed a little bit in the documents. There's been now two iterations of the overview of the BNRT.

What's going to happen with tax credits and NOLs that are at the end -- remaining at the end of phase-in? That's a very large issue.

Originally, the documents were silent. And we presumed that that meant that they would disappear. Now, it's listed as an option as to whether they would be carried over and be used either at face value or some variation thereof as an offset against BNRT liability.

But this is a serious balance-sheet issue.

FTB can give you the recent numbers; but the last time I looked at this, there's about $10 billion of accumulated and unapplied R & D credits alone.

So I state that for two reasons: One, to give you an idea of the magnitude of the balance-sheet issue, because there's $10 billion of these things on people's books. What happens to that could have a pretty profound impact on the books. But also it's a public-policy issue, in terms of to the degree that the decision is made to allow these, it's going to have a quite a significant impact on your BNRT rate, your transition issues, all these things. So all these things become interrelated and seamless.

There is also some -- and, again, I don't profess to be an expert on this particular piece of it -- but there's some issue of the treatment of deferred gains and deferred income at the end of the transition period as well. That's been referred to what's called "future legislative action." Again, more uncertainty as to what that would mean. But we would think that if that's not dealt with really up-front, the presumption is going to be that that income and those gains are going to be triggered at the end of the phaseout, which could again be a significant liability.

And again, just to end as I started, there's a lot we don't know. We will be very, very interested in seeing the details of the package and, again, trying to be a resource to you to help how to guide the discussion as we approach the end of the Commission's deliberations.

And with that, I'll end and try to get you back on schedule and be as brief as -– and I'm here for you.

CHAIR PARSKY: Thank you very much.

Curt?

COMMISSIONER PRINGLE: Yes, I personally am concerned if Eric limited his testimony. So I want to make sure I expand it as much as possible. I told him that was my singular goal.

And there's three areas, Mr. Chairman.

But first, before I get to those, so you believe, under the present local sales tax, of what you would assume is the most severe circumstance in reduction of sales tax under our present perceived plan, Pico Rivera area, at 4¾ may be the highest combined sales tax at the end of this process?

MR. MIETHKE: As I understand the Commission's, at least, current thinking --

COMMISSIONER PRINGLE: Goal or discussion.

MR. MIETHKE: -- as I understand what the thinking is, we're not going to disturb what exists currently at the local level.

Currently, statewide, there’s a uniform state rate of 1 percent. Local jurisdictions, pursuant to Prop. 218, are allowed to add local transactions and use tax. The jurisdictions that have added the most of those, again, I believe are Pico Rivera and Southgate, which have now gone up to I believe 3½ percent at the local level. If you add that to the pieces of the state rate, that piece that’s in the Constitution for police and fire and the piece that’s related to deficit-reduction bonds, which I presume are sacrosanct and can’t be repealed without at least a constitutional amendment as it relates to the half cent for police and fire. Certainly I don’t know what arrangement could be made with the bondholders. That’s how I came up with a worst-case scenario of 4.75.

COMMISSIONER PRINGLE: 4.75 --

MR. MIETHKE: And throwing in realignment as well. I’m sorry.

COMMISSIONER PRINGLE: As compared to today, the rate in that city is what?

MR. MIETHKE: 10.75.

COMMISSIONER PRINGLE: Okay, so I think that does demonstrate -- I don’t know necessarily if we can eliminate or even drop the entire state share, even after the constitutional restrictive pennies and half pennies.

But I think that, alone, is very demonstrable.

Do you think the entertainment industry makes many major purchases in Pico Rivera?

MR. MIETHKE: I can't say. I cannot say where people make their purchases. I'm just pointing out that --

COMMISSIONER PRINGLE: But if they did, if they did make major purchases in Pico Rivera, wouldn't you suggest that that is a tremendous benefit in savings as well?

MR. MIETHKE: Well, all I can say is that it's a reduction. Now, again, how much of an incentive that is depends, of course, on a number of things, which is all the other pieces put together.

COMMISSIONER PRINGLE: That's true.

MR. MIETHKE: I'm just saying –- all I'm saying is that –-

COMMISSIONER PRINGLE: Eric, I'm just giving you a hard time. You don't need to defend that.

MR. MIETHKE: Okay.

COMMISSIONER PRINGLE: So on the net operating loss carryback issue, I think that is interesting. And that's something we're going to have to struggle with both carryforward and look-back, or however that works.

But isn't the look-back a limited, sunsetted period of time in which that can occur?

MR. MIETHKE: No, sir.

COMMISSIONER PRINGLE: So the two-year look-back is permanently in --

MR. MIETHKE: It was.

COMMISSIONER PRINGLE: -- and it came to you without a sunset; is that correct?

MR. POWERS: Yes, it is. It's permanent, but only for losses generated 2011, going forward.

COMMISSIONER PRINGLE: Say that again?

MR. POWERS: So for losses generated in 2011 and future years, you can always carry back two years. So the existing pool of losses, you can't take back.

Does that make sense?

COMMISSIONER COGAN: Right. It starts in 2011.

COMMISSIONER PRINGLE: Yes, so, again, all of the NOL stuff we've got to figure out how that transition is made. And then anything we were contemplating, not everything would start on Year 1. Some of us would like to see one thing starting on Year 1, is the elimination of the corporate income tax side. And if that is the case, then it makes those issues more challenging to deal with right out of the gate. So I respect that.

The movie-industry credit that is in place, what type of credit is that right now?

MR. MIETHKE: It's a combined. Actually, it has two elements to it. One, if you're -- it has a sales tax refund element to it, and it also has, for other types of companies, it's just a regular income tax credit. Now, it can be, after 2011, like all credits, it will be able to be assigned amongst the members of the unitary group, which is helpful. But I don't know if that answers your question.

COMMISSIONER PRINGLE: No, it really doesn't.

What value -- I mean, what percentage of the value of the credit is in a sales tax credit-back versus a straight corporate income tax credit?

MR. MIETHKE: The credit is just getting off the ground. In other words, it's just part of the most recent budget negotiations that came out. I'm not even sure that -- just the first round of credits have just been awarded. So I think that's fairly premature to tell where all this is going to end up.

COMMISSIONER PRINGLE: Is this a pool of credit and then applied maybe --

MR. POWERS: Yes, so credit is actually -- it's an allocated credit. The Legislature granted $100-million-a-year authorization to the Film Commission. And as Eric said, the first credits are being awarded but won't be used until -- 2011 will be the year they could actually be used --

COMMISSIONER PRINGLE: I see.

MR. POWERS: -- is in 2011. The taxpayer has an election to apply it against sales tax. The independent films can actually be transferred to other entities. And, as Eric pointed out, in 2011, the larger entities can --

COMMISSIONER PRINGLE: So this is not just a straight corporate credit –– corporate income tax credit; therefore, the assignment of that credit -- I mean, if someone ever wanted to move into that realm, it could be assigned to a BNRT, for example? I mean, there would be nothing that would restrict that from that same type of assignment?

MR. MIETHKE: Well, it would take legislation because, in other words --

COMMISSIONER PRINGLE: Everything we're doing here today is contemplating legislation.

MR. MIETHKE: Right, yes. The answer to your question is yes. The only reason I was confused is because currently it can be used under the existing legislation. It can be applied against sales-and-use tax liability.

COMMISSIONER PRINGLE: Got it. So that makes it clean. Just so I understand, it could be assigned to a BNRT liability?

MR. MIETHKE: Yes, it could.

COMMISSIONER PRINGLE: And finally -- I've known you for a long time, maybe at least 20 years, as you have spent a lot of time in tax policy, tax advocacy, as an attorney, as a consultant, as a lobbyist, all that kind of stuff. And the Legislature addresses tax-conformity bills almost every year. And under that guise, that is similar to our charge here, where you have this desire to have a tax-neutral package, right, and we put together conformity on the federal side or things that the State wishes to do, but really balance them out in a package that is revenue-neutral; is that right?

MR. MIETHKE: The Legislature has, in fact, done conformity bills that they have done on what they tried to make a revenue-neutral basis, as close to as possible.

COMMISSIONER PRINGLE: And under that definition, though, of revenue neutrality, under no circumstances have we really looked to see if every single taxpayer would pay the same amount under the new legislation as they did under the existing legislation that we're modifying; right?

MR. MIETHKE: You are correct.

COMMISSIONER PRINGLE: So part of our charge --

you know, a previous speaker said something like the first rule is to do no harm. And I guess I accept that but not on a patient-by-patient basis. That, in fact, the --

COMMISSIONER EDLEY: Another one of the pull-the-plug people.

COMMISSIONER PRINGLE: Well, in dealing with the State's tax policy, it's not -- everything that is accomplished, even in singular year-by-year tax bills, that are tax-neutral, never contemplates every single taxpayer being -- their outcome being the exact same at the end of the day. That there are going to be folks within year-to-year tax conformity bills where there are winners and losers, and there are also going to be the same case when you're looking at the entire tax code and how to modify it and change it; right?

MR. MIETHKE: I agree with your statement that there's going to be winners and losers.

COMMISSIONER PRINGLE: Therefore, your job here is to make sure that we -– to ensure that the industries you're representing today are in the winners, or at least not in the losers. So I want that. But it's also -- I mean, this is one of our challenges. We're going to hear from all the different industries, and different industries are going to tell us where it may make them not a winner, and they're concerned about being a loser, just like we all would be.

But when you're dealing with this, and the Legislature deals with this type of stuff every single year in a package of bills that affect the tax code, there will always be, within that package of bills, some that win a little bit and some that lose a little bit in the final outcome.

MR. MIETHKE: Is that a question?

As I understood what the Commission requested, it was a description of how the BNRT proposal, in the narrow sense, and the proposed package would affect our industry, okay. That's what we've tried to come forward to, to talk about today.

COMMISSIONER PRINGLE: I think he should just stop or else he might get in trouble with his client.

But I think you did a great job. But I wanted to kind of put it in context for at least my point of view, that we're hearing from all of the different industries in that same vein.

MR. MIETHKE: I appreciate that. Thank you.

COMMISSIONER PRINGLE: Thanks.

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

MR. MIETHKE: You're welcome.

CHAIR PARSKY: Next, we have Ports/Shipping.

Jim?

MR. EUPHRAT: Good morning, Chairman and Panel Members. Thank you very much for this opportunity to address you. I think you've got a very challenging situation here for the State. And I'll give my perspective as a representative of a manufacturing industry.

My name is Jim Euphrat. I'm the tax manager of General Dynamics, National Steel and Shipbuilding Company, also referred to as "NASSCO." I've been employed as an employee there for 30 years, almost all of which has been in my current role in dealing with tax matters. I'm a CPA and I have a master's degree in business as well as a degree in economics. So I do tend to look at it both ways: As a tax practitioner and as an economist, trying to think big-picture for the state.

NASSCO is located in San Diego and is the only remaining full-service shipyard on the West Coast of the United States capable of building U.S. Navy ships. So we build really large ships. We also design and build all commercial vessel types. We also are a prime contractor and a strategic partner for the U.S. Navy for the repair of multiple ship classes. We're physically next door to the 32nd Street Naval Station, home of the Pacific fleet there.

We consistently deliver vessels to our customers that are superb in fit and finish, and ahead of schedule and below budget.

We also do face, though, a near-term business challenge. Our order book currently reflects no commercial work after the year 2010. And shipbuilding is a very long-lead item. So we're trying to look ahead much further than that, typically. And we have no Navy work after the year 2012 at this point. In order to attract new business in the immediate future, it's imperative that we remain competitive.

NASSCO is the largest manufacturing company in the San Diego region. We employ about 4,500 people in the San Diego area, plus an additional 1,000, approximately, long-term subcontractors and support personnel.

NASSCO provides a critical employment niche between San Diego's high-technology industries and the service-based tourist industry. We provide above-average hourly wages and benefits to skilled tradesmen and women, along with extensive training and education programs.

We take a lot of people right out of high school and offer them a very good mobile, upward path for a long-term career.

Many of the NASSCO employees are represented by the boilermakers and machinists unions; and we rely critically on a stable and well-trained local workforce to meet the needs of our customers.

NASSCO provides a significant economic benefit to California. In the year 2008, we spent over $500 million in payroll for employees and with over 370 suppliers, generating approximately $1.25 billion in the California economy. In addition, we spent an additional $80 million on facilities improvements. That's just since the fall of 2007.

It's a very capital-intensive industry, as you would understand, including a blast and paint facility that's beyond environmental compliance standards.

Today, I'd like to provide you, at least, my view of a real-world indication of what the proposed business net-receipts tax structure could mean to manufacturers in California using NASSCO as an example.

I would like to address three points: Job-creation incentives versus disincentives; competitiveness in the national marketplace; and net operating-loss carryforwards, which I've addressed a little bit, which encourages, in my view, business risk-taking.

First, in my reading of the BNRT proposal, it appears that a deduction is permitted for payments to subcontractors and suppliers. However, there is no similar deduction for labor costs. Therefore, since labor costs are included in the net amount that is taxed, it appears to discourage needed job creation in California.

Manufacturing jobs have a higher economic multiplier effect -- we estimated it at about 2.5 -- than most service jobs. Manufacturing companies are heavily dependent on the retention of skilled employees.

The BNRT, in our view, discourages just this type of job creation and has the unintended consequence of providing an incentive for manufacturing companies to relocate jobs elsewhere.

Further, since manufacturing businesses regularly contract with subcontractors or suppliers that operate nationally or globally, again, the BNRT appears to unintentionally encourage sourcing jobs outside of California.

Second, based upon testimony in front of this Commission at the July 16th meeting, I've done a preliminary estimate. I was using a rate of 3.3 percent that was mentioned then. It would appear that NASSCO would pay significantly more tax under the proposed BNRT than under the current system. And that's probably because we're a relatively low-margin business, and we have a lot of employees. So that’s probably not a surprise from other comments I’ve heard here.

There may be a perception, though, that large businesses of the California market can bear a higher price with low risk to the underlying business or related jobs. However, NASSCO very much competes in a national marketplace. A lot of our competitors are on the gulf and the East Coast.

The price of an ocean -- and they have, by the way, a lower general cost of living compared to California. So there’s a variety of economic concerns here. The price of an oceangoing ship, in order to protect the competitiveness of companies that employ thousands of people, this type of major tax-policy shift should be viewed in the context, obviously, of national and international markets. We’re already subject to a higher tax rate than our Gulf and East Coast competitors. A shift such as this could make NASSCO less competitive in the marketplace, resulting in business conditions that would force us to have layoffs and lead to job reductions.

Shipbuilding does have a history of being a very cyclical type of business. And we have had pretty public major losses in some years. So the current system has been helpful in that regard, in that in a loss year, we’ve been able to carry forward the net operating losses, and then that's helped to offset future profits.

The business cycle for shipbuilding is not one year, it's a multiyear deal. So the net operating loss has been very helpful even though we're not a start-up. We're a relatively large company. It's been critical to our long-term survivability here.

This tax convention could have the effect -- you know, the NOL has the effect, I would argue, of encouraging business risk-taking, creating jobs, with the state benefiting in the long run from taxes paid in profitable years.

The BNRT, again, has the unintended consequence of penalizing business risk-taking, by levying a tax, regardless of whether the company has any profits from which to pay the tax.

In conclusion, I respectfully encourage the panel to reconsider -- or consider rejecting a plan that relies on the BNRT as the tax standard in California. It's my opinion that BNRT will serve to negatively impact industrial manufacturing growth in this state, discouraging creation of middle-class jobs, and prolonging the economic downturn.

Representing just one of the manufacturers that will be harmed, the BNRT would encourage outsourcing jobs out of California, limit competitiveness in the global marketplace, and eliminate -- at least, as I see it, the net operating-loss carryforward to the detriment of business risk-taking.

Clearly, I'm basing this on what I've read. And the details, I appreciate fully, are still evolving. But NASSCO is fully committed to growth and maintaining our position as an economic engine in the San Diego region. We're not a real mobile type of business. We have been there in some form or another about 100 years. Like I say, I've been there 30 years. We tend to be pretty stable. Nonetheless, we do face a lot of volatility. Our number of employees, over the 30 years I've been there, has fluctuated down as low as a thousand and up almost to 8,000. And so we are volatile. And then I'm concerned that this BNRT could increase our volatility and put us on a further downward spiral at the extreme.

And I would, again, want to thank the commissioners for the opportunity to speak here. And anything I can do to answer questions, I'll be happy to do so.

CHAIR PARSKY: Thank you very much.

Maybe either Carl or Mark can articulate a little bit the thinking on how this tax would apply to purchases out-of-state versus in-state.

MR. IBELE: Sure. I'll start and Carl can jump in.

The purchases from other firms would be deductible. But to the extent that they're in-state corporations, they themselves would be subject to the business net-receipts tax, if that would be incorporated in their costs. There would be no real savings there.

There is a potential issue with subcontractors, that is not -- or independent contractors that we're still sort of grappling with as to whether there would be an advantage for outsourcing. So we're still kind of working with that issue.

Carl, I don't know if you want to --

MR. JOSEPH: Yes, I think that's right. One of the things that the Commission's package contains, is it contains an economic-nexus provision which would essentially mean that if a corporation went to use -- went and outsourced work, if that work was -- the benefits of those services or that work was provided to a California company, that contractor would itself become a taxpayer for purposes of the BNRT. And so from a standpoint of what you would have to pay that subcontractor, they would have to be taking that into account in the price that you're paying, assumedly.

So, you know, the thought is that that would make that a little more neutral, I think.

MR. IBELE: It would be incorporated in their cost of doing business as well.

MR. EUPHRAT: Right. Again, my concern, though, is maybe larger than that. Because if it is included in their cost to us and then, in turn, we're essentially paying what I perceive as a tax on labor that is in excess of what we currently have, that makes us less competitive in the national or global marketplace. And so just all by itself, it would seem to me to be a factor that would tend to decrease manufacturing jobs within this state.

COMMISSIONER COGAN: So there is really two separate issues, Jim: One is, does the BNRT create an incentive to outsource outside the state --

MR. EUPHRAT: Right.

COMMISSIONER COGAN: -- say, labor services.

And then the second one, quite independent of that, is to what extent does the BNRT impose an additional tax on labor, regardless of where those labor services are performed?

MR. EUPHRAT: Okay, right, sure.

COMMISSIONER COGAN: I think that's the right way to -- and you've touched on an issue that we've all just been grappling with for the last six months of this, this whole process -- to clearly think through the two separate issues.

And I know for myself, as I've thought through at least the outsourcing part, I do believe that for at least large, large transactions, we have mitigated the incentives to outsource quite a bit by the economic-nexus provisions of our plan. That is, there really is, for any sizable purchase, I don't see that there is really much -- in fact, any difference between subcontracting inside California and subcontracting outside California. Because of the economic-nexus provision, subcontracting services from outside California would also be subject to the BNRT, thereby neutralizing the effect.

It still leaves the larger question of what are the consequences here for labor. And that, we have to think very, very broadly about what we're doing. We have to think about the whole package here. We have to include what we're doing with the income tax. We have to include what we're doing with the retail-sales tax and with the corporate tax. So that's a very, very complicated issue. I know in my mind still, I'm very much open on this.

Thanks.

MR. EUPHRAT: If I could get a point of clarification on something you just said. On the subcontracting, let's say we have a subcontractor that's in another country -- in Japan or something like that --

and performing services there. So you're saying the BNRT would apply to the services performed in that other location?

COMMISSIONER COGAN: No, if they performed those services for your company, right, and sold those services to you in San Diego, then those services would be subject to the BNRT, just as if you purchased those services --

MR. EUPHRAT: Okay, because they're going to source revenue in California because of the apportionment factor?

COMMISSIONER COGAN: Yes, right.

MR. EUPHRAT: Okay, gotcha.

CHAIR PARSKY: Carl, did you want to add anything to that?

MR. JOSEPH: No. I was just curious. You know, you talked about you did the comparison between now and then. Did the analysis take into account the current expensing provision for capital purchases as opposed to having to capitalize?

MR. EUPHRAT: No, it didn't, although I don't think that would change the answer really significantly.

We are a real capital-intensive industry. And clearly, that would help mitigate it to some degree. But, you know, we do have existing credits and NOLs and things like that, that are pretty significant, that help us out quite a bit.

And even without that, though, I would say my own rough estimate, just because of the ratio of labor to gross receipts in our particular industry, and the fact that we're a low-margin industry, even with the expensing of the capital equipment and so forth -- which, again, clearly applies, if that's the way it evolves but not enough to offset the negativity of it.

COMMISSIONER BARRALES: Question?

CHAIR PARSKY: Yes.

COMMISSIONER BARRALES: Jim, thank you for your testimony here. I appreciate the effort that you're taking on. You've been following the Commission from the beginning.

So, number one, from your perspective, for NASSCO, the business net-receipts tax basically -- it creates a disincentive to hire people in California, in essence, because it increases your tax bill --

MR. EUPHRAT: That's correct.

COMMISSIONER BARRALES: -- at least as to labor costs?

MR. EUPHRAT: Yes, right.

COMMISSIONER BARRALES: Do you have any suggestions for the Commission in terms of whether, within that system of a business net-receipts tax, credits or other ways to deal with that, and/or have you had other thoughts about other systems that have been discussed -- expansion of sales tax or things that might work out better for a manufacturing company?

MR. EUPHRAT: Sure, yes, I'd be happy to talk about that.

First, within the context of a BNRT, the transition issues would be critical for us. Obviously, I've indicated we have some significant balance-sheet issues, tax assets, if you will, that I would hope that any system would at least provide a -- ideally, I'm going to say -- a value that's commensurate with the current life of those NOLs or credits.

Second, I would say -- there are a host of other transition issues that are potentially complex. I think Eric mentioned, you have timing issues with regard to both deferred revenues and deferred expense items. Those can be fairly complex.

As a shipbuilder, we fall under code section 460, which deals with long-term contracts. And there's some fairly complex income deferral and expense deferrals that come under that mechanism. And I'm sure you're familiar with some of those regulations. It's not --

MR. JOSEPH: It's complicated.

MR. EUPHRAT: It is. And so I just mention that there are lots of complexities. And, candidly, my own view is that this needs much more study, much more time than the Commission has been given to make sure that there are not unintended consequences.

You know, some of the big-picture economic concerns that I have are that when we're trying to look at volatility, I think it's important to look at a dynamic forecasting or modeling regime as opposed to a static analysis. Because I appreciate and share the goal of the charter purpose, I guess, as one of the goals, is reduce volatility. However, if the tax system that is put in place isn't properly modeled out to reflect potential negative consequences, you may assume a static, or minimal decrease in manufacturing activity, and there could be a loss of major manufacturing type employers or a decrease in that activity that could be very adverse.

So now if you ask the second part of your question, what am I thinking that could be preferable in terms of other paths to go down? And I would say, you know -- and there's nothing that's without controversy -- but in my own view, if there's a feeling that the service side of the economy is not being sufficiently taxed proportionate to activity, then I think I would much rather see just a straight sales tax on services. I think that the existing frameworks are in place to handle that. And, again, not without controversy, but I think that would be preferable.

And I'll say, you know, my own personal view, if we're looking for other tax areas, I would probably think about, you know, a gas tax, carbon tax, that type of thing. Again, obviously, quite controversial.

However, I think in terms of both the environmental and economic incentives and lack of harm to the overall economy, I think that that could be preferable to a BNRT. All these depends on rates and I think the fairness and all that has to come into play.

Part of my concern, which I didn't mention on BNRT, is that I view it as a relatively regressive tax. And if you look at the volatility of the overall revenue stream, I think a lot of that has to do with more the -- although clearly the corporate income tax side is volatile, but I think it's as much or maybe more on the capital gains on the personal income tax side. And that doesn't seem appropriate, in my mind, to go after the business community to deal with that side of the volatility issue as much, because businesses and jobs are so central and key to the long-term economic health and prosperity of the state.

CHAIR PARSKY: I just want to come back on one thing you said.

MR. EUPHRAT: Sure.

CHAIR PARSKY: You view the business net-receipts tax as relatively regressive.

MR. EUPHRAT: Yes.

CHAIR PARSKY: In comparison to the sales tax?

MR. EUPHRAT: No, in comparison to an income tax.

CHAIR PARSKY: Right. So if we, in lieu of recommending a business net-receipts tax, expanded the sales tax, that, in and of itself, would be more regressive?

MR. EUPHRAT: Well, I'm not sure. In my mind, it would probably -- the regressivity would probably be similar between a BNRT expansion or a sales-tax expansion. I have don't have any hard data on that.

CHAIR PARSKY: I think if you put your economist's hat on, maybe not your tax hat on, I think there would be open debate about that subject.

MR. EUPHRAT: Clearly, clearly.

CHAIR PARSKY: But that's the challenge.

MR. EUPHRAT: Yes.

CHAIR PARSKY: A challenge that has been faced by the Legislature. A challenge that's faced by this Commission.

We are very sensitive to the regressive nature of certain taxes. But if the choice, in terms of including a big sector of our economy, a sector that benefits from the government services that are provided, if the choice is expansion of the sales tax or the creation of this form of tax, I think there would be a number of people that would say that this is less regressive. Maybe not totally, but less regressive than the sales tax.

MR. EUPHRAT: No, I appreciate that. I realize I don't have any hard data on that. That's just -- I did try to find some, actually; and I found some neutral data but nothing clear.

CHAIR PARSKY: Thank you very much. We really appreciate your coming forward.

MR. EUPHRAT: Okay, well, thank you for the opportunity again.

CHAIR PARSKY: All right, next, Energy.

We have Jeff Barnett.

First of all, I want to thank you, Jeff, for coming forward, and to thank your chief executive officer, Ted Craver, who I've talked to a number of times. He is very interested in helping this commission. And I really appreciate both his input and your presentation.

MR. BARNETT: Thank you.

I have submitted some comments, so I'm just going to briefly go through these. And I'm going to be happy to address any questions that you'll have of me.

It will be much like you're thanking us, we also want to thank you, Mr. Chairman, and the other commissioners and those who are supporting you in this effort. I know this is a very big effort and one that is extremely important for us and for the state of California.

As a way of background on Edison International, it is a parent company of two major subsidiaries: Southern California Edison and the Edison Mission Group.

Southern California Edison is an electric utility, and its rates are regulated by the California Public Utilities Commission and the Federal Energy Regulatory Commission. It serves more than 13 million customers in more than 180 cities in Southern California.

And then Edison Mission Energy is a non-regulated competitive energy electric-generation company. And it's located in 14 states, and also has a presence here in California.

One thing we want to convey here on the front end is that we really support the principles that were laid out by the Governor in the Executive Order that created the mandate for this Commission. And I know your efforts are to satisfy those. I know that's very much a tightwire exercise to meet all of those. But we do think those are the right objectives at the start of this process.

Your scope, as we've talked this morning, you're broader than this net-receipts tax, but the comments I'm going to be presenting here are narrowly restricted to the business net-receipts tax. And it's based on what our understanding is, on what we heard in open hearings and the materials that have been submitted to us.

The electric industry, whether we're talking about Southern California Edison, which is regulated, or talking about the activities with the Edison Mission Group, which is not, is highly capital-intensive. And just to give some frame of reference -- and this is actually in our submitted comments -- Southern California Edison plans to spend about $20 billion to maintain the reliability of its electric grid in the next five years. So that's a significant amount of capital that will go -- or planned to go out the door here in the fairly near future.

We use or rely on the capital markets to finance these capital expenditures, and debt-financing is a major source of capital.

We understand, based on the materials that you have provided to us, that the interest expense is not included as one of the deductions or an item of purchase, and that would have a significant impact to us.

And based on this morning's discussion, it's clear that you're still evaluating the application of this to the financial industry. But if it were to apply to the financial industry, we would think that since the interest-income side of that to the lender would be taxed under that model, that we would, in effect, be able to exclude, as the borrower, that interest expense. And that's just an observation to point out.

The other part of the net-receipts tax that we see has an impact on us, vis-à-vis the income tax, is the fact that internal labor costs would not be deductible from the base. And we have a very significant amount of employees in the state of California -- over 16,000 -- and our labor, where benefits are included -- are in excess of $1.5 billion. At least that's the 2008 data. So a removal of that as a deduction would be something that would expand the base for us.

And we understand that the Commission is still evaluating whether or not benefit costs would follow the labor costs and not be deducted or would that be a carve-out exception.

We would support the notion of having the employee benefit costs be deducted from the base, even if the labor costs are not -- internal labor.

Being a very highly capital-intensive business, we will benefit from the rapid write-off of the assets, and that will create a significant timing benefit for us. The magnitude of that benefit is going to be a function of whether or not it's an immediate write-off or it's something more akin to the federal MACRS depreciation system.

We do have some concern that if you were to go down the path of the immediate write-off of these capital assets, whether or not that would put us in a situation we would have these excess purchases over gross revenue, where we would have the ability to recover that excess in the future. And right now, based on the materials that have been submitted, there is a provision for a five-year carryforward. And we do have, again, some concern that maybe a five-year would not -- in periods where we're investing heavily in new capital investments, may not be a sufficient carryforward period. So we would respectfully request the Commission to take that into consideration in your efforts here in putting something together for the Governor.

The rate, it was still a –- that's unsettled, and we understand why, and I know it’s been conveyed by many in front of you that when you broaden the base, any small change in the rate can have a substantial impact. And we, again, just want to convey the point that that is something that does give you concern, that a legislative change in the future to the rate will have a -- could have a more dramatic effect.

We are approaching this evaluation of the BNRT and as other details around the other items come out, in the same manner as we have done in the past related to either federal or state income tax changes, and that is, to look at what the economic impact is. And taxes are no different than any other business cost. And we work very hard within the legal parameters to reduce that cost to the business.

And I know that we -- this was brought up just a short while ago around the “shift” issue -- we don’t think you’re going into this exercise with a view of consciously shifting the liability or the relative tax burden from one industry to another; but we are concerned that something like that could happen out of this exercise. So that’s something that we’re looking very closely at when we evaluate this, the overall proposal.

The ultimate evaluation, from our perspective, really is at this point incomplete or extremely preliminary in the sense that we don't have all the pieces. And it's difficult without having all the pieces to understand where it all comes out in the end, in terms of the liability under the current tax regime, vis-à-vis what it would be under the proposed changes that would come out of this Commission that ultimately could make their way into legislation.

But we do, again, have an interest as part of that to look at it, to ensure that our industry, which we think is adequately taxed today, would not take on a higher burden.

Again, another area that has been addressed in part of my presentation is around the transition rules. And the transition-rule comments have focused primarily on NOL carryforwards and capital-loss carryforwards or other related carryforward tax attributes. We're also, though, concerned that when you enter into the transition period, we will have assets that were acquired in this pre-transition period, that we will not have recovered as a deduction from the corporate income tax base. And we feel that the transition -- at the end of the transition period, for any investments that we made prior to the transition date, that were made under the expectation that under the corporate income tax we would have full recovery of those costs as an offset to our income, that we should be entitled in that transition period to be able to recover the value of any undepreciated portions of our capital assets.

And so we would, again, respectfully request that the Commission take that into consideration as one of the tax attributes that needs attention in terms of making sure that taxpayers are not permanently harmed from the past activities in transition to the new.

And that's the extent of the comments.

We, again -- Edison International -- appreciates this opportunity to be able to discuss our view of this and be able to respond to your questions.

CHAIR PARSKY: Thank you very much.

John?

COMMISSIONER COGAN: Jeff, thanks very much. A very thoughtful testimony. I appreciate it.

You raise the issue of the treatment of employee benefits that I want to focus on for a minute.

Now, normally, many people think of employee benefits as part of compensation and should be treated no differently than labor compensation and, therefore, would be nondeductible in a BNRT.

But there's another way to think about it, which I really want to focus a bit of attention on and get your reaction, and maybe get Phil's and Carl's, and that is, one of the problems we're trying to avoid with the BNRT is the cascading of taxes through the various stages of production. A tax upon a tax upon a tax. And so by the time you get to the final product, that final product embeds an awful lot of taxes that nobody pays any attention to. And they're very, very distorting.

And so the rule under a BNRT is something like this: That the inputs that you get to deduct, are inputs that have already been subject to taxation. And that's a way that a BNRT would avoid double-taxing, okay.

And so it seems to me in the case of some employees benefits -- let's take health care -- if a firm purchases a health plan from a company, then the BNRT would be applied to that health-care company's gross -- or net receipts. And, therefore, it would have already been subject to taxation by the time its used by, say, Edison. And if we don't allow it to be deducted, then we have levied a tax upon a tax. And, therefore, if I think of health-care services as a good or a service that's purchased, it has already been subjected to the BNRT at a previous stage, and, therefore, under the BNRT should be a deductible expense, no different than any other purchased good or service that's been previously subjected to taxation.

Maybe I can get your thoughts, and then if staff have some, I'd be interested to hear.

MR. BARNETT: Well, I think you made a good distinction, in that if you look at it from the pure net business-tax perspective, that to the extent that any of the employee benefits were, in effect, acquired from an outside third party, that outside third party would have paid tax already. And then the disallowance of that as a deduction would constitute a double-taxation of that item by having that then be taxed to the firm hiring those employees -- or the firm who has hired those employees.

COMMISSIONER COGAN: And even with a -- even if a firm is self-insured, to the extent that its payments for health care to its employees is going to an entity that's subject to the BNRT, then the same logic would apply; would it not?

MR. BARNETT: I agree.

CHAIR PARSKY: How does the staff feel about that?

Not how you feel about it, but what your thinking is.

MR. JOSEPH: How does it make me feel?

CHAIR PARSKY: And this is not the staff making any recommendation. It will be the Commission. But let's engage in a dialogue on this subject because I think it's a very important subject.

We've heard from a number of health-care providers and others that have made this point. And I think John has highlighted it exactly right.

COMMISSIONER COGAN: Phil, the question is -- Phil, it's really a question about, what's the proper tax policy.

MR. SPILBERG: Right.

COMMISSIONER COGAN: Not are we going to grant some special exemption to some particular good or service.

MR. SPILBERG: Right. And I think that one way of thinking about this is that, is it a purchase by the business or not, in the case of the health care. And to the extent that it is, in fact, a purchase from another business, I think it would be in the realm of something that would, in essence, be deducted.

And in terms of self-insured service, fringe benefits, in that kind of situation, again, what you have is that the firm is actually purchasing something from somebody else.

COMMISSIONER COGAN: Right.

MR. SPILBERG: So I think that would be deductible.

CHAIR PARSKY: Carl, any thoughts on that subject?

MR. JOSEPH: Well, the only thing that I would add is that the other things that we’ve talked about -- wages, for instance, you don’t get a deduction for wages, and then the taxes are paid on wages at the personal income tax level, and that’s okay.

There is a little bit of that here, in that these things are not taxed at the personal income tax level. They’re treated as nontaxable benefits for purposes of the individuals who are receiving the insurance. But other than that, I mean, I agree, I don’t see much difference between that and other purchases from other firms.

MR. SPILBERG: And as far as the personal income tax side of this equation, that I look at as a personal income tax issue. I mean, there’s nothing inherent about the personal income tax that would not permit the inclusion of that as income.

COMMISSIONER COGAN: Right. We should consider that as part of our decisions on the PIT.

MR. SPILBERG: Exactly.

COMMISSIONER COGAN: Great. Thanks very much.

COMMISSIONER PRINGLE: I just want to make sure I understand that.

There would be a distinction then between buying health-insurance coverages and employee benefits versus making a 401(k) contribution; right?

MR. SPILBERG: That's right. In the case of the health insurance, it is, in fact, a purchase.

COMMISSIONER PRINGLE: So it really is the physical purchase then, as opposed to the investment or deferral?

MR. SPILBERG: That's right. In the case of a 401(k), it is, in fact, just a payment of wages but in a way which is deferred in terms of recognition for tax purposes.

COMMISSIONER PRINGLE: So I think I properly stirred up Mr. Cogan.

CHAIR PARSKY: Yes, Cogan will be talking to you.

COMMISSIONER COGAN: Another way to think about that employee benefit – and I'm not disagreeing with you –- but another way to think about that employee benefit is that: Gee, it's really a PIT issue. We should think about it as a PIT issue, and we can -- the income should only be taxed once. And we're either going to tax that -- the proceeds of that 401(k) at distribution, or we're going to tax them up-front as personal -- as income. So if we want to tax it once and only once, I guess I'm not really sure if that's not the --

MR. SPILBERG: Let's just take a look, and let us just think about the 401(k). And the question is -- well, again, under an income tax, you would, in fact, tax both the value-added and the earnings from capital. So in the case of 401(k), it does become taxable when the distribution occurs. So it is just a question of timing.

CHAIR PARSKY: I think this is a valuable discussion because I think there has been confusion in the public market as to how all employee benefits, in a big category, might be treated under just the BNRT, which is the subject here. So I think this is a good clarification.

Thank you very much. We really appreciate your presentation.

MR. BARNETT: Thank you, Mr. Chairman.

CHAIR PARSKY: Okay, we have both Small Business and Professional Services in one. I guess, three participants: Small business, lawyers, and others.

Why don't we go across and you all introduce yourself?

Hatef, why don't you start? And then we'll go across.

MR. BEHNIA: Hi. I'm Hatef Behnia. I'm a tax partner at Gibson Dunn and Crutcher.

CHAIR PARSKY: I happen to know that firm.

MR. LIPPE: I'm Greg Lippe. I'm a CPA. I'm managing partner of a firm in Woodland Hills. I'm also a business owner because I'm the founder of that firm. And I'm chairman of the Valley Industry and Commerce Association which is a business advocacy group. And lastly, I am a board member of a bank, but I've never been involved in a dry-cleaning business.

CHAIR PARSKY: We can show you some good ones. It's all right.

MR. KELLER: Yes, good morning –- or good afternoon. I'm Marty Keller. I'm the --

CHAIR PARSKY: We're running about 15 minutes behind.

MR. KELLER: Not too, too bad.

CHAIR PARSKY: We're working on it.

MR. KELLER: I'm Marty Keller. I'm the Small Business Advocate for the State of California.

CHAIR PARSKY: Well, just by way of introduction, I think one of the obviously major concerns that the Commission has had about the establishment from a business net-receipts tax and its objective of bringing into the tax base services is how lawyers, accountants, as well as other small businesses that might not be subject to the sales tax would react.

And again, we're here to talk about the business net-receipts tax, but I think it's impossible to come to a conclusion about it without taking into account adjustments that might be made –- or would be made in the personal income tax and the sales and use tax, as well as the corporate tax.

In whatever order you'd like to make comments.

MR. BEHNIA: I think given that the law practice contributes the least to the economy, I would suggest that we start with the small business and move on.

CHAIR PARSKY: I'm sure your partners would appreciate that.

COMMISSIONER COGAN: Did you use the words "law practice" and "contribute" in the same sentence?

CHAIR PARSKY: Marty, do you want to start?

MR. KELLER: Thank you, Mr. Chairman.

I did have the opportunity and privilege to speak to you on Wednesday. And we had quite a lively session with Mr. Greenstreet, who brought you an actual case study, looking at the issues. And so I won't spend a lot of time going over what I said before, just to highlight that first for the members that weren't there, the Small Business Advocate's job is to help small businesses deal with state government. And there are three and a half million small businesses and there are two people in my office. So we are quite busy all the time.

We focus on a number of issues, economic growth, economic development, working with local EDCs, and with the State Business, Transportation, and Housing Agency on their plans.

We work on regulatory issues. We help individual businesses deal with problems that they may have, or we help look at macro issues at the regulatory level.

We work on state procurement issues. We just do a whole range of things. But our job is to basically advocate for the businesses to the policymakers on the issues of concern that they may have.

Recently, the Governor appointed me to his Economic Stimulus Task Force, and we've been holding a number of events, outreach events around the state to help small businesses figure out where the money is and where there may be possibilities for them. And I only raise that to you to reiterate what I said to you on Wednesday, which is the key thing that small businesses are interested right now in is finding adequate capital to finance their daily operations, and those who look to grow, to find the investment capital necessary to help this economy grow out of its doldrums.

We had the opportunity to help the Governor host a conference on small business here in Los Angeles last

November. And the small businesses who attended came up with a number of recommendations. And they did have one on taxation, which I mentioned on Wednesday, which was to eliminate the minimum franchise business tax. And they were willing to do that in a revenue-neutral kind of way, and they were willing to work with the Legislature on that. And that's obviously the approach that the Commission here is taking on that.

Just a couple of points to reiterate. I really appreciated what the mayor had to say about this macro issue. And we talked a lot on Wednesday, looking at the micro issue, looking at this from a business-to-business context. And you also did that a lot today in the previous testimony. But I think it also, from the point of view of small business, is important to look at the macro impact on the economy. And your last witness talked about that. It is your balancing act here.

But for small businesses who are looking to escape the doldrums of this economy, they're looking to expand -- those companies who are looking to expand, to be able to get the investment capital they need and to hire the employees they need, having a stable economy, in an economy that's growing is really critical to them -- recognizing that the issues that you're dealing with may have an impact on that.

Nonetheless, what I hear over and over and over again, is requests for stability and the ability for them to have a sense of where they're going to grow into, what's the structure, particularly with respect to taxes and regulations that they're going to be growing into.

So it's important for small businesses to understand what you are proposing here, to see that within the nest of all of the different measures -- again, you've addressed this quite thoroughly on Wednesday and you've addressed it again today -- to look at the net impact of all these measures.

I just wanted to point out a couple of things again, to put some context on this from the point of view of small businesses on a macro level, which is that, as I said, there's roughly three and a half small businesses in the state. Of those, about 800,000 are employer firms and the rest are sole proprietorships. And that's according to SBA data as of 2006.

The Department of Finance is estimating that 90 percent of the businesses that -- and we're defining "small business" for the state purpose here as a hundred employees or fewer -- that the Department of Finance estimates that 90 percent of these businesses have less than $500,000 in gross receipts, presumably then would be exempt from the BNRT. So that's part of the macro issue that we have to look at, is who is affected, as we have looked to flatten the tax base and lower the rates.

Secondly, just to point out with respect to the sole proprietorships, that -- which is roughly $2.6 million, the IRS data that we've been able to look at, say that the average gross receipts of those is $60,000 or less. So we're looking, again, as we look at the broad picture of the number of firms that would be affected by this, those are some data to keep in mind. At the same time, 98 percent of firms are a hundred or fewer with respect to the employment. So small businesses do, obviously, comprise the vast bulk of our economy.

We heard earlier today from the entertainment industry that the entertainment business, like all the other businesses that we hear from, actually comprise small businesses to a large extent, although we think of the major studios and so forth. But really, again, the vast majority of the industries that we deal with, regardless of the principal players, are supporting a huge network of small businesses as suppliers and users.

So I just wanted to point those issues out. Some of those are a reiteration from what I said on Wednesday. But from the point of view of small businesses, the issue of the economy itself, the stability, and then the fairness of any kind of new approach so that small businesses' competitive advantage is enhanced rather than reduced.

So these are just some overarching themes that I wanted to share again with the Commission, and thank you for the opportunity to point some of those things out.

CHAIR PARSKY: Thank you.

MR. LIPPE: I'd like to go next.

CHAIR PARSKY: Go ahead, Greg.

MR. LIPPE: Okay. What's happening here is that it appears that the tax -- the BNRT -- will shift the burden of taxation from the large corporations to the smaller companies, because the majority of small companies are pass-through entities. And what this is going to do is, it's going to require a double-taxation on the pass-through entities, both at the entity level and then again when it passes through at the individual level. So as you had mentioned, you know, you don't want to tax twice. This does it, okay.

Now, in addition to that, the -- I'm going to go through the presentation from the beginning, if it's all right.

The concerns that I have are a number of things. One is jobs. You know, it's great that the goal is to broaden the tax base, improve tax competitiveness, and stabilize tax revenues are in there. Those are good goals. But another goal would be to create jobs, not to disincentivize jobs. And I’ve got several examples.

One, if a company is considering the possibility of automating, which would eliminate a number of jobs, but the equipment is too expensive, they might not do it. However, the BNRT allows them to deduct the purchase of that equipment, but it doesn’t allow them to deduct the compensation to the employees. So, therefore, it could eliminate jobs.

Outsourcing to other states and countries. Now, I understand what was said about the nexus laws, bringing the other companies from other states in. However, the law that creates a nexus is a new law. It hasn’t been tested. It may turn out to be without legality.

Additionally, if you are to outsource to a foreign country, that foreign country would -- the revenue from the company and the foreign country would not be creating nexus here because of the water’s-edge protection. So if it was a foreign company that was an affiliate of a U.S.-organized company, then you would not have -- you wouldn’t get that protection.

Let’s see -- another thing, owners of companies outside California, they could set up numerous entities outside California, and they could all be just under the exemption level. So if each one of these entities made just under $500,000, they'd be exempt. So you could wind up having a significant amount of outsourcing going on with a lot of different entities in a lot of different places and, therefore, just basically kill the jobs here.

One thing I would recommend is that if it was decided to have this tax, that there be a phase-in above the exemption threshold. The reason being that if somebody were earning $499,000 and then the following year they went up to $501,000, they'd always get hit with potentially $10,000 in tax for $2 more of income. I think that would probably be a better idea to phase it in.

I think I've covered it.

CHAIR PARSKY: Hatef? As a private citizen.

MR. BEHNIA: As a private citizen, I wanted to thank the Commission for having me here. I commend you for all the hard work and certainly don't envy all the efforts and frictions you've had to put up with. In fact, I think by the end of this process, you will not be loved by anyone other than tax lawyers. So that's why -- in fact, I was going to make a strong argument at the beginning --

COMMISSIONER COGAN: I wasn't sure they were capable of love.

MR. BEHNIA: Well, I hope at the end of this, that you'll have some affection from me, at least. In fact, I was going to make a strong argument why all law firms should be exempt from any tax, but I thought you would all laugh at that, so we'll move on.

I think that no matter what I say today, somebody will become upset. So I'm going to keep my comments at a more abstract level, sort of dealing with the matter as a tax lawyer. And in that spirit, I thought I should really start with sort of a pretty practical administrative issue, which is -- and I'm going to assume that some sort of this proposal goes through so we'd sort of deal with the consequences and the issues that the Franchise Tax Board itself has to deal with.

So the first question is, since the sales tax will go away at the state level but we'll have it at the city and local level, we'll still need somebody to administrate. Today, the State Board of Equalization is the party or the State agency that adjudicates all the sales-tax issues. And I recommend that it continue to do that, even though the State has no -- potentially no interest in sales tax after this proposal anymore. I assumed that was presumed, but I just thought I'd point it out.

I think on a -- and I'm going to make some observations that I hope helps you in sort of thinking through the issues here. I think if you look at where we are today, we have a sales tax and an income tax. So we have double-taxation, there's no issue about that. And we made the judgment a long time ago that we are only going to tax tangible personal property and not services. So every year that goes on -- and, again, I'm speaking against interest here -- but every year that goes on by keeping that arrangement, means that our judgment is that that's a good judgment, that's a good decision, okay. So that's okay, and that's sort of an economic and political issue. But we ought to be aware of what we do by action or inaction.

So the first consideration here -- I mean, the door is being opened, and I finally have myself given up a few years. I thought that it was inevitable that some sort of tax would be applied to services. But I think what we should consider there, politically and economically, is that this would be the first time a major tax would be imposed on services. And so a lot of people would be emotionally and economically very upset about it because -- and I make the case of accounting firms, law firms. You know, in a typical large you firm, up to 50 percent of your gross receipts are paid as compensation. So that's a big chunk of tax that -- it's not just -- and remember, it's not just the fact that it’s labor-intensive, it’s just that it’s the first time that you’re going to impose -- it’s as if you did the sales tax but not tried to make it a little nicer. And I concede that this tax is much nicer than the sales tax if imposed on services, but…

So the first thing that will happen is that they’ll say, “Why?” And the second thing they’ll say, “Well, but look at us, we have to pay so much in compensation.”

I do want to focus on that point, that compensation is not allowed as a deduction. So, first, we contrast that with self-employment and an independent contractor, okay. So -- I’m sorry, with self-employment as an independent contractor and an employee.

So assume that you were going to look at a value-added tax in its broadest form. As goods and services move through the chain of commerce, if you will, value is being added. Value is being added by employees as well. They go from day one where they have no money; by the end of the year, they’ve exerted sweat and earned money. Okay, so if you wanted to apply a value-added tax, you would consider and have the entire stream of commerce be subject to it, as each party adds value.

Now, if -- I assume that that’s politically undoable to impose a value-added tax on employees unless you were to get rid of the income tax. And that's a totally separate issue.

So for now, let's assume that we were not going to impose a tax on employees. Okay, so given that we don't want to do that, if we also allowed a deduction for businesses, for the compensation, in effect, the value added by the employees goes untaxed. So by the decision we make not to exclude compensation paid to employees, we're saying to the employer that, "You're going to bear this tax. You're going to bear the tax for the value added by the employees. Whereas you don't bear the tax for the value added by independent contractors."

I'm pointing this out as an asymmetry that I think you ought to consider. I have a couple of things I'll propose later, but I think this is a definite asymmetry. So it imposes a bigger burden, okay. And by virtue of what it is, it imposes a much bigger burden on service-extensive industries.

I do remind you of what happened in Florida. I think if you want to push this idea, you ought to make sure that it's sold properly to all the businesses. I think the media and advertising basically managed to eliminate, on a retroactive basis, the Florida tax. I think it was 1989. So, again, you know, just to keep it in mind, an employee is not subject to this net employment tax.

Now, you say, well, taxes are borne by individuals and society, and that's a fair point. The question is, when you impose a tax on a business, who is going to bear it? Well, it will be the owners, the suppliers, the employees, the customers, and various parties.

Who really bears it in each industry? It's a complicated question that I think all your economists have already addressed. I think they're different supply and demand curves, and depending on the market you operate in. So I think that's a difficult question.

I think at the beginning there will be some chaos, but ultimately there will be an equilibrium, and maybe lawyers will get poorer and maybe somebody else gets richer. But I think that's a hard consideration for you guys. I understand that.

So given that for the first time you're hitting services, service providers with the tax, then the next thing they'll say is, "Wait a minute, so if I was a manufacturer and I operated on a thin margin, I won't -- basically my tax as a proportion, as a ratio to my receipts is much, much lower than a law firm or accounting firm or a media company or a number" -- I mean, any professional business, because there, 30, 40, 50, 60 percent of the expenses, if you will, are for compensation paid to employees which, you know, get taxed, in effect.

So I think this is a hot potato. I don't know what you're going to do with it. But, you know, either you sort of keep a pure system; and you say, "Well, tough. Every time we change the system somebody is going to be hurt." And presumably -- I'm assuming you've reached the judgment that this is better than a sales tax imposed on services. Maybe you have, maybe you haven't. But for this discussion, let's assume that all those judgments have already been received. So I think my focus is just, so what happens under this system.

I think that if you wanted to reduce the effect of that, to some extent -- I mean, other than the question of phase-in and so on and so forth, one could argue that some businesses should have a lower tax rate, if you will.

I think this opens the door -- it's quite a slippery slope. Every industry will argue that you should impose it on somebody else, like we saw today.

By the way, I'm the only one with who doesn't argue that because I'll do better under either system. There will be more tax work, or I won't have to pay tax, either way.

So I think that's a possibility you can

consider. It’s complicated because differential in tax rates on their face is discriminatory, okay. But that’s a possibility.

The other possibility is to say, “Well, we know we’re hitting you with tax for the first time, but what we’ll do is, at least we’ll try to make it nondiscriminatory in the following way. We’ll look at an average -- for all the taxpayers -- an average ratio of payroll, if you will, to net receipts, and we’ll apply that. So all the guys who are benefiting from that will have a little additional tax, all the companies that are being disadvantaged will have a little adjustment to sort of make up for that asymmetry.

I think this is tough, and I think the other proposal you might consider is that, you know, you do impose it on employees, but eliminate the income tax and so you sort of have a value-added tax across.

A couple other sort of difficult issues that come up there is -- and I won’t -- I’ll express a very theoretical view -- I think you might, as part of that, consider eliminating all personal deductions, which I think has always been a strange -- including mortgage interest and so on. But people didn’t hear that from me. And I won’t say one word about Prop. 13, because I assume that’s untouchable either way.

So I think that's sort of the quick summary about the issue of compensation.

I want to move to the question of investment income and gain. I confess that as I read the proposal, I wasn't sure how that's treated. But I think my best reading was that if I'm an individual and I have capital gains, interest, and dividends, those are not subject to tax because -- and the rationale is that they have been subject to a value-added tax at the entity level so when I get it, it's not subject to tax again.

And I'm also assuming that if the same thing is true in a partnership or other pass-through entity, so long as it's coming from an entity that's already been subject to the net-receipts tax, that it should not be subject to tax.

I think that that's what I recommend in that respect.

I think the questions get more complicated if there's some services involved between parties, you know, much like you get in a hedge fund, and so on, I think those are much more complicated issues. I think there's some federal analysis of all that, that might be useful. But that's -- I think that's sort of a separate subject, and I'm not going to address it today because it will take about an hour by itself.

So given that we're going to not impose this tax on investment income, if you will, of investors -- and, by the way, that's supported by California law, that says that investment income is not business income. And so I think this is typed business income. Given that, and given that we're eliminating the corporate income tax, then I think that, to be fair, there is really no double-taxation, in my opinion. Because income tax is income tax. I don't think we should mix it up. Income tax and sales tax have always been double-taxation.

So if you eliminate the sales tax and add this tax, they'll still be double-taxation. There will still be double-taxation. Okay, so I think that's -- unless you eliminated one of them. But if you tax at the business level and then the returns from that business in the form of interest, dividends, and capital gains are not subject to tax, then basically we don't have double-taxation of net-receipts tax. And, of course, if you eliminate the corporate income tax, we don't have double-taxation at the individual income tax level. I think those are very commendable goals and objectives here. I mean, I think that's -- we've talked about that forever in the federal income tax context. And maybe if California does it, maybe the federal government will follow -- you know, from my ears -- from my mouth.

So, let's see. A couple of other points.

Again, you know, I understand there's a lot of issues with this scheme, and so I think it's really gone through, on what you guys should focus on.

I think it is commendable that interest is not excluded from the calculation because everybody knows -- I mean, this question of deductibility of interest income versus nondeductibility of dividends in the federal and state income tax scheme have really wreaked havoc with economic decision-making. In other words, there is no reason -- absolutely no economic reason -- to favor debt over equity from a federal income tax or state income tax point of view. So I think that, at least, is a correct step in that direction.

Of course, it's painful because, again, people who are for the first time being subjected to this tax will say, "Wait a minute, I'm also paying so much to the bank. Why are you taxing me on all of that?" That's another tough one, you know.

I hope you appreciate that my tone is much more sort of abstract as opposed to trying to see which industry comes out ahead and which one comes out worse off. Because I think there's plenty of studies you're going to see on that. And I'm just really making these comments as sort of, if you will, a microanalysis of the provisions.

Two more things. Taxation of M & A transactions. I wasn't clear how that works. I'm sure a lot of thought has gone into that. In this scheme, if a corporation sells an asset as to which it had taken a deduction -- because when it purchased it, it excluded it from net receipts -- then I assume when it sells the asset, it will have to pay, it will be included in the net receipts. I think that's -- I think that follows from the principles I've heard today, okay.

So, now, I assume that instead of that, the corporation takes this asset and contributes it to another corporation or to a partnership in exchange for an interest, these are transactions that, under current California and federal income tax law, are exempt from tax. In other words, they're tax-deferred. So I'm thinking that the same regime -- the same issue will apply here because as the asset moves from the transferor to the transferee, the transferee should not get a deduction for it because he didn't pay for it in cash. And at some point -- and this was already taxed -- it was already tax-deducted once so I'm assuming that sort of that should be the result. In other words, no tax on the transferor and no deduction by the transferee. Ultimately, when it gets sold, it will get taxed again.

So, again, as it moves through the stream, there will be one tax.

It gets a little more complicated when you deal with mergers, two corporations merge together. That's -- in an economic sense, that is a sale or exchange of assets between two companies, you can think of it like that. I think the income tax law has always treated those as tax-free transactions if the consideration that is received in the merger is just stock of the corporation. I think those kind of transactions need to be specifically dealt with here or else you'll make my life really happy, okay.

I mean, you ought to assume that when these provisions go through, there will be an awful lot of talent that be working through and thinking through them to see what can be done.

MR. LIPPE: I hope so.

MR. BEHNIA: I mean, that's just how life is. Okay, so the more specific, the more fair, the more addressing issues of different taxpayers, I think the better it will be.

Last, but not least, I noticed that it was quite cavalierly stated there that this tax will create nexus if somebody out of state is selling to a California corporation or a California business.

I suggest that that issue, you guys look at much more carefully. There's an awful lot of litigation on that. And it absolutely, by no means, is settled that that is the case. In fact, I think the law, as I understand it today, is exactly the contrary. So in other words, it's not enough to create nexus in California if somebody sells an asset to California. Otherwise, we wouldn't have all these tens of thousands --

COMMISSIONER EDLEY: If it's a sales tax. If it's a sales tax.

MR. LIPPE: There's a new law. There's a new law coming in 2009.

MR. BEHNIA: No, no, no. There's a new law coming in. But what I'm saying, it has not been tested, and I assure you -- I assure you -- there's significant constitutional arguments against those. In fact, it's happening in every state. I don't think, as the case law developed, I don't think the state law can change that under federal Constitution. We'll see what happens.

Thank you very much for the opportunity.

MR. LIPPE: May I ask a question, since this is informal?

CHAIR PARSKY: Absolutely.

MR. LIPPE: Why was it part of the proposal to not allow the deduction of compensation, other than you needed to do something to be able to reduce the tax rate? Was there a specific reason for not allowing compensation?

COMMISSIONER COGAN: Yes, because we're considering a value-added type of tax, is the way we thought about it, and what's being taxed is part of the value-added.

So let me try to give you maybe a little bit of an example, all right, to help people understand this. This may not work, but let me try.

So let's suppose we've got a farmer who has a tree on his property, and he pulls a grape off that tree, and he cleans it up, and he sells it to a winemaker. Under the value-added type of tax, the guy has no inputs at all. And so the amount that would be taxed would be the price of the grape -- or the receipts from the grape. Then the winemaker takes that grape, and the winemaker turns it into a fine bottle of wine. What gets counted as receipts is the amount of the selling price of the wine, and what gets deducted under a value-added tax is the price of the grape.

That vintner has created value in society of a certain amount. And under the value-added tax concept, what's being taxed is part of that value. And that's sort of the logic of the tax.

MR. LIPPE: Understood. But when you do take a service industry, like an accounting firm, for example, you know, 60 -- well, at least 35 percent of our cost of sales is compensation --

COMMISSIONER COGAN: Right.

MR. LIPPE: -- and you are allowing for the deduction of the same services purchased from an independent contractor.

COMMISSIONER COGAN: But only because it's already been taxed. I think that's the important concept here.

MR. LIPPE: Got it.

COMMISSIONER COGAN: I think that's really it. All right, so we have to think about it that way. I'm not disagreeing with you that this may end up being some tax on labor. I'm not saying that it's not so. All right, but I'm just saying, you've got to think about it a little bit differently than you have been.

Now, if I could come back, I want to say something to Hatef about, you had said early on that you thought that we -- you didn't want to upset us by anything you said. I want to make one thing absolutely clear, I think for all of the commissioners, nobody has endorsed this BNRT, okay. What we decided was that this idea has at least -- it's at least of sufficient merit to warrant our detailed consideration. And it's only after hearing from the comments that you all have made about the concerns that you have and the things we haven't thought of, that we're going to make a decision on this. But I think there might be this presumption out there that the Commission is going down this road, it's made up its mind and so forth. And I can assure you that that just is not so.

Now, if I could, I want to direct one point that you made, Greg, that I want to ask the staff about. You made this comment that because of the water's-edge provision, that there is an incentive in the system for outsourcing. Perhaps not to another company in the United States, a large company in the United States, but certainly with respect to a European company; correct?

MR. LIPPE: Right.

COMMISSIONER COGAN: So then the question becomes, is there a way to deal with that outsourcing incentive that doesn't violate a WTO arrangement? Maybe you could help me out with that, or -- and I don't know if the staff has thought about it.

Carl, have you thought about it?

MR. JOSEPH: Well, I think you asked the right question. I mean, how can you do this in a way that's going to pass muster. And that is the problem. I mean, clearly, in our system now, you know, before we had a water's-edge system or election for that, we were worldwide-combined and that raised its own series of problems for international companies. But in the water's-edge system, there is a policy involved there that basically answered some constitutional arguments that were made back when worldwide-combined reporting was being examined by the court.

It's difficult to say that you can discriminate against foreign commerce any more than you can discriminate against interstate commerce.

MR. LIPPE: Yes, keep in mind that the nexus law that brings the out-of-state in here may not hold up, either. So I think the problem here is that it definitely encourages outsourcing.

COMMISSIONER EDLEY: You also addressed the pass-through. I think there was some confusion --

MR. LIPPE: The pass-throughs, yes.

COMMISSIONER EDLEY: There was some confusion about that because the intention --

MR. LIPPE: Right, so there's a double tax, because --

COMMISSIONER EDLEY: Well, the intention is that the individual would get a credit against their income.

MR. LIPPE: Not a credit. It says a deduction.

And a deduction is not -- so it’s not a dollar-for-dollar credit. So there’s still a double –- a part of double-taxation involved in there.

COMMISSIONER COGAN: Right.

Double-taxation, Chris, in the sense of the income is being taxed.

MR. LIPPE: Right, the income is being taxed twice.

COMMISSIONER COGAN: Right, right. And that stems from the fact that we would have a BNRT in conjunction with --

MR. LIPPE: At the entity level.

COMMISSIONER COGAN: -- an income tax.

Now, it’s true that you could make the same argument with a sales taxes, right, a retail sales tax, in some sense?

MR. LIPPE: But you’re still paying sales tax out there. Well, the only sales tax that isn’t going to be -- as I read it, there will not be sales tax to the State -- well, wait a minute. You’re saying that because I’m a consumer, I’m going to then use that money that I’ve been taxed on to go buy, and I’ll be taxed there so, therefore, it’s a double tax. Because earlier, it sounded like people were saying -- were confusing things and thinking that the sales tax was a tax levied on the seller company, and it’s not.

CHAIR PARSKY: No, no, we recognize that. But under the sales-tax scheme --

MR. LIPPE: Right. But here, you’d be taxed three times because, again, you get the BNRT, you get the tax on the income tax when it passes through, and then you’re going to take that money and you’re going to go out and buy something and pay sales tax.

COMMISSIONER COGAN: Good point.

And so what we would like to do, of course, if you’re going to add the BNRT on top of the existing tax system, that would be a huge mistake.

MR. LIPPE: Exactly.

COMMISSIONER COGAN: And it would be triple taxation.

MR. LIPPE: Exactly.

COMMISSIONER COGAN: And so clearly in this context, you have to think about the BNRT in conjunction with what we’re doing -- what we would be doing on the sales tax and on the income tax.

MR. LIPPE: Correct, correct.

COMMISSIONER COGAN: But I think that’s an extremely important point.

MR. LIPPE: Because what this really does is, it takes away the whole benefits that were put in by the pass-through entities, it was to have one level of tax.

COMMISSIONER COGAN: Right, right.

CHAIR PARSKY: But, again, if for an individual accountant or lawyer you have to look at the combination of a reduction in the personal income tax rate --

MR. LIPPE: That's right.

CHAIR PARSKY: -- the elimination of the state sales tax rate, and the imposition --

MR. LIPPE: Right, you'd have to add them all up and see how you come out.

CHAIR PARSKY: Exactly.

MR. LIPPE: And it appears that you're going to come out worse under this scenario.

CHAIR PARSKY: Well, anytime something is new, the appearance is -- I guess would dig it a little deeper. Let's wait.

MR. LIPPE: Yes, you have to do the numbers. Thank you.

CHAIR PARSKY: Curt?

COMMISSIONER PRINGLE: I mean, I actually want to pick up on that point, because I appreciate today is a BNRT discussion, and we hear mostly from business folks on BNRT. And our job isn't to propose one tax; our job is to look at a package that we can put together.

And just by its very definition, as we're evolving this package, if we only hear from business that is only looking at the business bottom line, virtually all business will be paying more.

MR. LIPPE: Uh-huh.

COMMISSIONER PRINGLE: Because at least a third of the savings in this package, if not almost half, if you look at personal income tax paid by individuals and sales tax paid by individuals, the majority -- or at least a third to a half of the benefit is derived to the individual, not to the company. So if you're saying that BNRT is to pay for 100 percent of the benefits of the eliminating the corporate income tax, of drastically cutting the personal income tax from 20 to 30 percent, and to eliminate all, if not a majority of the state sales tax, those benefits don't just ascribe to a corporation's bottom line, they go to corporate bottom lines and all the personal individuals out there that are engaged in any type of activity in the state, from working to buying something.

So just by its very nature, if we're just hearing a BNRT discussion, we will only hear business say, "We will be paying more." And I get that, as a nice, conservative guy raised by a dry-cleaner, I can certainly see --

MR. LIPPE: Yes, it works for dry-cleaners.

COMMISSIONER PRINGLE: I can certainly see that. But that's not our job, to look at any of these in isolation. And it's wonderful to hear the perspective of how different industries are going to be challenged to implement it. And I think that's what we're trying to figure out, how to implement it. But I don't necessarily feel a major momentum away from a BNRT just because I hear business concerned about it. My job is to look at the whole package of state tax structure. Because 53 percent of the burden of the general fund is on the personal income taxpayer today, I think that has contributed to so much to the volatility and a disproportionate tax burden, that I'm willing to look at all of those things.

And for me, I need to put it into perspective to hear the concerns of business and the challenges they will face. I get it.

MR. LIPPE: I think the more important --

COMMISSIONER PRINGLE: I think our job, today is to hear BNRT discussion, but our ultimate job is to put a package together that addresses all of those issues.

MR. LIPPE: Sure. But you don't want to incentivize jobs to go elsewhere.

COMMISSIONER PRINGLE: Yes, but your examples are good and enjoyable to hear, but I don't necessarily agree with many of them.

For example, the idea that some outsourcing of jobs would be created by multi-tiered companies that come together and have, under-the-$500,000-receipts threshold and create a whole bunch of them in Nevada, that doesn't make any sense to me.

COMMISSIONER EDLEY: Because they don't get a deduction of 4 percent or 3½ percent BNRT in their labor bill.

COMMISSIONER PRINGLE: But, in fact, the flip side of that is why, if that is the scam somebody wishes to put together, why don't they put it together in El Monte? Because the point is that the $500,000 deductibility is -– the threshold is the same as if you're an in-state employer or an out-of-state employer. So why would someone create a whole mechanism by which they hire a whole bunch of employees in Nevada, when they could do the same thing here --

MR. LIPPE: Yes.

COMMISSIONER PRINGLE: And I think part of what we need to do is just say, how do we define "independent contractors" and separate value-added, and to make sure that that type of thing doesn't happen in California? But that's not a driver for out-of-state companies being formed and all the jobs running out of state, because that same type of mechanism is because we're concerned about small business. We're talking about this minimum threshold point, but that same minimum of threshold would apply to a California-based company, just the same as it applies to a Nevada-based company or a Chinese-based company.

MR. LIPPE: But we do have to be concerned about the out-of-the-countries.

COMMISSIONER PRINGLE: Out-of-the-country is one thing. I don't necessarily think your dry-cleaning is to be taken out of the country. But the bottom line is, you used the example that someone is going to set up a whole bunch of out-of-state companies to do that.

MR. LIPPE: They can set up a bunch of local ones, too. You're right.

COMMISSIONER PRINGLE: But we can address that issue, and it's not a point by which jobs will just be sucked out of California, because nobody would be doing that.

MR. LIPPE: Your point is good. Thanks.

COMMISSIONER COGAN: Yes, with respect to international outsourcing issue, you've hit on really the right point here, and then Chris did as well. It depends upon -- the incentive depends upon the rate. And if what happens as a consequence of California -- let's suppose we went down this BNRT route. If we ended up with European-style VAT tax rates, we would create an enormous incentive to outsource. Whether a 3 to 4 percent differential would justify an economic decision by a firm located in California now to outsource to Europe or to China is --

MR. LIPPE: How sure you that the rate would be 3 percent and that it wouldn't have to be 10 percent?

COMMISSIONER COGAN: So, so far from the calculations that the staff has made -- and they're very, very preliminary -- that's sort of the nature of the tax that -- at least it's been in that range. Don't know where it's going to come out. It depends upon a lot of these detailed discussions, right?

MR. LIPPE: Right.

COMMISSIONER COGAN: I mean, if you go with expensing of capital equipment, if you say health-care insurance purchases by firms on behalf of their employees are deductible, then, of course, the rate is going to go up a little bit. So if we say that for a small business as the franchise tax part of this proposal, the franchise business tax goes away, then the rate has got to be a little bit higher. So the ultimate rate depends upon a lot of the things that we've been talking about today and on Wednesday.

COMMISSIONER EDLEY: But nowhere near 10.

COMMISSIONER COGAN: Right, right.

MR. LIPPE: Sorry for taking so much time.

COMMISSIONER COGAN: I don't think you would get --

COMMISSIONER EDLEY: We could buy Montana, though.

COMMISSIONER COGAN: And one final point with respect to the whole package. I think what has really encouraged us to look at this is because of the concerns that Marty raised, you know, we have the highest sales tax rate of any state in the union; one of the highest income tax rates, personal income tax, of any state in the union; the highest corporate tax rate. And so you ask yourself, have we, through our system of current taxation, created an environment that really discourages economic activity in the state, and would we not be better off if we went with a system that got rid of that 8.8 percent corporate tax rate, that cut personal income tax rates for everybody down, that eliminated that sales tax and replaced it with a broad tax that was on the order of 3 to 4, 4 percent. I think that idea is what's motivated the Commission to go down this road. And all the difficulties that you have raised with it are very, very important and they may, in the end, dissuade us from going this route.

But you can see how attractive it is when we look at the big picture for California as we go forward.

CHAIR PARSKY: And you couple that with the way in which how dependent the general fund revenue has become on the personal income tax.

MR. LIPPE: Sure.

CHAIR PARSKY: I mean, from what was, a number of years ago, maybe contributing 20 to 25 percent is now contributing 50 to 52 percent. And so those combination of things -- I think John has articulated it exactly the way all of us are thinking -- that's what's driving us to consider this. And so it's very important that the entire package be looked at.

Jennifer?

COMMISSIONER ITO: Yes, my primary question still remains this: What is the impact on all industries and the potential for their restructuring in the long-term? And in particular, not just around the outsourcing and whether it goes in-state, outside the state or internationally but, really, about what it can do to employee-employer relations, especially for the service-intensive, knowledge-based industries. Because I just don't see any incentive for -- I see a lot of incentive for companies to go the route of independent contractors. And so that, for me, is a question about what is the long-term impact. Because as we look at the entire package, if we're also looking at changes to the personal income tax -- so if we're looking at implementing a business net-receipts tax and having an exemption for small businesses, so we're going to miss out on a lot of that revenue. I'm assuming that a lot of these independent -- if industries go the route of independent contractors, a lot of those independent contractors will then be exempt because they won't have the net receipts of half a million or more.

And then also, if we're making changes to the personal income tax and lowering that, again, that's going to result in lower revenue.

So I just want to be -- you know, put those out on the table as that's kind of my concern, and looking at that as we evaluate this overall package, really looking at what the long-term impact is going to be.

CHAIR PARSKY: Well, I think you point out very appropriately that the revenue-estimating relating to a new form of tax like this has got to be dealt with very carefully.

One of the reasons that we are contemplating a phase-in or a transition period is, in part, for that reason and that we might consider starting a tax like this at a very low level, and maybe eliminating the corporate income tax, and then phasing in, as this tax goes up, so that we have a system that reflects what the revenue-estimating really is, and for just that reason.

COMMISSIONER ITO: No, I understand that. But I'm more worried about the longer-term impact. So if this does create an incentive for companies, right, to go farther, I think that's a reality -- that's something that we need to be aware of. So I understand kind of the revenue for the short-term, and I realize that there may not be a lot of impact because companies won't make those adjustments within the first three years of this tax going into effect. But I'm more worried about the longer-term impact.

CHAIR PARSKY: Carl, did you have a comment?

MR. JOSEPH: Well, I just wanted to sort of make a reminder that there is more from a legal determination as to somebody being an independent contractor than merely calling them an independent contractor. You can choose to call somebody an independent contractor and give them a 1099, but that doesn't necessarily mean from a legal perspective that they are, in fact, an independent contractor.

You know, there's lots of concerns such as unemployment insurance and other areas where the law is quite concerned outside of the income tax context with whether or not somebody is, in fact, really an independent contractor. And in some businesses, you know, you don't really -- you want control over the activities of that person. You do not want them to be independent. It's a business decision as opposed to a tax decision to need to have employees versus all independent people. So I just want to keep that out as a reminder.

CHAIR PARSKY: Ruben?

COMMISSIONER BARRALES: Yes. Well, the whole issue of contracting out and creating jobs -– I mean, you still create jobs if it's in California. So I'm not as concerned about that as I am, though, encouraging job growth. And I guess I'm struggling with actually what, in the business net-receipts tax scheme, encourages job growth? I just don't -- I don't see anything that does that. Other than if you truly -- as John elaborated on, if you truly are able to reduce the personal income tax and the sales tax and all that.

So it leads me to my question to the lawyer, and it's probably a legal term, and that's why I don't quite -- you mentioned that the business net-receipts tax is nicer than the sales tax a couple times. And I'm just wondering what you mean by being "nicer"?

MR. BEHNIA: A couple of things. One is that it does consider expenses that were incurred in creating value, if you will. So it’s not sort of -- the sales tax is imposed gross -–

COMMISSIONER BARRALES: Right.

MR. BEHNIA: -- and there is no consideration for sort of what went into the production of the good.

So I think -- and maybe this question is better to an economist than to me -- but I think the idea of value-added tax, is that you’re taxing each party on the value it created. And -- and from an efficiency point of view, a sales tax is imposed at the end. So there’s a lot of opportunity for avoiding it. In fact, in cash businesses, it’s quite prevalent.

With a net-receipts tax, which is a value-added tax, I think in the chain of commerce, each party will pay its share, and you try to make it fair in the sense that it’s somewhere between a net income tax and a gross-receipts tax. You’re giving them deductions for important expenses but not for everything.

I think that the two big nondeductions, if you will, one is for compensation -- and I think we talked about the theoretical basis for that; I think that’s still an important political and economic issue -- and the other one is interest. And I think my view -- and this is consistent with what the economists have written -- is that there's no reason to favor interest over dividends. In other words, how you finance your business should have no bearing on how much tax you pay.

So from that point of view, if you look at the net-receipts tax, it's very much akin to an income tax but much simpler, in a way. In other words, you don't have to worry about the depreciation issues and a lot of other issues that are inherent there.

COMMISSIONER BARRALES: Yes, but in some ways, a sales tax is nicer or easier to implement. There are compliance issues, obviously, but…

MR. BEHNIA: Well, I think the principal argument that I heard about and I read about was that because you have multiple companies and they have an infrastructure there to sort of pay tax and they're not going to pay the corporate income tax, this is substituted there. And basically, the computation is relatively similar, okay. So nicer in the sense that you're collecting it at each stage and you don't have the problems with the enforceability of the sales tax, in that sense.

COMMISSIONER EDLEY: And/or concluding on services.

MR. BEHNIA: Yes. One more thing. One more thing. I think this is a perception, but I think, again, it’s an economic issue. The perception is when the tax is imposed at the retail level, because the consumer is going to buy something it needs, it probably is easier to pass the tax on completely from an economic point of view to the consumer, okay. Because now you’re only dealing with one marketplace. It’s a demand curve and a supply curve, just between two people.

I think as -- the other way, as you go down the chain, I think you’re facing different supply and demand curves for each of those industries. So for each of them, the question is, can it be passed on to the consumers, can it be passed on to the employees, can it be passed on to the customers and suppliers, or does it all have to be borne by the owner?

I think an economist will argue that that creates a more efficient market because in each case, the market will determine what’s the correct allocation of resources.

I’m saying big words that I don’t understand, but that’s sort of the argument, okay?

COMMISSIONER BARRALES: It sounds good.

MR. BEHNIA: So instead of facing one supply demand curve, you’re facing multiple and that’s supposed to make it more efficient. So in that sense, I mean nicer.

COMMISSIONER BARRALES: And, I'm sorry, I know we discussed it before, but the Florida case was an extension of sales tax, is that right, to services?

COMMISSIONER COGAN: Yes.

CHAIR PARSKY: Right.

COMMISSIONER BARRALES: Then it was repealed?

COMMISSIONER COGAN: They dropped it.

COMMISSIONER BARRALES: Yes, dropped. Thank you.

CHAIR PARSKY: I want to thank all of you very much -- thank you very much for coming forward and helping us.

We still have a public-comment period, and we have three speakers that have asked to speak.

First, Chriss Street.

MR. STREET: Mr. Chairman, Members of the Commission, thank you for the opportunity to speak. Chriss Street, Orange County Treasurer. I'm also the former CEO of two New York Stock Exchange companies and have a lot of experience in venture capital and in restructuring companies. I do have a degree in econometrics, so I'd like to keep my comments somewhat on the economic side, but I'd like to finish on the political side.

I have some observations from this morning's presentation and issues I think that are probably going to distract the Commission with the reality of California.

First of all, I think tax collection is very stable in California. Now, the reason I think it is stable is because property tax collection is a huge percentage of the tax in California. I can tell you, in Orange County, along with most other counties in California, we had higher tax collection for the last two years. For example, for the 2007-08 year, we were up $305 million. For the 2008-09 years, I'm up $192 million. The year that we're in right now, 2009-10, even with the disaster of real estate, for most people, we'll be down -- flat to down less than 1 percent. So I think the issue that's perhaps more variable here is success.

Now, if one was to take and regress the trend of tax collection, it would look pretty stable, the longer you took a regression. But, of course, in any one year, you can have great variability. This year, we probably have $20 billion; next year, maybe another five.

Secondly, the current tax system is part of the countercyclical mechanism of the economy. For example, when the business goes down for most people, they're eligible because of profits in the past, usually, for clawback of taxes. This becomes a funding mechanism and also helps to reduce the intensity of a recession. And, once again, tax collection goes down so they get cash back, their costs go down and, in fact, they turn around.

The public understands the current system and is able to vote its preference through the initiative process or through the normal political status. The concept of a business net-receipts tax is probably very attractive to politicians because, of course, it becomes invisible to the voter. A sales tax, of course, is not very invisible and, of course, generates tremendous political input from the public.

Income and corporate taxes are relatively easy to track through the existing technology that exists today. One of the taxes perhaps that makes it more difficult to track is discretionary valuation. And the tax collectors in California, of course, have the issue of unsecured property taxes. Now, many of you may know, and I'm sure the Franchise Tax Board knows, that many of our assessors over the last 80 years have actually gone to prison because of some of those discretionary issues. The business net-receipts tax would have a tremendous opportunity for bribery and fraud.

Collection efforts also allow for different kinds of treatment, especially when it comes to input from political entities. This business net-receipts tax undoubtedly would end up having political influence. As we've seen from the presenters this morning, it's a matter of whose bull is getting gored. Because I have this one great need at this one point in time, I come in and get my special treatment. And, of course, as I move on, I now have a special treatment compared to the rest of society.

Also, this effort of business net-receipts tax would be tremendously intrusive into the personal liberties of Californians. I can tell you that there has been conversations going on with the Assessors' Association and the Tax Collectors' Association on what kind of infrastructure would be necessary to collect a business net-receipts tax. This would require a tremendous amount of new people. These people would be very much involved in the day-to-day business of our citizens. For example, in California, for Orange County, we have approximately three million citizens. Those three million citizens, we have 235,000 unsecured tax items, and about 885,000 properties which are on our secured roll. So any effort to get involved in a business net-receipts tax would require a tremendous amount of intrusion into the day-to-day business.

Because although I've heard today people talk about some outsourcing issues and perhaps arbitrage issues for moving it around, remember that most people start their business when they have to, not because when they want to. There is a tremendous amount of business formation going on right now in California that will result in a tremendous economic boom. It's called, "I got fired." When you get fired at the age of 40 or 50, most people find it very hard to get a job. And, invariably, they think about starting a business and they do start a business. They're going to start that business, once again, off borrowing against their house or borrowing against their credit card.

An argument for the value-added tax is that there will be an elimination of the bias from borrowed money. As I've said, you hear a lot of conversations going on about hedge funds, how they managed to manipulate the system by creating capital gains instead of income.

I understand that this is a big issue. I think that it's a game. But, obviously, it's the best government money can buy for hedge funds, and they've done a good job of it. But when you look at most businesses you, once again, these are small folks. You know, their idea of a multi-level corporation is their brother, their sister, and their next-door neighbor.

This change in business net receipts I think would discourage investment during the transition period.

As many of you know, we have the investment tax credit comes along probably every ten or 12 years and creates some success. But in the six to 12 months prior to its expiration, there is a tremendous amount of success as people make that move. Any effort to introduce a business net-receipts tax would be very jolting to the economy and would destroy a lot of the investment decisions that were made by companies who do not recapture their money very quickly.

I've heard talk about high gross margin. Most people who have a business have a really low gross margin. I've heard 3 percent business net-receipts tax. Most businesses in the real world are lucky to have a 3 percent margin. They turn that margin several times a year so it looks much better. But if you hit them every time at 3 percent, you'd pretty much do them in as far as a margin line, I believe.

Over time, a large interest, once again, would use this business net-receipts tax to sway the system in their manner. I think it's extraordinarily dangerous to take the visibility of taxes out of the hands of the public. As we've seen, the state of California's politicians clearly know how to use Excel. They get a trend in property-tax collection. They simply extend that trend to the moon, and you end up with spending like you've seen.

Orange County is an absolute expert in irresponsibility. In 1994, Orange County filed for bankruptcy based on irresponsible spending. At the time, we had 18,000 full-time equivalents. Today, Orange County has 18,000 full-time equivalents. The state of California has 11.9 percent unemployment; and some numbers are actually as high as 15 and 16 percent, depending on how you do the arithmetic. And I see some people here represent more diverse elements of the business.

One person's laid off and out of the statistics, you know, as "I can't collect unemployment." But in Orange County, we have a 7.8 percent unemployment. I see no one complaining because our law enforcement is weak. As a matter of fact, three of the top most-safe towns in America are in Orange County. I see no one talking about our social services as being completely crumbling. You don't see a lot of really, really poor people walking around Orange County because they have this thing called a job.

And last, and perhaps more important, what you do today could have a really important long-term effect on the competitive nature of California. People are looking at California, and they're understanding that what made this fantastically successful, has now turned a corner. California is competing with Rhode Island and Michigan as the economic disaster of America.

What has been going on in California is this endless sense that we can continue to spend at around 8½ percent, compounded, and revenue is increasing at about 4 percent, compounded. That little 4 percent doesn't sound like much -- kind of like your 3 or 4 percent business net-receipts tax -- but over time, you end up splaying it out. And now you're in a situation where these types of decisions have come home to roost.

California's taxpayers want lower costs, and they want smaller government. They want efficient services and they want them to be very, very transparent and understood.

I think that anything on the nature of business net-receipts tax will be incredibly nontransparent and could be incredibly more destructive than the current system.

Thank you.

CHAIR PARSKY: Thank you very much.

Michael Shaw.

CHAIR PARSKY: It's nice to see you again, Michael.

MR. SHAW: Thank you again, Mr. Chairman, Members of the Commission. I will be real brief because

I don't want to restate a lot of what I said on Wednesday. But for those of you who were not able to be at the meeting in San Francisco, which I think was very productive, I wanted to restate a couple of things and also provide you with the case study that we used in discussing that. Joe Greenstreet, a CPA and a member of NFIB, was there.

Our primary concerns are one of the ability to pay. You know, I think it's been stated already pretty clear. If you have an income, right under the current system, you pay a tax; if you don't have an income, you don't pay a tax. Net business-receipts tax does not take that into account. And, obviously, as is highlighted in the case study that Mr. Greenstreet provided on Wednesday, this business, a 30-year-old restaurant had a loss in 2008 of $58,619. No income tax. Under the business net-receipts tax, as we understand it, it would be about a $17,419 tax liability. How is he going to pay $17,000 with money he doesn't have is the question.

Also as Ms. Ito noted, there is a concern over the employee-employer relationship and the push to independent contractors. And that creates a whole other set of issues for a small business, in that the state -- between the state and federal laws, there are probably half a dozen or more, close to ten different sets of criteria for determining who is and is not an independent contractor. And so pushing people in that direction through something like this a business net-receipts tax, which we will assume for argument's sake that that could lead to that type of activity, would create a host of other issues for small businesses, many which of which start out as independent contractors, in that way. We also have questions, and I believe we discussed this briefly last week regarding payroll taxes. Benefits are one thing. If you're including that as part of compensation and, therefore, excluding it from the purchases deduction, is a policy choice. Obviously, in California and across the nation, there is a great crisis with regard to health care. And so that is a political choice that will have to be made ultimately.

But payroll taxes are a different matter. Payroll taxes are not a discretionary expense. Whether or not to provide health care, 401(k) benefits, those are things that a business can decide. But payroll taxes are not optional. So we would strongly encourage, if you choose to not include compensation, wages, and/or benefits, that you would at least include the payroll taxes, workers' comp insurance, and other things that are not optional in that category. Because if you want to do business in the state, those are things you have to provide.

And that was all I had to say. But I wanted to again thank the Commission for the time that they've dedicated to this issue. And, of course, we do want to recognize that the other potential offsetting reductions in the personal and corporate income taxes are things that -- and the sales tax -- they are things that we do need to take into account.

And I think as we committed to do last Wednesday, we are more than happy to look at these examples and case studies in light of those issues and try and provide a richer and more accurate projection of how this overall change will affect small business.

And to that degree, of course, the sooner and more in-depth information you can provide in terms of the rates and the thresholds and those types of issues would certainly speed that along.

CHAIR PARSKY: Thank you very much.

Our last public-comment speaker is William Spillane.

MR. SPILLANE: Mr. Chairman, Commissioners, thank you. A couple of general comments and then a few specifically about the BNRT.

Generally speaking, does anyone here know of anybody who spent $22 million on research on taxes in the last few years? Anybody? $22 million research?

We have. We hired the best minds in the country and the best think tanks in the country to research taxes. And once they did their research, the tax proposal wrote itself, starting with a blank sheet of paper. Nonpolitical. Nonpartisan. If somebody wants to make it partisan, that's their problem. We're nonpartisan.

And as a matter of fact, some of our leading consultants are on the left side of the aisle. Dale Jorgenson of Harvard -- "Mr. Tax USA" -- did a lot of research for us. A gentleman from Boston University, Lawrence Kotlikoff is on the left side of the aisle.

The last think tank we hired to do our numbers, because there were so many lies about the FairTax. Here's a book just to rebut some of the lies. Not all of them. It would take three books to rebut all the lies about the FairTax. So if you want an excuse to put your head in the sand about the FairTax, they're all in here. They're rebutted, but you don't have to read the rebuttals. Lots of excuses there.

So we could get Kotlikoff, we could get Dr. Karen Walby here to talk to you. The commissioners need and deserve to hear about this. It's the solution to the state's and the federal government. It's a simple sales tax.

The BNRT is too complicated. It’s the “full employment act” for tax preparers and for tax attorneys. It’s outrageous. It’s way too complicated.

You’re talking about tax loss carryforward for essentially a sales tax? A VAT is a sales tax, a complicated sales tax. And this is a complicated sales tax over the moon. Thank you very much.

Now, anybody who has played any ball -- football, baseball, whatever -- knows that every good coach learns from his opponents. And, boy, do we have opponents. Every state around, every nation around -- we’re in a competition. So you learn from every opponent. And when you’re down near the cellar, not quite in it -- and that’s where we are in California -- you learn from the guy who is below you, in the bottom, but you certainly don’t duplicate Michigan. You look to the winners. Who is winning? Texas. Florida.

By the way, Texas created more new jobs last year than all the 49 states combined. And if you will rent a U-Haul truck to take you and your family from San Francisco to Austin, it will cost you four times what it cost for a return trip. Think about that. They’ll charge you $2,500 or more.

I just had the fellow in the lobby double-check my figures -- he came up with four times more -- to rent a U-Haul truck in San Francisco to haul your junk to Austin, Texas, than it will cost you to rent a truck in Austin, Texas -- the same truck -- for the same distance back to San Francisco. Why is that? People are going to Texas.

Now, I've lived in Texas. I've lived in Florida. I'd rather live in California. But the jobs are going there. Why? We're screwing it up.

So please give us the time to tell you what will solve the problem. And it's progressive. We have a mechanism to make it progressive. It's called a rebate -- or a "pre-bate," we call it, because it's an advance. In California, it would be $90 for an adult, $30 for a child. And it skews the tax rate like that. It's more progressive than our present income tax. It's beautiful. And it's all in the letter that I gave you about five weeks ago. And that starts out, "Don't spend good time after bad, or good money after bad," in the first sentence.

You've done an admirable job. You've worked very hard. Let's stick a fork in this turkey because this gentleman, the CPA from Woodland Hills and the shipbuilder from San Diego just really did a job on it.

So give up on this thing. Go to something far superior, far simpler, far less costly, and it will bring jobs into California. Because if you're an investor somewhere in the world and you find out that there are no taxes on investment in California, you're coming here.

And unlike the BNRT, you'll be able to export your products with no taxes included. That's what the Europeans do to us. They have the VAT over there and they export to us with no VAT included.

We have all of our embedded taxes in all of our products because of corporate taxes and payroll taxes included on all of our products. We ship it to Europe, and they put the VAT on top of our taxes. Incredible. We're not competitive over there. We're not competitive here. Let's get serious.

This will bring investment to California, it will bring jobs to California, and California will no longer be the caboose. We'll be up there in the top of the leagues with Texas and Florida and the others that don't have an income tax.

So please schedule a little time for the FairTax, folks. Please.

Thank you.

CHAIR PARSKY: Thank you very much.

That will complete this public workshop.

Our planning group will get together at lunch and a little bit this afternoon to try to summarize where we are.

I want to thank the public and certainly thank all of our presenters here for a very informative session.

Thank you all very much.

(The COTCE BNRT workshop concluded at 1:20 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 1st day of September 2009.

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