COST
COUNCIL ON STATE TAXATION

Testimony to the California Commission on the 21st Century Economy
February 12, 2009

Joseph R. Crosby
COO & Senior Director, Policy
Council On State Taxation (COST)

Chairman Parsky, and Members of the Commission, thank you for inviting me to provide the Council On State Taxation's (COST) views on California's tax system. My testimony covers three related issues: 1) the current state and local tax burden on California businesses; 2) sales taxes on business inputs, including proposals to extend the sales tax to services purchased by business; and 3) administrative simplification that will benefit California taxpayers regardless of the type or level of taxes imposed by the state.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of over 620 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Taxing Business

Ernst & Young, in conjunction with COST, annually estimates the total state and local tax burden imposed on businesses in each state. Our seventh annual report is being released today.[1]

This study provides estimates of the taxes paid by businesses in each state, an important first step in any evaluation of business taxes or tax reform. To enable comparisons across states, the study also expresses business taxes as a share of total state and local taxes and as an effective tax rate on private sector economic activity (taxes as a share of gross state product).

[1] Phillips, Andrew, Robert Cline and Tom Neubig, "Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2008," February 2009, http://www.cost.org.

These comparative measures were developed to answer questions from legislators asking, "Are businesses paying their fair share of taxes?" Increasing economic competition among states and around the globe has transformed the initial question into a more fundamental query: "What is the basis or rationale for business taxation at the state or local level?" The basic rationale for business taxes, recognizing that the economic burden of business taxes are ultimately borne by consumers or owners of factors of production (including workers), is to pay for government services that directly benefit businesses.

If state and local business taxes were equal to the value of the benefits business received from state and local public services, they could be considered a payment for services, and taxes would not influence business location decisions or impact competitiveness. However, if state and local business taxes exceed the value of the benefits received from government services, the difference represents an excess cost to business that will reduce profitability in the absence of shifting the tax through higher prices or lower payments to labor. When such excess costs exist, they can affect a company's choice of locations.

In FY 2006, the study estimates that California businesses paid $70.2 billion in state and local taxes while benefitting from only $42.1 billion in state and local expenditures. In other words, the state and local tax burden on California businesses is 67% higher than justified by the services government provides to businesses. The economic impact of these excess taxes falls on consumers through higher prices, workers through lower pay or reduced employment, or shareholders through reduced profits.

Sales Taxes on Business Inputs

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

The COST Board of Directors has adopted a formal policy statement regarding sales taxes on business inputs. COST's policy position is:

> *Imposing sales taxes on business inputs violates several tax policy principles and causes significant economic distortions. Taxing business inputs raises production costs and places businesses within a State at a competitive disadvantage to businesses not burdened by such taxes. Taxes on business inputs, including taxes on services purchased by businesses, must be avoided.*

---

[2] Ibid. This figure includes sales taxes paid on business purchases of operating inputs and capital equipment; it does not include taxes collected on sales to final consumers.

[3] Cline, Robert, John Mikesell, Tom Neubig and Andrew Phillips, "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," January 2005, http://www.cost.org.

A sales tax on business inputs violates several tax policy principles—economic growth, equity, simplicity and efficiency—and causes a number of economic distortions. Notably, these distortions result from pyramiding, where a tax is imposed at multiple levels, such that the effective tax rate exceeds the retail sales tax rate. Companies are forced to either pass these increased costs on to consumers or reduce their economic activity in the State in order to remain competitive with other producers who do not bear the burden of such taxes.

All states that impose sales tax currently tax business inputs to some extent, but few states tax services principally purchased by businesses. Proposals to eliminate existing sales tax exemptions for business inputs or to extend the sales tax to services purchased primarily by businesses further exacerbate the adverse economic distortions from the current taxation of business purchases. For example:

- Taxing business inputs encourages companies to self-provide business services to avoid the tax rather than purchasing them from more efficient providers and paying tax (vertical integration);

- Taxing business inputs places companies selling in international, national and regional markets at a competitive disadvantage to many of their competitors, leading to a reduction in investment and employment in the State;

- Taxing business inputs unfairly and inefficiently taxes some products and services more than others by imposing varying degrees of tax on inputs in addition to a general tax rate on final sales; and

- Taxing business inputs unfairly hides the true cost of government services by embedding a portion of the sales tax in the final price of goods and services.

Efforts to extend the sales tax to services purchased primarily by business also suffer from the significant administrative complexities associated with determining where such services are "used" or consumed. This determination is much more complicated for services purchased primarily by business than it is for tangible goods.[4]

Numerous attempts to extend the sales tax to services purchased primarily by business have failed, including broad efforts by Florida and Massachusetts and narrower, more recent efforts in Michigan and Maryland. Not only have these efforts been hindered by the administrative complexity of such taxes but also by the recognition that such taxes are fundamentally flawed and increase the cost of doing business in a state.

When considering any changes to California's existing sales tax base, the Commission would do well to understand the economic burdens associated with taxing business inputs, including the relatively high level of such taxes already imposed by the state.

---

[4] Ibid.

Fair, Efficient and Customer-Focused Tax Administration

Regardless of the types of taxes utilized in any state's revenue system, taxpayers deserve fair, efficient and customer-focused tax administration. COST's policy position is:

> *Fair, efficient and customer-focused tax administration is critical to the effectiveness of our voluntary system of tax compliance. A burdensome, unfair, or otherwise biased administrative system negatively impacts tax compliance and hinders economic competitiveness.*

COST has long evaluated state statutes governing tax administration and has identified several key areas that are indicative of fair, efficient and customer-focused tax administration.[5] These areas include:

- Equivalent Statutes of Limitations – Statutes of limitation should apply equally to assessments and refund claims. Requiring taxpayers to meet one statute while the tax administrator is granted additional time is unfair and should not be tolerated in a voluntary tax system. Extension of the statute of limitations for federal adjustments should apply equally for assessments and refunds. Claims for refund based on constitutional challenges should not be singled out for discriminatory treatment by shortening the statute of limitations.

- Equalized Interest Rates – Interest rates are meant to compensate for the time value of money and should apply equally to both assessments and refund claims. Failure to equalize interest rates diminishes the value of the taxpayer's remedy of recovering tax monies to which it is legally entitled. While states are entitled to penalize taxpayers who underreport tax liabilities, the punishment should be imposed through the penalty structure. Refunds and liabilities should be offset in calculating the amount due.

- Adequate Protest Period – The first step in the administrative process in most states is the issuance of an assessment with notification of a right to protest. That protest period should be at least 60 days and preferably 90 days. Shorter protest periods are unreasonable and could jeopardize a taxpayer's ability to fully respond to a proposed assessment. A notice period of 60 days or longer is of increasing importance in a global economy where taxpayers are working to comply with the laws of numerous jurisdictions and complex financial accounting rules.

- Reasonable Due Dates – The state's corporate income/franchise tax return due date should be at least 30 days after the federal tax return due date. Further, the state's corporate income/franchise tax return due date should be automatically extended with the granting of a federal extension. Extending state due dates assists taxpayers in their efforts to file correct returns based on complete federal return information. Although corporate taxpayers often file a single consolidated federal return, the adjustments necessary to

---

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

generate the multitude of state tax returns required are complex and time-consuming. To ease administrative burdens, an automatic state extension should only require attaching a copy of the federal extension with the state return to qualify.

These areas represent the bare minimum necessary to provide fair, efficient and customer-focused tax administration. Other areas, including the administration of local taxes and other administration of federal tax audit adjustments, should be considered on a state-by-state basis.

In COST's most recent survey of fair, efficient and customer-focused tax administration, California scored poorly. California's C- grade placed it among the bottom seven states. Two of the states ranked with or below California—North Carolina and Texas—have since made significant changes to their tax administrative statutes and practices to improve their fairness, efficiency and customer-focus.

California tax administrative statutes deviate from COST's recommendations in the following areas.

- Equalized Interest Rates – While California's interest rates for understatement of tax mirrors that of the federal government, the overstatement interest rate is modified to the lesser of 5% or bond equivalent rate of 13-week treasury bills. The interest rate on underpayments and overpayments should be identical.

- Adequate Protest Period – California provides a mixed message with respect to the amount of time allowable to protest an assessment: a taxpayer has 60 days to protest for income tax issues and 30 days to protest a sales/use tax issue. Taxpayers should have at least 60 days to protest an assessment in both instances.

- Independent Dispute Forum – California does provide an independent, prepayment tax dispute forum for corporation franchise and income taxes; sales/use tax issues, however, are appealed to the same body that administers these taxes. Access to an independent court requires a taxpayer to pay the disputed tax and file a refund claim. Taxpayers should have access to *de novo* review of disputed taxes before a trained, independent tribunal prior to having to pay or post bond for the disputed taxes.

- Other Key Issues – California was also penalized for its onerous Voluntary Compliance Initiative (VCI). Under the VCI, onerous retroactive penalties and interest were imposed upon taxpayers with limited rights of appeal. The state's recent imposition of an additional 20% penalty on certain underpayments will undoubtedly further harm California's grade in COST's next version of this report, which will be published this spring.

Conclusion

In reviewing the existing tax system, the Commission should seek opportunities to minimize obstacles to investment and job creation. Proposals that would further exacerbate the state’s current excess business taxation, including those that would impose sales tax on services purchased primarily on business, should be avoided. Finally, regardless of the recommendations the Commission makes with respect to the state’s tax structure, the Commission should recommend changes that will make the state’s tax administrative system fairer, more efficient and customer-focused.