Best Practices for Taxation and Spending in the 21st Century Economy

Remarks Submitted by Teresa Casazza, President, California Taxpayers' Association

February 6, 2009

The task of deciding when and whether to modify California's tax system to enhance stability and reduce volatility is monumental. California's tax system, which includes sales tax, property tax, excise taxes, personal and corporate income taxes, as well as limited liability company taxes, is gargantuan, with many different layers. These layers include: Who is subject to tax? Which activities should be taxed? Which is the right tax rate? Which is the appropriate method for apportionment? Which is the appropriate method for computation? How should taxes be administered? Who should have rights of appeal? Which appellate rights appropriately lie with taxpayers and tax agencies, etc.?

Rather than getting bogged down in these important, but overwhelming details, given the short period of this Commission's deliberation, I instead will focus on a few points that are of the utmost importance to our members, California's taxpayers.

A Strong Economy Is the Best Approach to Increasing Revenue in the Long Term

A recent report, which can be found on California Forward's website, indicates that a 1 percent increase in California's GDP would result in a $17 billion annual increase in company revenue and another increase of $2.5 billion to $5 billion in new tax revenue. How can this be? When the economy is doing well, businesses are hiring workers and purchasing equipment and supplies from other businesses that also hire workers. These businesses must use trucks to haul their products and even more workers to staff warehouses and sell their products. While the businesses are paying sales taxes and then yearly property taxes on new equipment purchases, they also are paying income taxes on profits. The workers they hire pay income taxes, and with their earnings may be able to buy a house on which they also will pay property taxes. Their disposable income will allow them to purchase things like clothes, cars and electronics, all of which results in more sales tax revenue to the state. In sum, the more our state's businesses thrive, the more tax revenue will be generated for the state.

We can encourage a healthy economy on the state level by allowing businesses the freedom to thrive. Tax policies that are enacted without considering interstate and international competition disadvantage California businesses and hinder their ability to grow and create jobs. Regulatory policies that encourage litigation and reduce employer flexibility also hinder job growth and investment.

Creating an economy that is sufficiently healthy to enhance state revenues in any significant way will take time, however. Recognizing the goal of this Commission to make changes in our state's tax structure that will benefit the state in the short-term, the focus should be placed on tax simplification and budget reform.

Simplification of Tax Administration Enhances Taxpayer Compliance

Federal Income Tax Conformity

A major issue with respect to taxpayer compliance costs is the lack of general conformity with the Internal Revenue Code. California's tax laws have been out of sync with federal law since 2005, when the last comprehensive tax conformity bill was enacted. This lack of conformity has created a huge burden for taxpayers in California, including many small and large businesses, who already are overburdened by excessive regulation and taxation. A lack of conformity merely perpetuates the perception that California is hostile to business. California is in the midst of a budget crisis, and conformity is one tax policy that will not drain the state coffers, but will save money for both the State of California and its taxpayers.

Conformity will ease taxpayer compliance burdens. Federal and state tax laws are so complex that when they are out of conformity, taxpayers must spend more time and money unraveling what is required to comply with the law. Conformity with federal law also improves taxpayer compliance. Fewer taxpayer errors resulting from differences in state and federal tax laws will improve taxpayer compliance and increase revenues that are due to the State of California. In addition, conformity will reduce tax agency administrative costs of auditing and correcting taxpayer errors. Fewer dollars spent on accountants and tax penalties inevitably will result in more dollars being invested in productive jobs and capital in this state. More investment results in more property, income and sales tax revenues to the state due to a healthier economy.

Our recommendation is for an annual federal tax conformity bill, sponsored by the revenue and taxation committee each year. Any controversial and costly provisions enacted at the federal level would be amended out.

Major Impacts of Proposed Tax Law Changes

Sales Tax Nexus

Under *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), out-of-state businesses must have a "physical presence" in the state for there to be "substantial nexus" sufficient to impose a use tax collection duty. This "physical presence" may include the presence of sales representatives on a retailer's behalf, which helps the retailer establish and maintain a market in the state. In contrast, advertising alone is insufficient to establish nexus. Much has been made of a recently enacted New York law that imposes a use tax duty for remote online sellers if they provide commission to New York residents to refer potential customers to their websites. Most often, this type of advertising would take the form of a "click-through," in which the New York-based website provides a link to the remote seller from its website and receives a fee for this service. The New York law was upheld by the New York Supreme Court, the trial court of New York, and is being appealed.

Mail-order catalog sellers are not subject to a use tax collection duty without a physical presence in the state. Why should it be any different for Internet retailers? As many as 23 other states have computer server safe harbors. Retailers currently using California web hosts could simply choose to use a web host in one of the safe harbor states, causing California web hosts to lose a substantial amount of business, and possibly even leading those web hosts to stream their websites through non-California servers. Rather than be subject to a use tax collection duty in New York, Overstock.com simply pulled its New York affiliates.

Until the sales tax nexus issue is resolved, either by Congress or the U.S. Supreme Court, the state should decline to take an aggressive approach similar to New York's. Without a federal solution, an aggressive approach could lead to a competitive disadvantage for California web hosts.

Sales Tax on Services/Base Expansion

Talk of taxing services has been around for some time, and this year is no exception. With the state's budget deficit estimated at over $40 billion, lawmakers again are raising the idea as a means of "modernizing the economy," closing California's budget gap, and stabilizing cyclical fluctuations in tax revenues. Some argue that a change in consumption patterns has led to a drop in the percentage of sales tax revenues. This is a flawed argument. Sales tax revenue has increased substantially, from $23 billion beginning in 1999-2000 to $32 billion in 2007-2008. This may not be as much as the spending lobby would like, but it is substantial and stable. Surely a tax on services would tend to depress the growth of purchases of services.

Taxed activity, such as the purchase of tangible goods, tends to grow slower than untaxed activity precisely because it is taxed. If services are taxed, the growth rate will slow. Some estimate that a broad sales tax on services could generate as much as $45 billion annually

in new revenues. However, the real question with regard to taxing services is whether expanding the base would result in an overall benefit to the General Fund and whether that benefit would outweigh the natural, but likely unintended, consequences that would flow from such an expansion.

According to the Federation of Tax Administrators (FTA), other states have been reluctant to undertake a broad-based expansion of the sales tax base since Florida enacted and repealed expansion of its base in 1987 and Massachusetts enacted and repealed its base expansion in 1990 in response to strong opposition. Although Michigan and Maryland attempted similar expansions, they joined Florida and Massachusetts in repealing services taxes shortly after enactment. (See discussion below.) Preliminary data from the FTA's upcoming 2007 survey on taxation of services (expected to be completed in 2009) notes that states enacted only minor changes from 2004-2007 by adding or repealing selected services. The exception is New Jersey, which increased its taxation from 55 to 74 services.

Although many states tax some services, a trend toward expanding the sales tax base to include more services is not at all apparent. Only Hawaii and New Mexico have broad-based sales taxes on services, according to the FTA survey.

Four States Experienced Major Public Outcry in Response to Broad Services Taxes:

- **Florida.** Hailed as a way to meet the expanding fiscal needs of this fast-growing state, the Florida services tax was expected to bring in $1.3 billion annually. Unanticipated, however, was major opposition in the business community, assailing the tax as extending beyond the state's borders and substantially increasing the costs of advertising, news, and legal services. Reportedly persuaded by public opinion polls, the Governor of Florida withdrew his support for the measure after it took effect. Florida enacted its services tax in July 1987 and repealed it six months later in December.

- **Massachusetts.** The Massachusetts services tax, enacted in 1990, attempted to tax only services provided to businesses. These services included legal services, accounting, auditing, bookkeeping, engineering services and architectural services. If these services were used by Massachusetts businesses, they would be taxed irrespective of where they were performed. Services used both within and outside of Massachusetts were apportioned based on the corporate income tax apportionment formula. The tax created competitive disadvantages for service providers located within Massachusetts. Massachusetts repealed the tax shortly after enactment.

- **Maryland.** In 2007, the Maryland Legislature enacted a computer services tax, covering web design, facilities management, custom computer programming, data center

support, systems integration, installation and maintenance, computer training and data entry. According to the Maryland Computer Services Association, the tax would have been "a serious blow" to Maryland IT businesses, which employ 68,000 people with an annual payroll of $5.2 billion. The tax was repealed in 2008 after tremendous pushback from industry. According to the National Tax Foundation, nine states now tax computer services, and litigation has arisen in several states regarding the difficulty of separating computer services and other types of services.

- **Michigan.** The Michigan Legislature enacted a 6 percent tax on services in October 2007. This tax was imposed on business service center services, consulting and investment advice services, janitorial services, landscaping services, warehousing, packaging, procurement, and personal services. A coalition known as the "Ax the Tax Coalition" was formed to petition for repeal of the tax, arguing that it would hurt Michigan's economy and force jobs to leave the state. According to a Michigan Chamber of Commerce poll, 90 percent of respondents supported repeal of the tax. The tax was also widely opposed by the financial services industry and the logistics industry. Before the coalition's effort reached the ballot, however, the tax was repealed, just 17 hours after its effective date.

A variety of problems would result should the state decide to tax services. First, According to the Center on Budget Policy and Priorities, economists recommend against taxing business-to-business sales, as it leads to "tax pyramiding." Tax pyramiding is a term used to refer to the phenomenon of taxing an input when purchased and taxing it again when the cost is passed on to the consumer. When businesses pay more for inputs, consumers pay more at the cash register.

Taxation of services also would disadvantage small businesses. Larger businesses that can afford to hire employees to do the work of an independent contractor would not pay tax on the service performed by the employee. Smaller businesses, however, would be forced to pay a tax, as they must contract out these services. This results in higher costs on small businesses that must pay tax on the same services used by large businesses that don't pay the tax.

Although considered to be revenue-neutral if coupled with a rate reduction, adding even 4 percent to the cost of all services virtually overnight will be highly inflationary. This cost includes the cost of administering the tax, which will be passed on to the consumer. This will ripple through the economy, creating increased pressure for wage increases, which will lead to job loss and potentially lost revenue from the Personal Income Tax.

Further, studies have shown that expanding the tax on services is more regressive than California's current sales tax. Such impositions would require lower-income individuals to pay a

larger portion of their income for service taxes than higher-income earners. Repair services are particularly integral to budgets of families who cannot afford to purchase a new appliance or a new car, or whose homes are past their prime. Tax would now be paid on services to repair the car, fix leaky pipes or replace a roof.

A tax on admissions would increase ticket prices to places like Disneyland, Six Flags, and sporting events of all kinds. For example, a family of four now pays $376 for one-day hopper passes to Disneyland. That same family would pay $410.78 with tax. A family desiring to go to a professional basketball game now pays approximately $272 for admission, but would pay $299.88 with tax. In this economy, working families simply do not have the disposable income to support a tax on non-necessary activities, and instead will forgo the activity altogether.

A services tax would worsen California's business climate. California services would immediately have a substantial competitive disadvantage compared to services provided in other states. Companies based in California that could obtain less costly services from out of state would do so. The motion picture industry, already hurt by runaway production, would suffer a major blow. If this tax were added to all movie industry-related services, fewer films would be made in this state.

Moreover, a tax on services would widen the tax gap. Because a new tax on services would be imposed on many cash businesses, much of this tax would go uncollected. These businesses would migrate to the underground economy, and the tax gap - the difference between taxes owed and taxes paid - would grow substantially larger.

Proposition 13 Continues to Be Good for the State

Although many have alleged that Proposition 13's limitation on annual property tax increases and its "acquisition value" assessment system contributed to the state's fiscal crisis, quite the opposite is true. In fact, Proposition 13 has made the property tax stable and predictable for property owners and local government, ending the guesswork and worry that plagued the system in the 1960s and most of the 1970s. Prior to Proposition 13, the real estate market and assessors' subjective valuations caused massive, unpredictable swings in the property tax.

Proposition 13 has made the property tax a relatively stable source of revenue for local government. The state's real estate market has gone through major ups and downs during the past 30 years, but thanks to Proposition 13, the assessed values subject to the "acquisition value" method have increased, at an average annual rate of 8.4 percent, present year excepted. During downturns, assessed value growth has exceeded the growth in values of real estate.

Proposition 13 also protects taxpayers by requiring a two-thirds legislative vote for tax increases. This has not prevented tax hikes when lawmakers believed there was a real need. Since Proposition 13's passage, there have been 22 increases in state taxes.

In addition, contrary to popular belief, the tax initiative has not shifted the property tax burden from businesses to homeowners. Since passage of the initiative, the assessed value of non-homeowner property subject to Proposition 13 has grown an average of 8.5 percent per year, while homeowners' property has grown an average of 8.3 percent. Thus, the Proposition 13 property taxes paid by non-homeowners have outpaced homeowners' property tax burden. For example, in 2006-07, taxes on non-homeowner property were $6.2 billion higher than those on homes. Data from the Board of Equalization also shows that business property is assessed much closer to market value: Since 1988, business property has been assessed, on average, at 75.1 percent of market value, while homeowners' property has been assessed at 66.3 percent of market value.

A Split-Roll Property Tax Would Harm State Businesses and Consumers

A split-roll property tax comes in two versions: one attempts to reassess non-homeowner property to reflect fair market value when no change in ownership has occurred. The other seeks to apply a higher rate to the current acquisition value of non-owner-occupied property. A split roll represents a massive increase in the cost of doing business in California. This increase will result in higher prices on consumer products and a less-competitive climate for California's businesses to expand and create jobs. Such a move would imperil the state's economy and would be the single most damaging tax policy change that could occur in California.

The Legislative Analyst found that a split roll would increase costs to businesses due to higher property taxes, which could result in higher product prices, reduction in employee salaries, as well as a reduction in overall economic activity. A split roll also would adversely impact small businesses, because their rental costs would increase with higher property taxes. Commercial buildings, shopping centers and business parks all are held in corporate ownership, and most commercial leases allow for increases in rent to reflect increased property taxes. Smaller businesses would be less able to absorb a sudden rent increase due to reassessment, and likely would close down if split roll were enacted.

Because Proposition 13 had the effect of making property tax assessment more objective, a split roll, which removes the protections of Proposition 13 from commercial property, would lead to unfair and subjective tax policy. Prior to Proposition 13, assessors used the theory of "highest and best use," which meant that the property value was determined by considering the "highest and best use" of the property, rather than the actual use. A return to

market value assessments would return to this undesirable assessment theory, which was partly responsible for the property tax revolt that led to enactment of Proposition 13. Assessors would value many properties on the basis of higher use, with higher taxes forcing the taxpayer to move on. Moreover, a return to market value assessments shifts taxes from an objective standard ("sales price") to a subjective one ("assessors' opinion of value"), leading to arbitrary assessments and more appeals.

A split roll also would roll back Proposition 13's reduction in property tax revenue volatility. A reassessment split roll would increase volatility in property tax revenue, as revenue would be directly impacted by the fluctuation of property values from year to year. Proposition 13 stabilized the flow of property tax revenue by locking in acquisition values and allowing those values to increase slowly from year to year. Since enactment of Proposition 13, the assessed values subject to the acquisition value method have increased at an average annual rate of 8.4%. Were Proposition 13 not in place during the recent housing downturn, revenue would be more severely impacted.

A reassessment split roll also would increase administrative costs and workload on county assessors who must revalue business property annually, or in the case of a stock-change split roll, upon each change of ownership. The stock change split roll is administratively unworkable. There could be a change of ownership numerous times each year for some companies. This would require constant reporting. For the assessor, it would mean property must be revalued each time a change occurs, leading to hundreds of reappraisals each year. With each reappraisal, a supplemental roll tax bill must be issued. Taxpayers would have the right to appeal the value of the property after each reappraisal, overburdening the assessment appeals system.

Some have suggested that the multiple reassessments could be deferred. We do not think this would be constitutional under Proposition 13. When there is a change of ownership, and the split roll proposal defines the stock change as a change of ownership, Proposition 13 provides that the full cash value of a property is the appraised value when a change of ownership occurs. This means the value has to be determined after each change of ownership. There seems to be little flexibility on this point.

Revenue Volatility Should Be Addressed by Budget Reform

Because healthy tax revenues depend largely on a healthy economy, the state's tax revenues are particularly vulnerable to large fluctuations in economic growth. Rather than slow economic growth by making services more costly to businesses and consumers, a preferred approach is to address volatility through spending limitations and a "rainy day" fund.

Budget reform is vital, because the current process is severely broken. Under the existing boom-and-bust budget system, the state routinely commits one-time revenue surpluses to ongoing spending programs. When the economy slows and the surpluses disappear, the state is left with a major deficit. This is an irresponsible way to manage the state's finances.

Budget process reform also is an essential element to the state's fiscal health. In an effort to avoid interest group pressure, our state's budget recently has been decided by five people – the Governor, the Assembly and Senate Minority Leaders, the Senate President Pro Tem and the Assembly Speaker. Budget deals are usually presented to legislative members without public hearing or analysis, and frequently passed in the dead of night. This process results in ill-considered proposals without transparency or public input. Consequently, major mistakes are made and the consequences are felt long after the budget is signed.

The 2008-09 budget, apart from falling far short of projected revenues, included a provision in SB X1 28 (Senate Budget and Fiscal Review Committee) that imposes a new 20 percent penalty, in addition to existing penalties, retroactive to 2003, applicable to corporations for underpayments of tax in excess of $ 1 million, with no right to appeal. This bill is now leading corporations to overpay any potential liabilities by May 31, 2009 or be faced with a massive penalty. Taxpayers will file a claim for refund the moment the overpayment is made. The bill neither was in print, nor was it accurately represented to the Legislature or the press before it received a legislative vote. On the contrary, it was represented as a doubling of an existing penalty from 10 percent to 20 percent. This penalty will have the result of pulling massive amounts of capital out of productive use in the economy at the worst possible time.

This type of surreptitious gimmickry must stop if California ever is to have a viable, functioning fiscal structure that is trusted by the taxpayers who fund government's work.

Conclusion

The foregoing barely touches upon the many issues to be considered when attempting to overhaul the state's tax structure. The California Taxpayers' Association hopes that the Commission's deliberations acknowledge the interplay between a healthy economy and strong revenues, and the favorable impact of federal conformity on tax compliance. In addition, the Commission is urged to consider the components of our existing tax system that function well, while avoiding changes that may adversely impact the state's businesses. Finally, budget reform is a crucial element to smoothing out peaks and troughs in the state's revenues and to ensure that annual budgets are well-vetted and transparent.

Teresa Casazza is president of the California Taxpayers' Association, a non-partisan organization formed in 1926 to oppose unnecessary taxes and to advocate for government efficiency. Cal-Tax is online at www.caltax.org.