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# California Tax and Comparative Data

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February 11, 2011

## Content

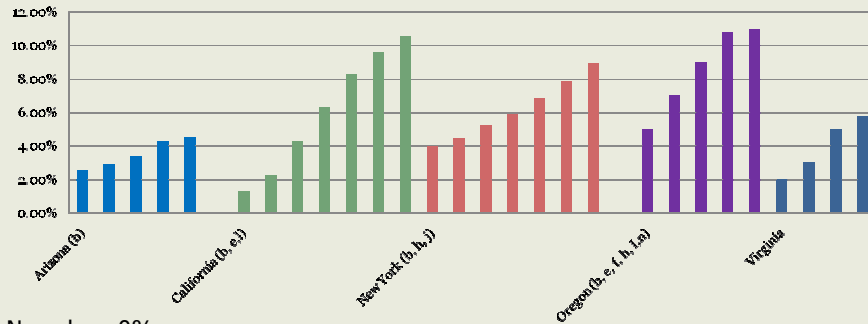
2

- CA tax rate in comparison with other states
- Type of taxes California collects
- CA Tax expenditures
- NY Tax expenditures
- TX Tax expenditures
- Governor Brown's Budget Discussion
- Selected California Facts

## CA Tax Rates

3

### CA Individual Income Tax Rates



Nevada = 0%

Texas = 0%

Florida = 0%

Illinois = 3% of federal adjusted gross income with modification

Source: Tax Foundation: Tax Data 2009

## Types of taxes CA collect

4

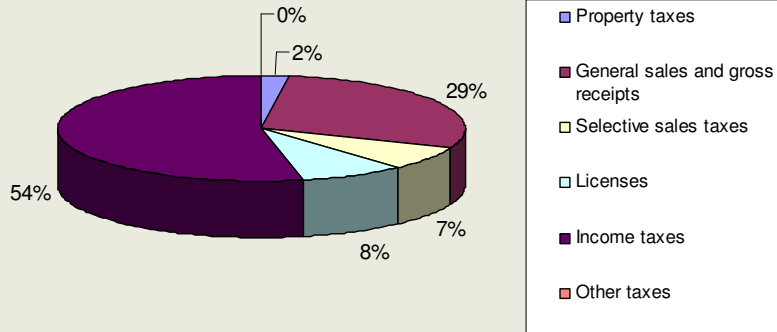
1. General sales and gross receipts
2. Selective sales taxes
3. Licenses
4. Income taxes

Source: State Government Tax Collections 2009.

<http://www.census.gov/govs/statetax/0905castax.html>

## CA Taxes collected in 2009

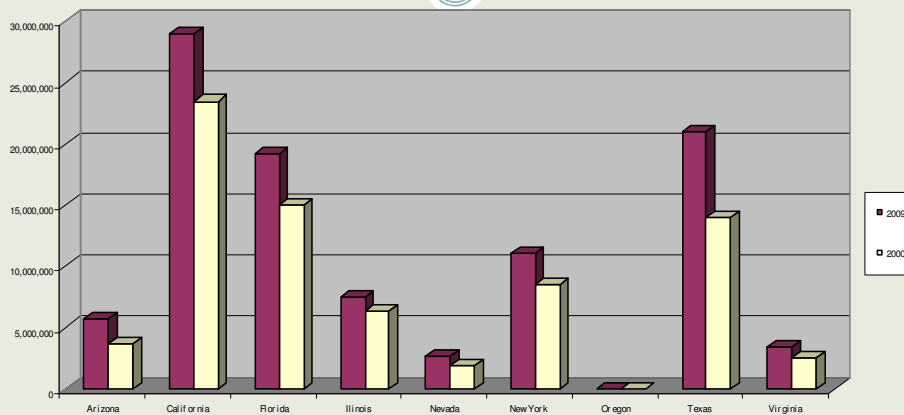
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Source: U.S. Census Bureau 2009;  
<http://www.census.gov/govs/statetax/0905castax.html>

## 1. General sales and gross receipts

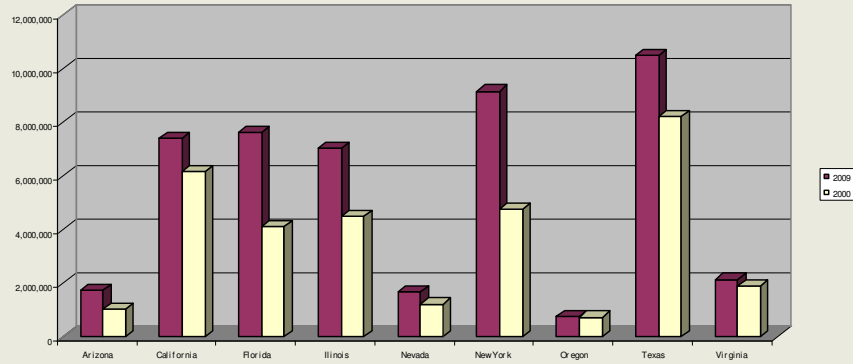
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Source: U.S. Census Bureau 2009

## 2. Selective sales taxes

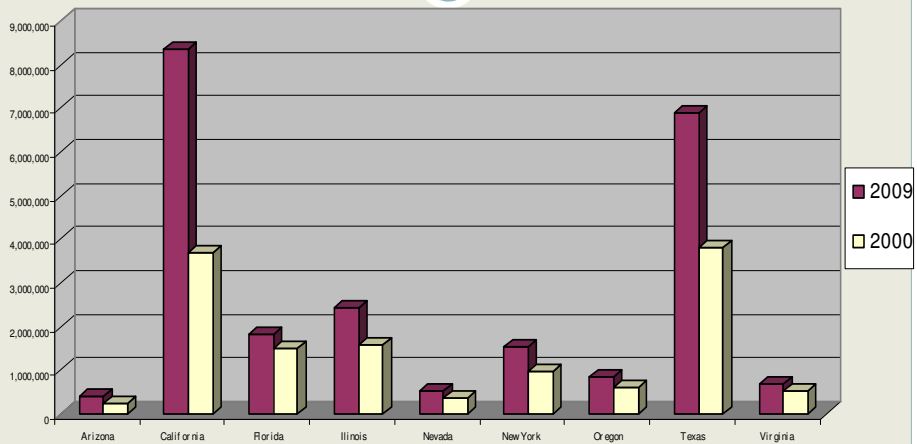
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Source: U.S. Census Bureau 2009

## 3. Licenses

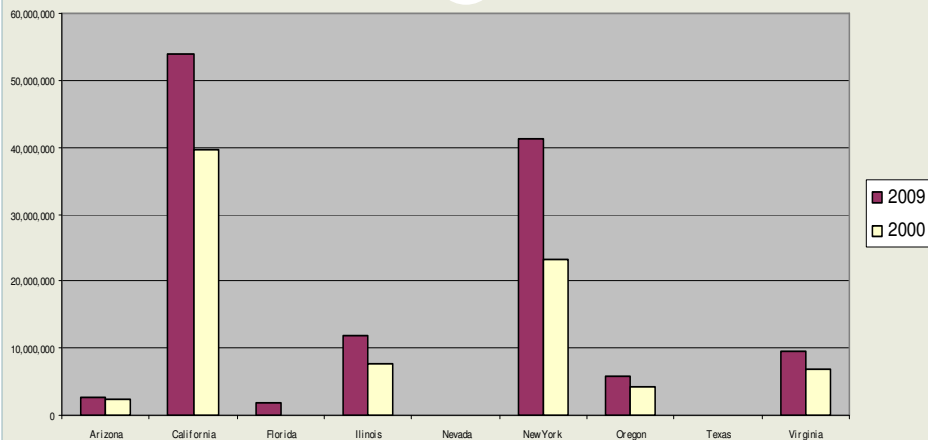
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Source: U.S. Census Bureau 2009

## 4. Income taxes

9



Source: U.S. Census Bureau 2009

## California tax expenditures

10

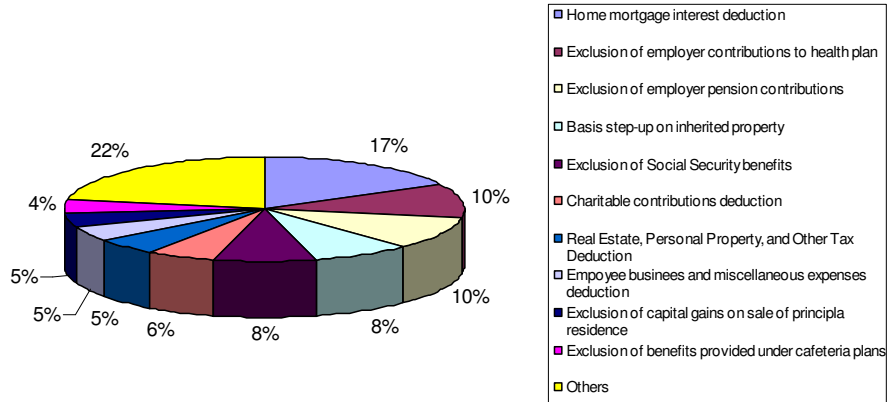
1. Personal Income Tax
2. Corporation Tax
3. Sales and Use Tax

Dept. of Finance – “There is no absolute rule for defining tax expenditures, and the concept of a “tax expenditure” can be defined in several different ways. Section 13305 defines tax expenditure as “a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by the state.” Thus, items that do not fall within a law, such as intangibles and services under the CA sales/use tax, are not listed in the tax expenditure report. Tax expenditures reported for FY2011 total about \$47 billion at the state level.

Source: Tax Expenditure Report 2010-2011;  
[http://www.dof.ca.gov/research/documents/Tax\\_ExpenditureRpt\\_10-11\\_web.pdf](http://www.dof.ca.gov/research/documents/Tax_ExpenditureRpt_10-11_web.pdf)

# 1. CA-Personal Income Tax

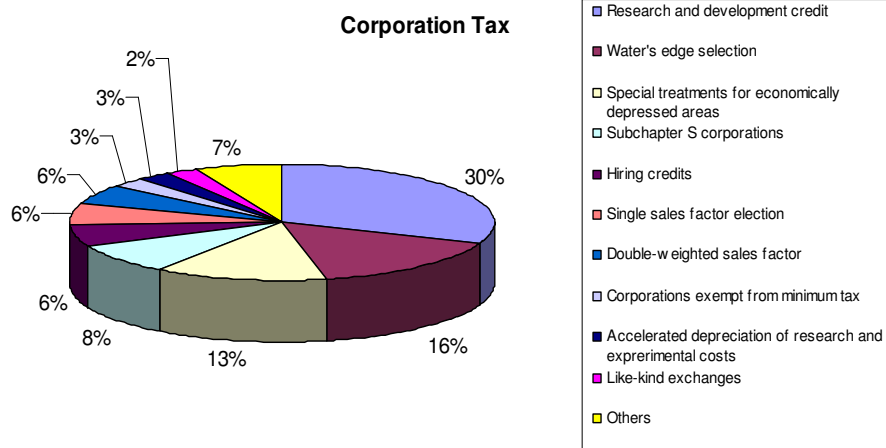
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Source: Tax Expenditure Report of the Department of Finance 2010-2011;  
[http://www.dof.ca.gov/research/documents/Tax\\_ExpenditureRpt\\_10-11\\_web.pdf](http://www.dof.ca.gov/research/documents/Tax_ExpenditureRpt_10-11_web.pdf)

# 2. CA-Corporation Tax

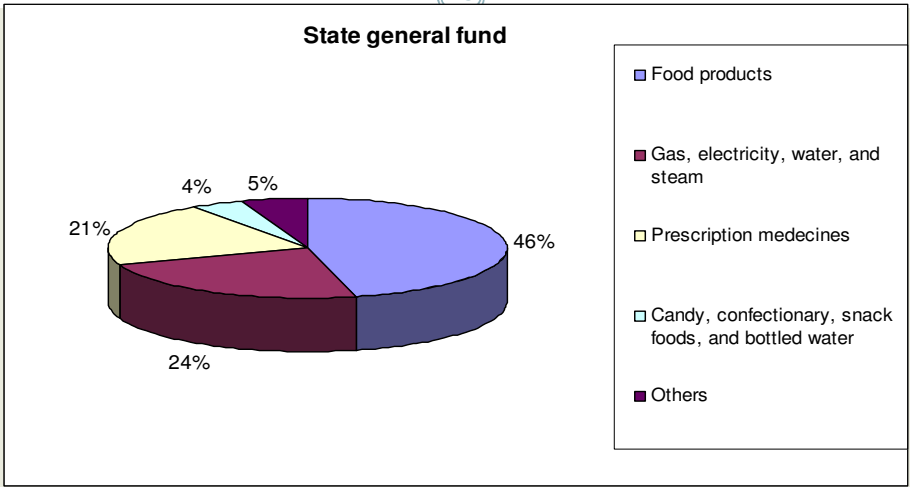
12



Source: Tax Expenditure Report of the Department of Finance 2010-2011

### 3. CA-Sales and Use Taxes

13



Source: Tax Expenditure Report of the Department of Finance 2010-2011

### New York tax expenditures

14

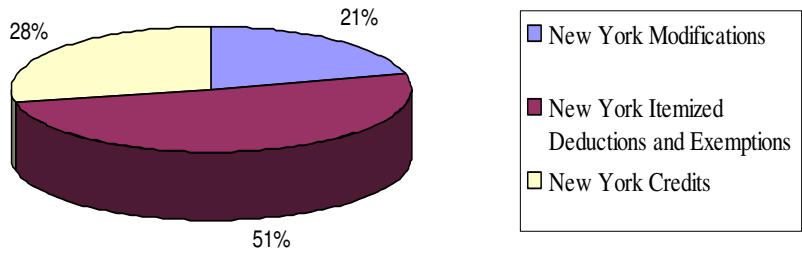
1. Personal Income Tax
2. Corporation Franchise Tax
3. Corporation Tax
4. Sales and Use Tax

“As defined by the Executive Law, tax expenditures in this report are defined as “features of the Tax Law that by exemption, exclusion, deduction, allowance, credit, preferential tax rate, deferral, or other statutory device, reduce the amount of taxpayers’ liabilities to the State by providing either economic incentives or tax relief to particular classes of persons or entities, to achieve a public purpose.” This definition is less subjective than an approach that defines tax expenditures by first defining a normal tax structure because it avoids judgments about what constitutes “normal.”” [Report, p. 3]

Source: Paterson, 2010;  
<http://publications.budget.state.ny.us/eBudget1011/fy1011ter/TaxExpenditure10-11.pdf>

# 1. NY-Personal Income Tax

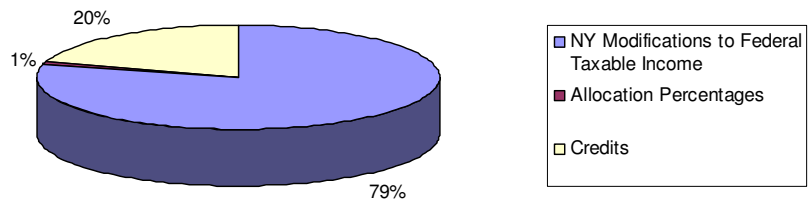
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Source: Paterson, 2010

# 2. NY-Corporation Franchise Tax

16

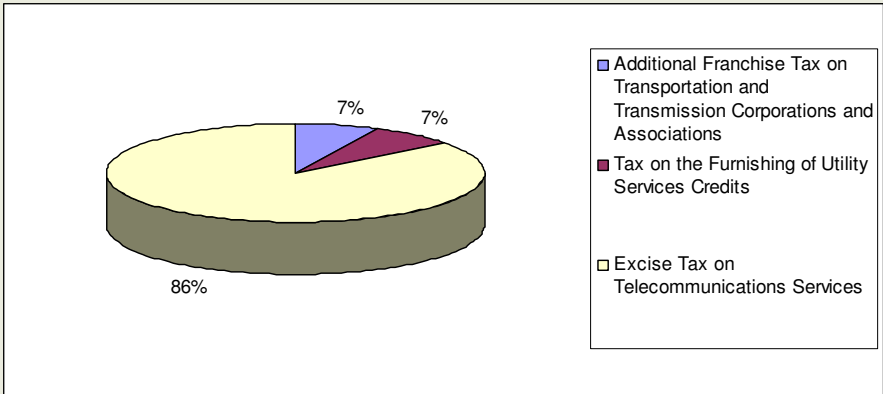


Source: Paterson, 2010



### 3. NY-Corporation Tax

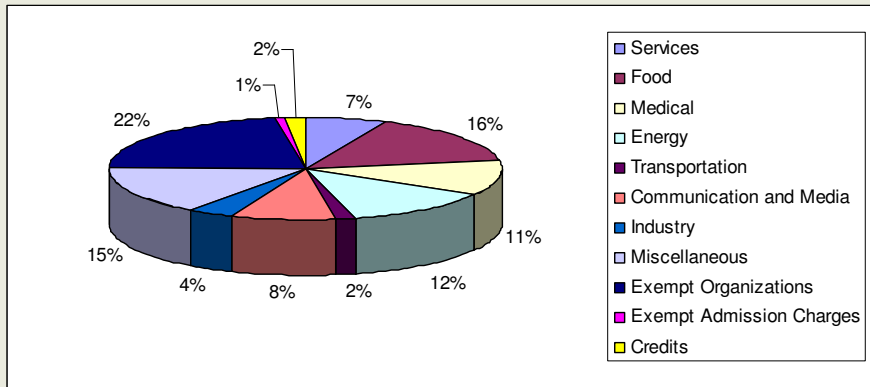
17



Source: Paterson, 2010

### 4. NY-Sales and Use Tax

18



Source: Paterson, 2010

## Texas tax expenditures

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1. Limited Sales and Use Tax
2. Franchise Tax
3. Motor Vehicle Sales and Use Tax
4. School Property Tax

FY 2009 – “exemptions\* from the sales, franchise, gasoline, motor vehicle sales, and natural gas taxes will amount to \$33.5 billion.”

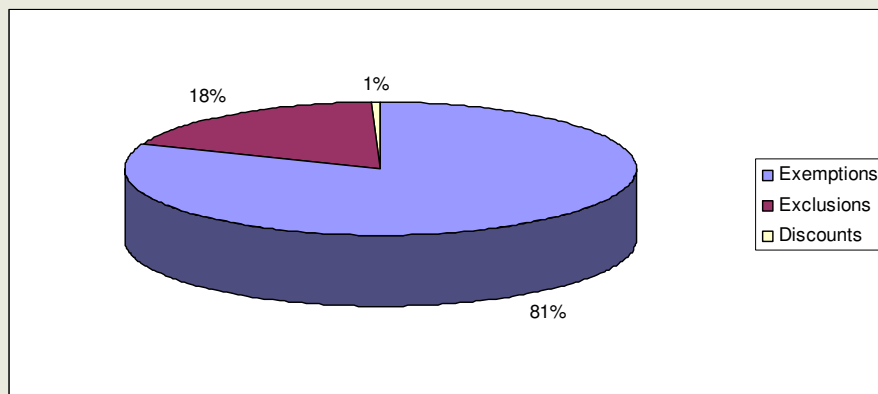
\* *The term “exemptions,” as used in this Overview, includes exemptions, exclusions, discounts, deductions, special accounting methods, credits, refunds, and special appraisals.* [Texas Comptroller report, page 1]

Source: Combs, 2009;

<http://www.window.state.tx.us/taxinfo/incidence09/incidence09.pdf>

## 1. TX-Limited Sales and Use Tax

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Source: Combs, 2009

Exemptions are specific laws removing items from the tax; exclusions are items not covered by the law such as intangibles; discounts are handling fees allowed to be retained by filers.

## Details – TX Sales and Use Tax Exemptions

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- Following are some of the items that comprise a portion of the Texas sales/use tax exemption category:
  - Food for home consumption 6%
  - Gas and electricity 7%
  - Items taxed by other laws (includes oil, fuel, insurance, alcoholic beverages) 33%
  - Property used in manufacturing 45%

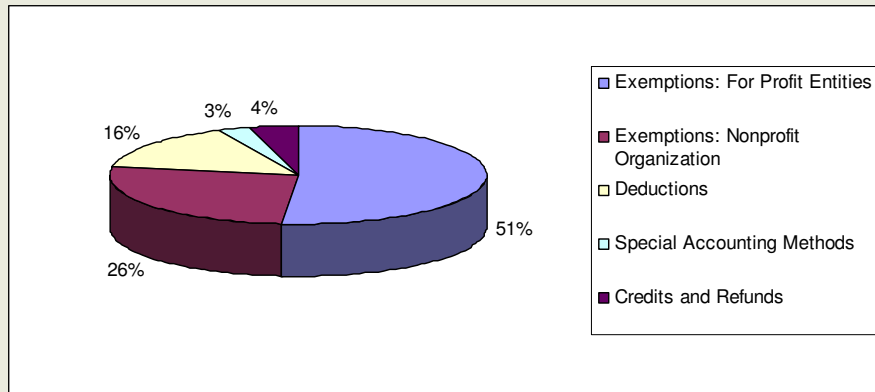
## Details – TX Sales and Use Tax Exclusions

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- Texas began including certain services in its tax base starting in the mid-1980's.
- Following are some of the items that comprise a portion of the Texas sales/use tax exclusion category:
  - Freight hauling 4%
  - Auto mtc, wash 6%
  - Legal, acctg 12%
  - Health services 30%

## 2. TX-Franchise Tax

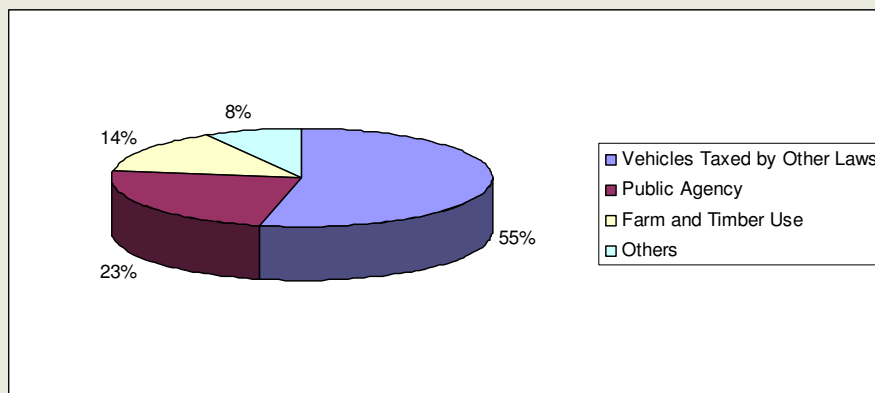
23



Source: Combs, 2009

## 3. TX-Motor Vehicle Sales and Use Tax

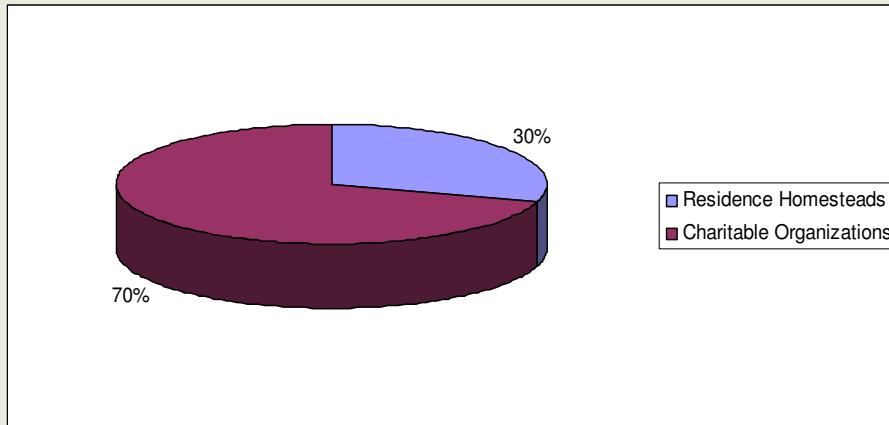
24



Source: Combs, 2009

## 4. TX-School Property Tax

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Source: Combs, 2009

## Governor Brown's Budget Discussion

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- Budgeted expenditures are spent mostly on education (30% for K12 and 10.6% for higher education) while CA holds position 49<sup>th</sup> in the ranking system of the Pupil-staff ratio (Brown, 2010).

Students per teacher	Students per counselor	Students per librarian	Students per school administrator
20.8	809.2	5,038.5	433.1

Source: Brown, 2010; [http://www.treasurer.ca.gov/brown\\_briefing.pdf](http://www.treasurer.ca.gov/brown_briefing.pdf)

## Governor Brown's Budget Discussion (cont.)

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### Some examples of General Fund Expenditures

- Medi-Cal: \$17.6 billion
- All state prisons: \$9 billion
- All funding for UC and CSU: \$5.4 billion
- Services to the developmentally disabled: \$3.1 billion
- CalWORKs: \$3 billion
- State mental health hospitals: \$1.2 billion
- In-Home Supportive Services: \$1.7 billion
- State employee payroll: \$9.2 billion

Source: Brown, 2010

## CA Facts

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1. CA's economy
2. State–Local finance
3. Program Trends

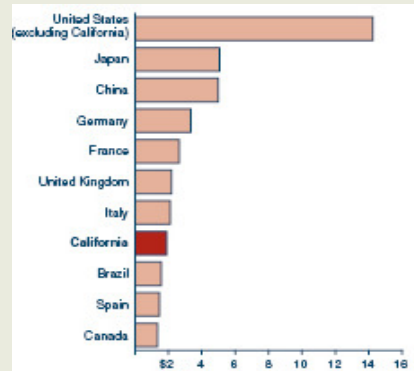
Source: LAO, 2011;

[http://lao.ca.gov/reports/2011/calfacts/calfacts\\_010511.aspx](http://lao.ca.gov/reports/2011/calfacts/calfacts_010511.aspx)

# 1. CA's Economy

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CA ranks among the world's top ten economies



- California's gross state product, the total value of final goods and services produced in state, was about \$1.9 trillion in 2009, making it one of the world's largest economies.
- California accounts for 13 percent of the nation's output.
- The next largest state economy—Texas—is about 60 percent the size of California's.

Source: LAO, 2011

# 1. CA's Economy (cont.)

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**Change in Employment, July 2007–2010 (In Thousands)**



**Construction Jobs Hit Hard During Recession**

- The state added an estimated 844,000 jobs between July 2003 (the previous low point) and July 2007. Between July 2007 and July 2010, however, the state lost 1.3 million jobs.
- The construction sector lost the most jobs of any sector since 2007. Construction employment is nearly 40 percent below the level of July 2007.
- The only sector to add jobs between 2007 and 2010 was educational and health services.

Source: LAO, 2011

## 1. CA's Economy (cont.)

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### Personal income in CA declined in 2009



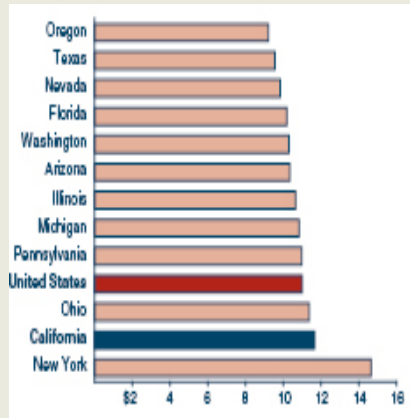
- Personal income declined by 2.4% for the first time due to economic downturn in 2009 (LAO, 2011).
- Previous recessions (1991 and 2000) made personal income growth slow but not decline (LAO, 2011).

Source: LAO, 2011

## 2. State–Local finance

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### CA's tax burden is somewhat above average



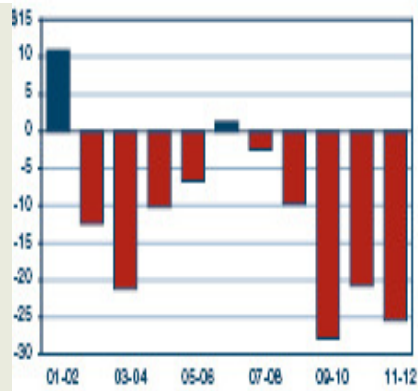
- In 2007–08, California's state and local tax burden—\$11.66 per \$100 of personal income—was somewhat above the \$10.99 average for the U.S. as a whole (LAO, 2011).
- California's tax burden was higher than that of all neighboring states. Of other major states, only New York's tax burden was considerably higher (LAO, 2011).

Source: LAO, 2011



## 2. State–Local finance (cont.)

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<sup>a</sup> Based on LAO projections made in November preceding each fiscal year shown. Represents difference between current-law resources (including reserves) and expenditures.

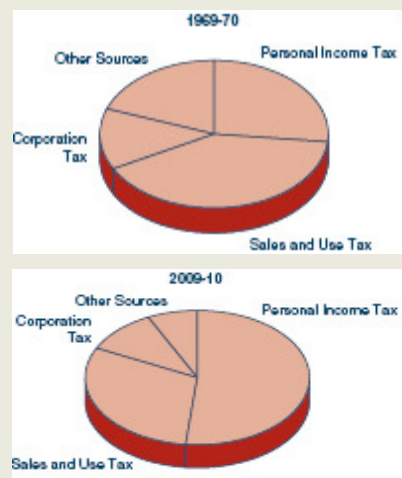
Source: LAO, 2011

### Significant state budget shortfalls since 2001.

- California has dealt with large state budget shortfalls since 2001 [due to the recessions in 2001 and 2007 to 2009 were major causes of the shortfalls].
- In addition, major new program and tax cut commitments were made in 1999 and 2000 that raised the level of state spending.
- The state's fiscal condition deteriorated rapidly in the months following the near collapse of world credit markets in late 2008. Eventually, the Legislature had to enact about \$60 billion of one-time and ongoing actions to address the 2009–10 budget shortfall. In 2010–11, the enacted budget, as well as 2010 special session actions, contained about \$20 billion of budget solutions.

## 2. State–Local finance (cont.)

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Source: LAO, 2011

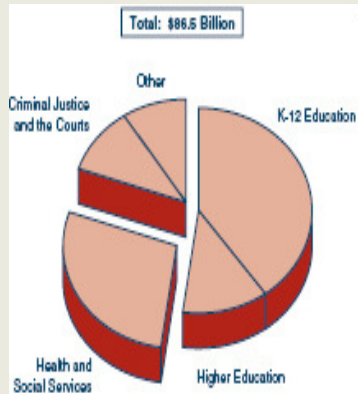
### The composition of revenues has changed over time

- Over the past four decades, personal income tax revenues to the General Fund have increased dramatically—rising from 27 percent to 51 percent of General Fund revenues.
- This growth is due to growth in real incomes, the state's progressive tax structure, and increased capital gains.
- The reduced share for the sales tax reflects in part the increase in spending on services, which generally are not taxed.

## 2. State–Local finance (cont.)

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### General Fund 2009–2010



Source: LAO, 2011

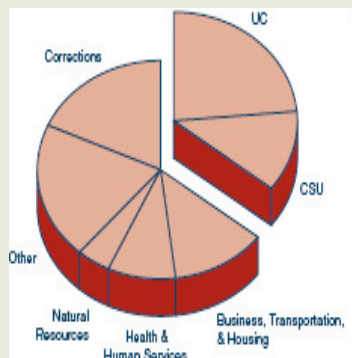
### Education, Health, and Social Services dominate spending

- The General Fund spent \$45 billion in 2009–10—52 percent of the total budget—on education, including payments to school districts, community colleges, and universities. Health and social services spending accounted for \$24 billion (28 percent).
- In 2009–10, \$67 billion—77 percent of the total General Fund budget—was paid to local governments (including school districts and counties) and the university systems. State personnel costs, excluding university employees, accounted for about 10 percent of the budget.

## 2. State–Local finance (cont.)

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### Higher education represents over 1/3 of state employment



Source: LAO, 2011

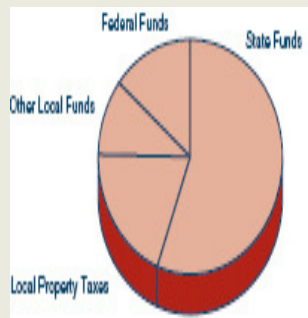
- In 2009–10, the state employed the equivalent of 356,436 full-time staff at a salary cost of roughly \$22.2 billion (all funds). Employees in higher education represented more than one-third of these totals.
- Two-thirds of State General Fund salary costs (excluding universities) are for corrections and rehabilitation employees.
- The state has many positions that are authorized but not filled. The current vacancy rate is about 12.3 percent.
- Over the past 30 years, state employment has averaged 8.8 state employees per 1,000 population. In 2009–10, there were about 9.3 employees per 1,000 population. On this basis, California ranks 47th among the states.

### 3. Program Trends

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2009-2010

#### State is primary source of revenue for K-12 schools



- In 2009–10, the state provided 56 percent of all K–12 school revenue, including approximately 1 percent from the state lottery.
- Local sources (through property taxes and other local incomes) provided about 30 percent of all K–12 school revenue.
- The federal government provided 14 percent of all K–12 revenue. This amount is higher than in previous years, primarily due to additional funds provided through the American Recovery and Reinvestment Act.

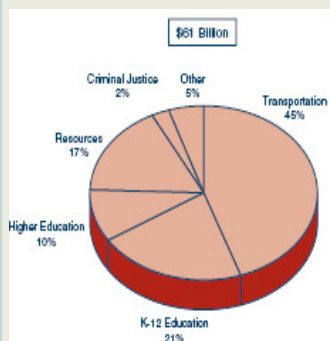
Source: LAO, 2011

### 3. Program Trends (cont.)

38

#### Infrastructure Spending, 2005–06 to 2009–10

#### Most State Infrastructure Spending Is for Transportation and Education

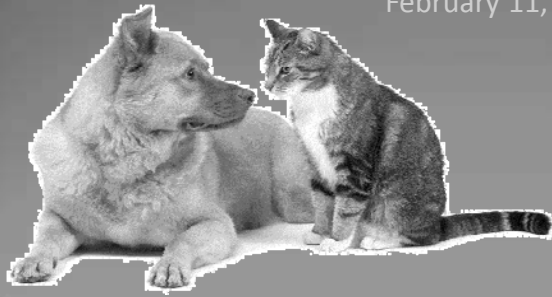


- Over the past five years, transportation projects and education facilities (K–12 and higher education) accounted for 75 percent of state infrastructure spending.
- State infrastructure spending included approximately \$28 billion in local assistance, mainly to K–12 school districts and local transportation agencies.
- State general obligation bonds provided 60 percent of infrastructure funding. Special funds accounted for about 35 percent.

Source: LAO, 2011

# The Challenged Relationship of California and its Cities

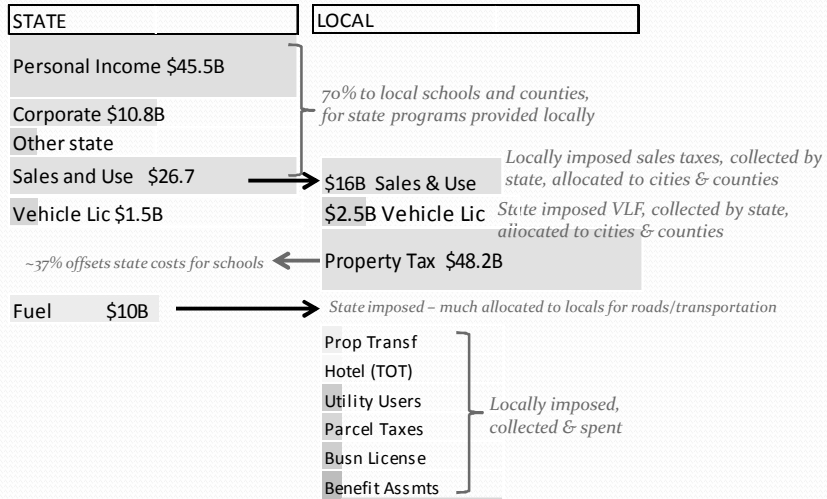
TEI-SJSU Tax Policy Conference  
The State of Tax Policy in California  
February 11, 2011



Michael Coleman  
*CaliforniaCityFinance.com*  
Fiscal Policy Advisor  
League of California Cities



# California's Tax Revenue Structure



\*Not shown: user fees, franchises and other misc revenues

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# California City Revenues



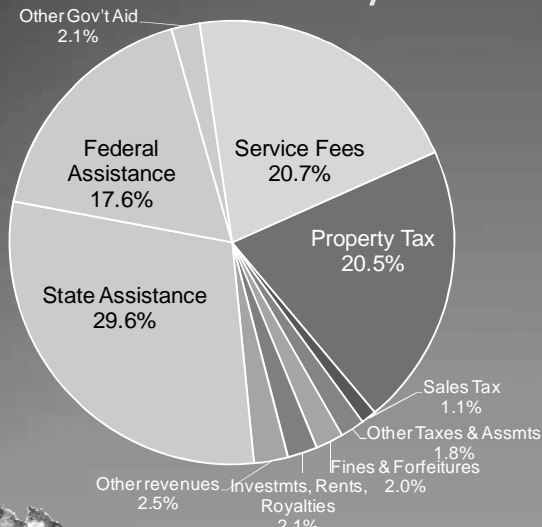
Source: CaliforniaCityFinance.com computations from data from California State Controller (revenues). Does not include data from the following cities that failed to report: Beaumont, Gustine City, Loyalton, San Diego, Taft, and Tulelake.

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## California County Revenues



Counties are hybrid local/state

- **state/federal programs:**  
Aid to families (CalWORKS), food stamps, foster care, In-Home Support Services (IHSS), alcohol & drug treatment.
- **countywide services:**  
jails, courts, elections, property tax collection & allocation.
- **“city” services to unincorporated areas**

Counties have

- more mandates,
- less discretionary \$, and
- are dependent on state budgetary action.



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Source: CaliforniaCityFinance.com computations from data from California State Controller, CaliforniaCityFinance.com



## Proposition 13 - nuts & bolts

1. **One percent rate cap.** Property tax rates capped at 1% of full market value
2. **Assessment rollback** of property values for tax purposes to 1975-76 levels
3. **Assessment growth capped** at 2% of property value (or CPI)
  - reassessment at full market value only upon change of ownership
4. **Special taxes** (local) require 2/3 voter approval
5. **State tax increases** require 2/3 vote of Legislature
6. **Authority for allocating property tax revenues transferred to the state**

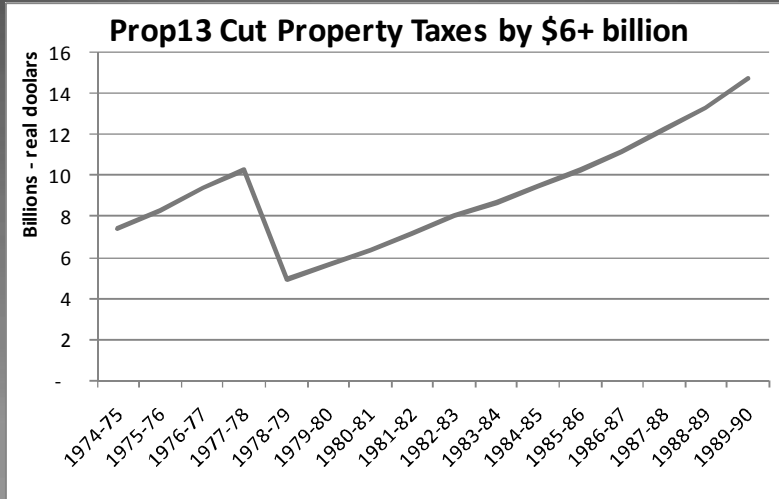


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## Proposition 13 – The Landmark

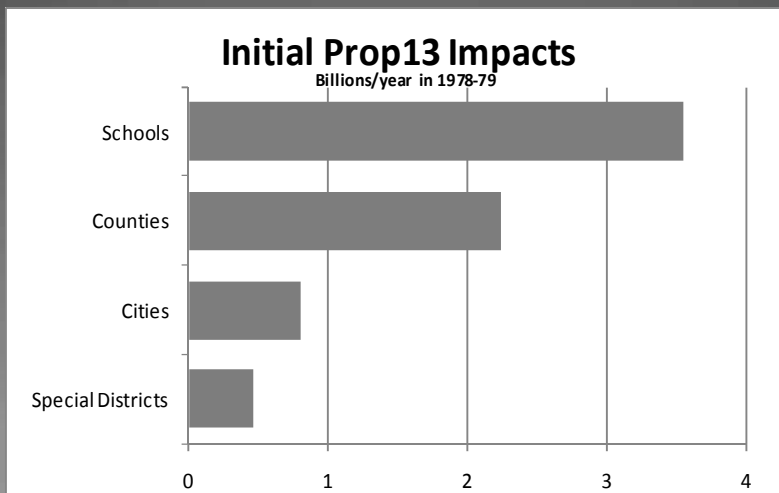


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## Proposition 13 – The Landmark

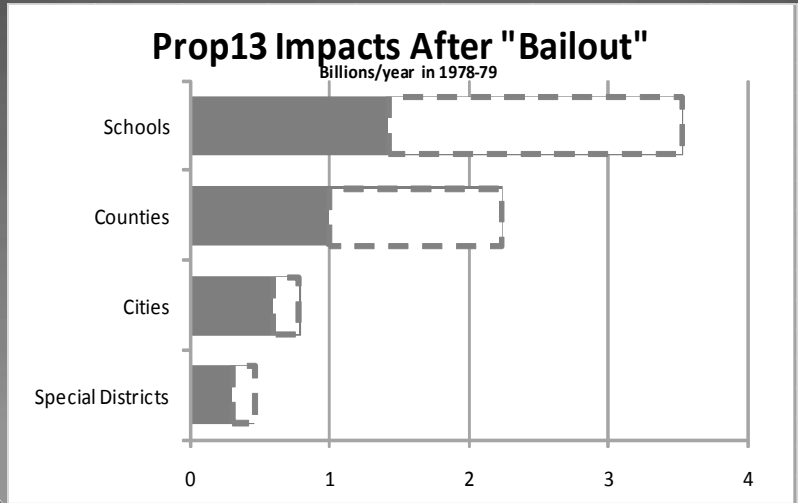


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# Proposition 13 – The Landmark

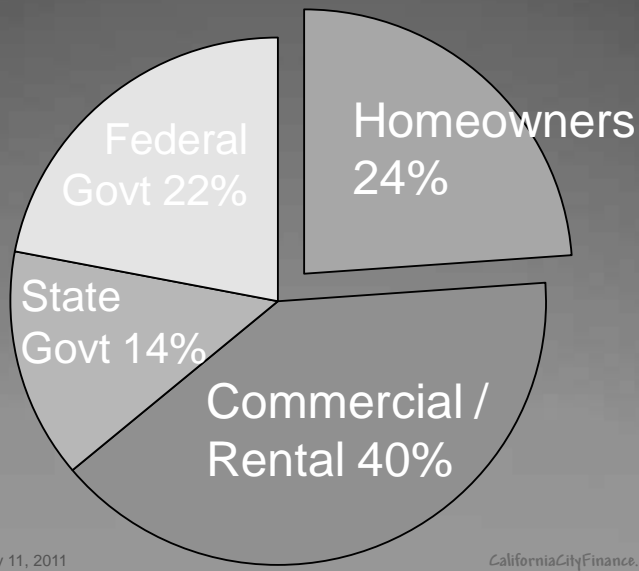


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# Proposition 13 Winners



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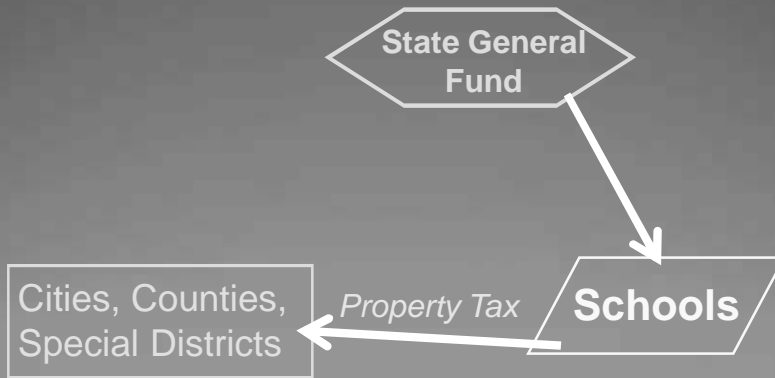
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# The AB8 (1979) Bailout

Shifting Local Property Tax to Cushion Impacts of Prop13

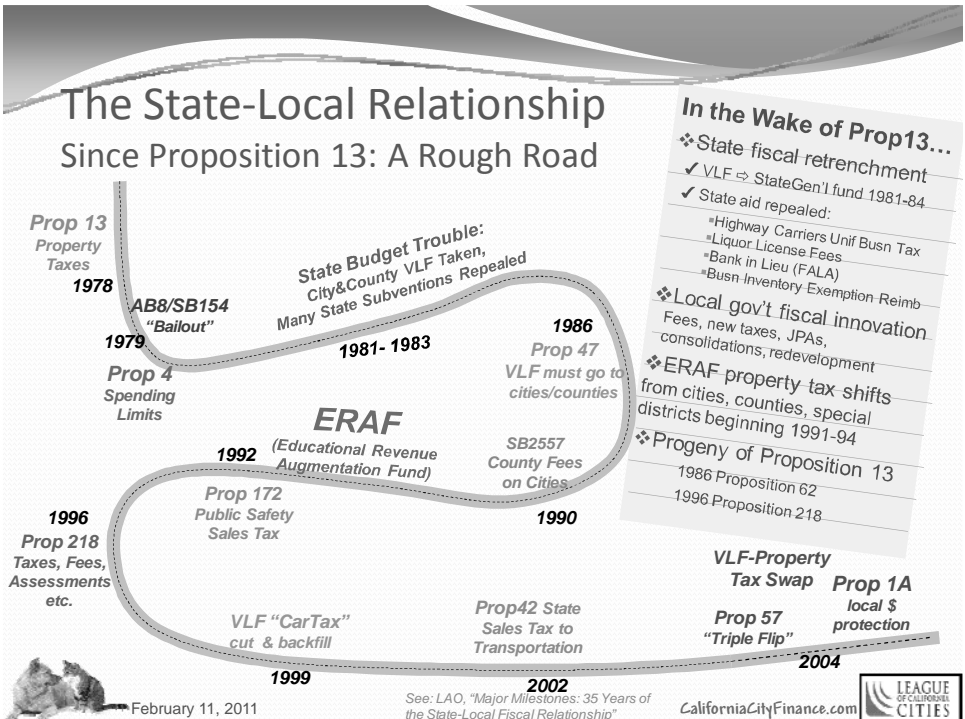


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# The State-Local Relationship Since Proposition 13: A Rough Road



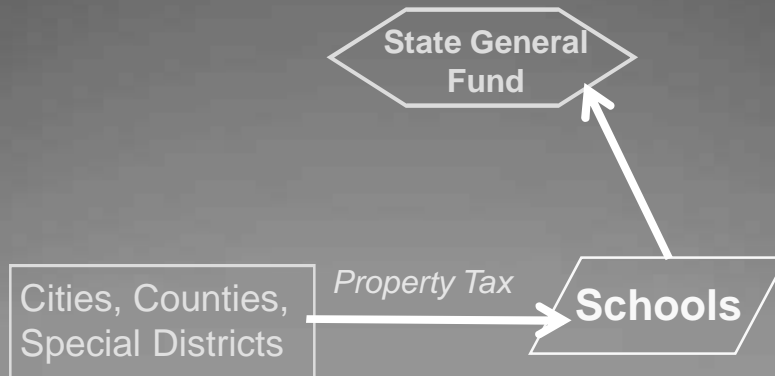
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See: LAO, "Major Milestones: 35 Years of the State-Local Fiscal Relationship"

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## E.R.A.F.(1992): Shifting Local Property Tax to Save the State General Fund



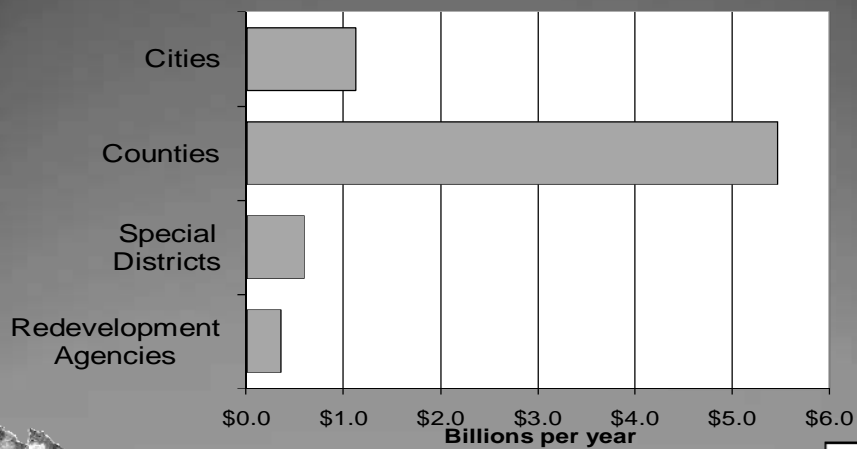
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## Loss to E.R.A.F.

Annual Statewide in 2010-11



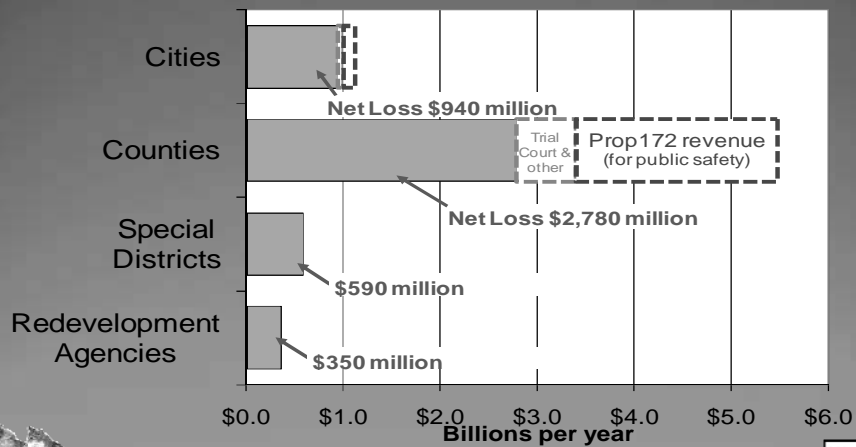
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# Loss to E.R.A.F.

Annual Statewide in 2010-11



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## Reforming Local Government Finance in California

1. Chronic state budget problems, desperation and bad public policy.
2. Revenue viability/sustainability in the new social economy  
sales tax, TOT, gas tax, UUT, etc.
3. The Decline of Local Revenue Authority  
Voters can't increase property tax above 1% (except GO bonded debt with 2/3)
4. Lack of local control of local property tax allocation
  - Fragmented property tax \$ and governance among overlapping agencies
  - Allocations out of step with current needs & priorities
5. Disconnect between service costs and revenues from urban growth  
("The Fiscalization of Land-Use")
6. Unsustainable employee compensation levels
  - especially retirement benefits.



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# CA Tax Policies' Effects on Local Jurisdictions

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February 11, 2011  
Sid Espinosa  
Mayor  
City of Palo Alto



## Overview of Presentation

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- Palo Alto's historical tax revenue data
- Effects of state budget crises
- Initiatives and legislation dictating policy
- Where Palo Alto is today and challenges ahead
- What would ameliorate tax revenue uncertainties



## Opening Remarks

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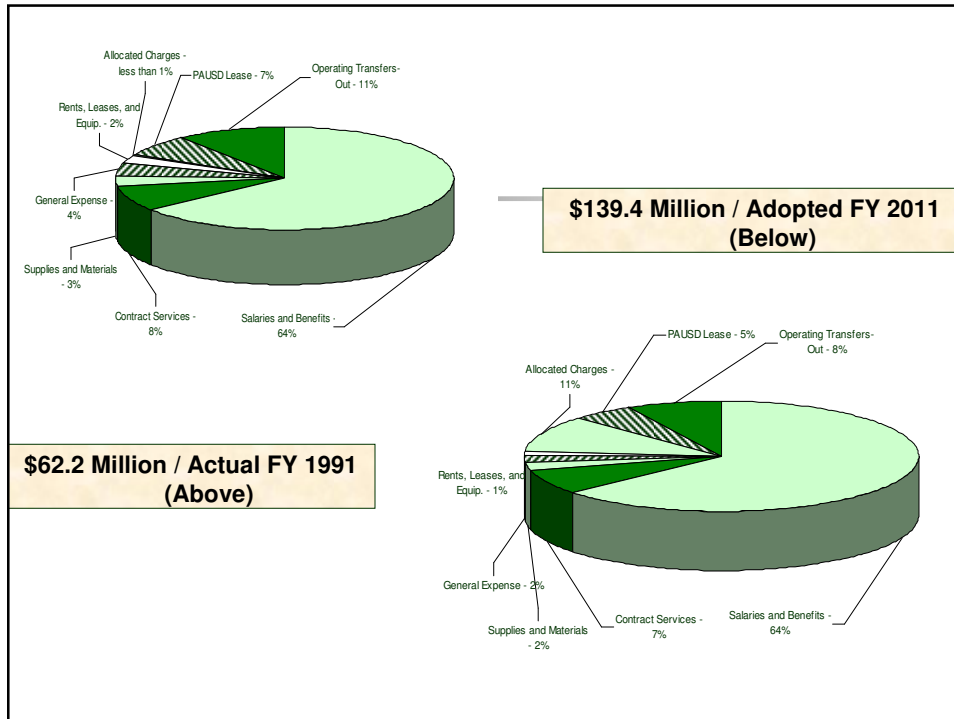
- The “Great Recession” has called into high relief deep fissures and structural issues in government budgets
- All jurisdictions have faced significant reductions in revenues while facing ongoing operating, benefit legacy, and infrastructure costs
- Many cities are at a crisis and inflection point



## Palo Alto 101

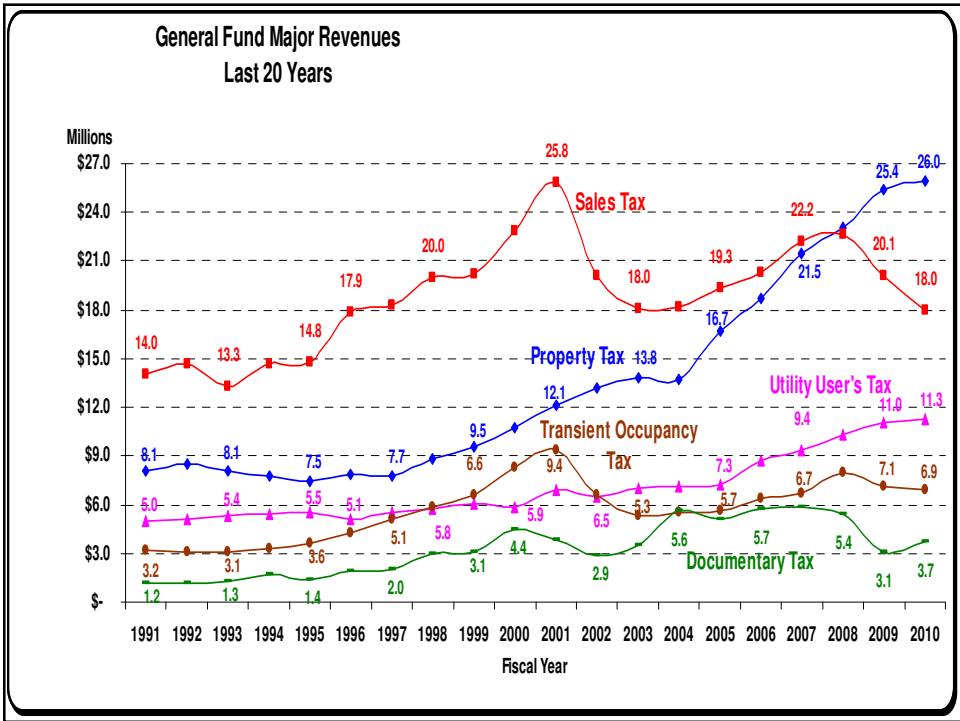
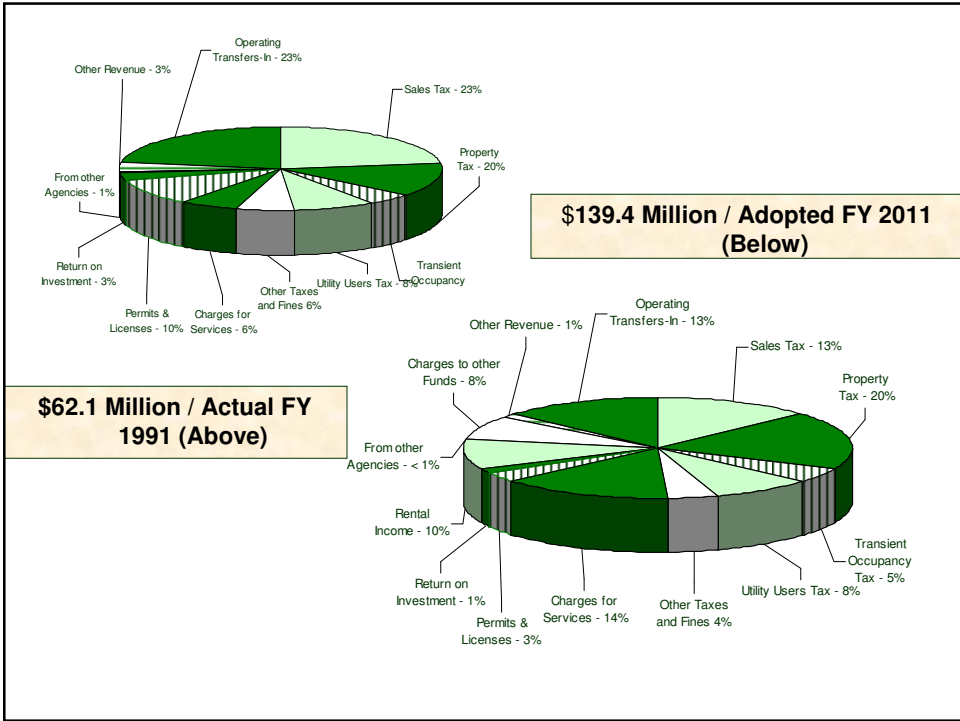
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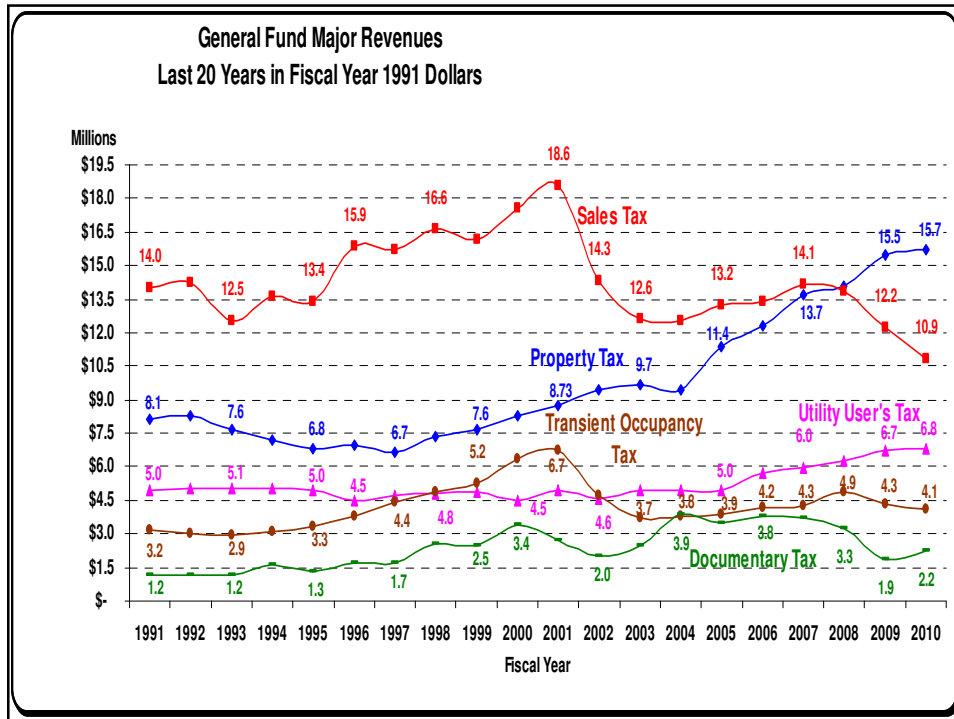
- Budget: \$139.4M
- Employees: ~1000
- Stanford
- Wealthy, educated, engaged populace
- Vibrant business environment (two “downtown” areas; Stanford Shopping Mall; Stanford Research Park – Hewlett-Packard, Tesla, Skype, Facebook); hotels; law firms; banks; VCs; restaurants
- Jobs-housing imbalance
- Owns utilities; airport; complex city departments
- Expensive property – residential and commercial



## Palo Alto Taxes

- **Sales Tax**
  - Palo Alto – 9.25% with city getting 1%; 13% of GF revenue
- **Property Tax**
  - Basic 1% property tax of assessed value and city gets 9.4% (9 cents for \$1); cannot increase more than 2% each year; 20% of GF revenue
- **Transient Occupancy Tax (TOT; “hotel tax”)**
  - 12% tax on room charge per day; 5% of GF revenue
- **Utility Users Tax (UUT)**
  - 5% on electric, gas and water consumption and on telephone use; tiered rate; 8% of GF revenue
- **Documentary Transfer Tax (DTT)**
  - One-time tax on all commercial and residential transactions
  - \$3.30 per \$1000 of transaction value; Santa Clara County has a DTT at \$1.10 per \$1000 so in Palo Alto, sales generate \$4.40 in DTT
  - 3% of GF revenue

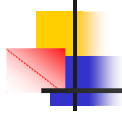




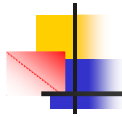
## Important Challenges

- **Property taxes:**
  - It is commonly assumed by property owners that the lion's share of property taxes go to pay for City services. In Palo Alto, for every \$1 paid in property taxes, the City only receives 9.4 cents. The remainder of this dollar goes to school districts and the county.
  - As a consequence of Proposition 13, assessed valuations can only increase by a maximum of 2% regardless of market value. This has not only placed a significant cap on revenue growth, but it has disproportionately burdened new property owners to the benefit of older ones.
- **Sales taxes:**
  - Of the 9.25% in sales tax paid by Palo Altans, only 1% is returned to the City
  - The City cannot raise this revenue source without voter approval



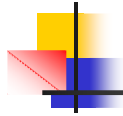


As much as might wish that it were the case, Palo Alto does not exist in a bubble.



## State Budget Impacts

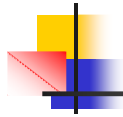
- The State has typically solved its budget crises by taking away or shifting local revenues
- A prime example is what is known as the Education Revenue Augmentation Fund or “ERAF” (1992)
  - State shifted property taxes from cities and counties to schools to relieve the state of a significant portion of **their** financing obligation to schools pursuant to Proposition 98
  - Statewide loss to cities in 2010-11 alone estimated at approximately \$1 billion
  - Since 1993, Palo Alto has lost \$63 million due to ERAF whereas these funds could have been used to make needed infrastructure repairs



## Proposition/Legal Constraints

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- Proposition 13 (1978)
  - Set property tax rates at 1% of the property's 1975-76 market value
  - Limited annual assessment increases to lesser of 2% or CPI
  - Required 2/3rd voter approval for "special" taxes that would be dedicated to specific programs such as roads
  - Transferred authority for allocating property tax values from localities to the State



## Proposition/Legal Constraints

---

- Proposition 218 (1996)
  - Prior to passage of Prop 218, local governments could levy "assessments" or charges on a property to pay for a service or benefit that the property received (e.g. park maintenance, street lighting).
  - Proposition 218 required voter approval and strict guidelines for establishing assessments and property-related charges, further limiting local revenue flexibility



## Proposition/Legal Constraints

- Proposition 26 (2010)
  - Reclassified many state and local fees as “taxes”
  - Fees reclassified as taxes under Proposition 26 must be approved by 2/3rds voter approval
- The Central point is that propositions have determined tax policy at the local level by stripping jurisdictions of any control over tax and fee revenue levels



## Long Range Financial Forecast

### 2011-2021 LRFF - BASE MODEL SUMMARY

	FY 2010 Actual	FY 2011 Adopted	FY 2011 Projected	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
<b>Revenues</b>													
Subtotal: Taxes	67,881	68,518	69,191	70,642	73,166	75,659	78,394	81,066	84,103	87,372	90,440	93,021	95,559
<b>TOTAL REVENUES</b>	<b>144,947</b>	<b>139,433</b>	<b>140,962</b>	<b>144,009</b>	<b>146,626</b>	<b>151,503</b>	<b>156,707</b>	<b>161,932</b>	<b>167,613</b>	<b>173,629</b>	<b>179,517</b>	<b>185,008</b>	<b>190,551</b>
<b>TOTAL EXPENDITURES</b>	<b>146,625</b>	<b>139,399</b>	<b>141,899</b>	<b>146,163</b>	<b>150,906</b>	<b>155,913</b>	<b>160,007</b>	<b>164,304</b>	<b>168,695</b>	<b>173,237</b>	<b>177,850</b>	<b>182,733</b>	<b>187,698</b>
<b>GRAND NET SURPLUS (DEFICIT)</b>	<b>\$ (1,767)</b>	<b>\$ 33</b>	<b>\$ (937)</b>	<b>\$ (2,154)</b>	<b>\$ (4,280)</b>	<b>\$ (4,410)</b>	<b>\$ (3,300)</b>	<b>\$ (2,372)</b>	<b>\$ (1,082)</b>	<b>\$ 393</b>	<b>\$ 1,667</b>	<b>\$ 2,275</b>	<b>\$ 2,853</b>



## Sound tax policy

---

- Predictability
- Reliability
- Equity
- Simplicity
- Relationship between federal, state and local

## “California Dreaming: A More Competitive Tax Climate?”



**Scott Hodge**

President

202-464-6200

[www.TaxFoundation.org](http://www.TaxFoundation.org)

1

### **Tax Foundation’s Mission Since 1937:**

- ✓ Authorities on and Advocates for Economically Sound Tax Policy
- ✓ Stick to Principles: Taxes should be Neutral, Simple, Stable, Transparent, Promote Growth.
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2

## California Tax Climate in Brief

- ☞ Outmigration is shrinking the state's tax base.
- ☞ CA's Tax Burden is Among Nation's Highest
- ☞ CA's Tax Climate is Near Bottom
- ☞ Personal and Corporate Income Tax Rates Near the Top
- ☞ Neiman Marcus corporate income taxes when you need Wal-Mart tax prices.
- ☞ Sales Tax Rate Near the Top

### Solution:

- ✓ Take Utah/Colorado Approach: Reduce corporate & personal rates to same low level (say 5%). Eliminate incentives.

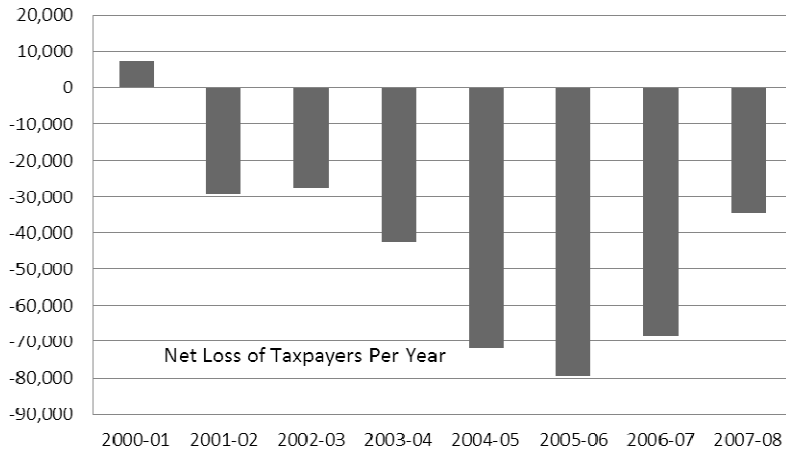
3

## How Others Rank California

- Chief Executive Magazine – #51
- CNBC's America's Top States for Business – #32
- Forbes The Best States for Business – #40
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4

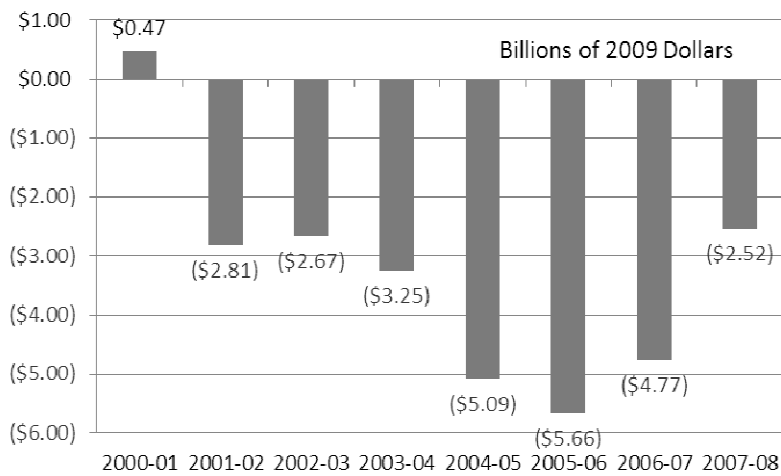
**Since 2000, Outmigration has Cost California More than 346,000 Taxpayers to Other States**



Source: Tax Foundation based on IRS Data

5

**Since 2000, California has Lost \$26.3 Billion in AGI to Other States**

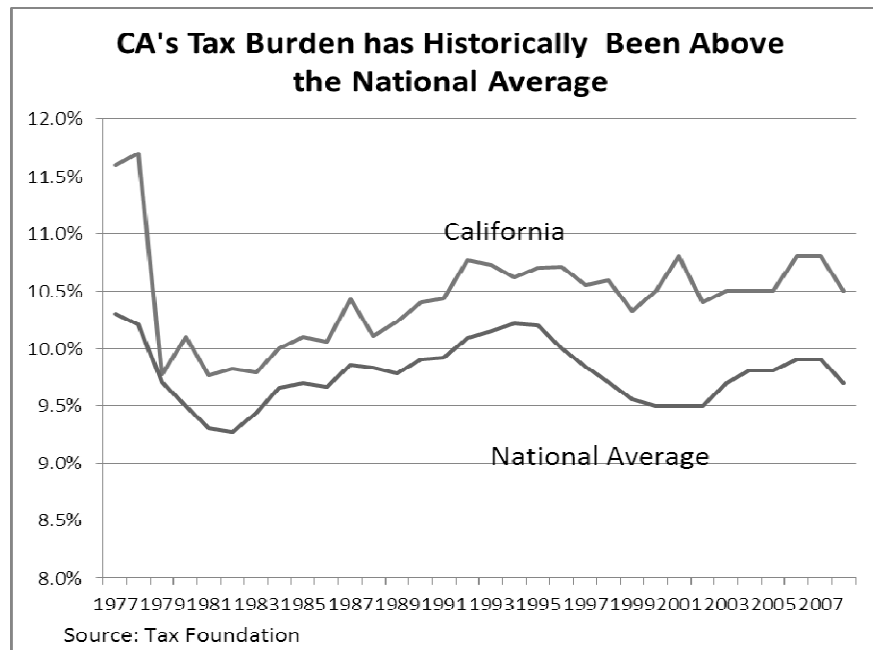


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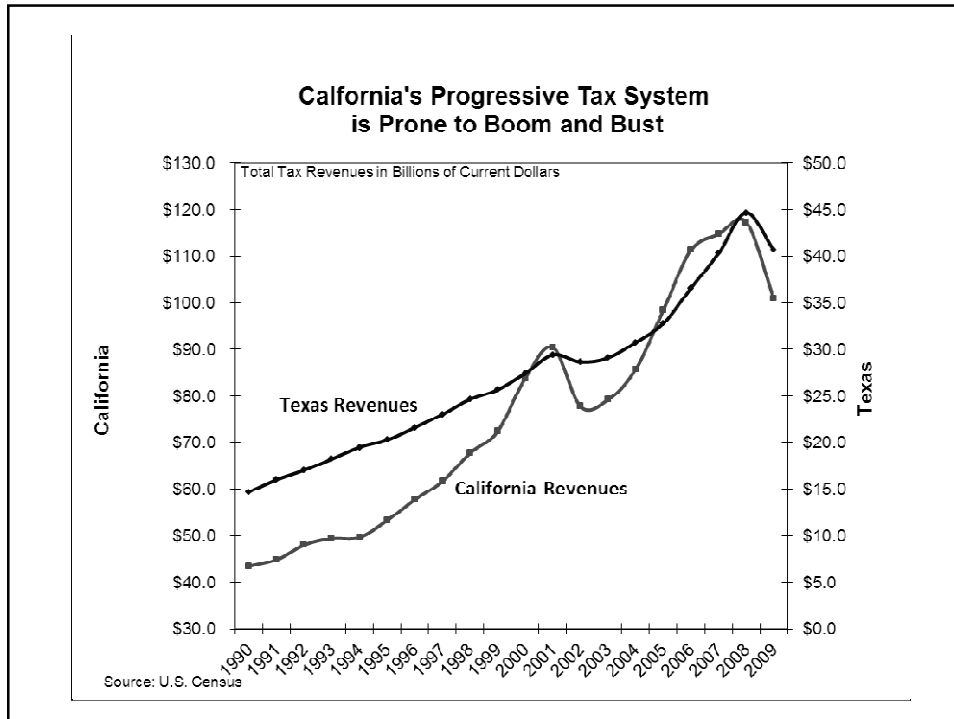
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## Two Ways to Judge a State's Tax System

- ✓ How Much a State Taxes – the Tax Burden
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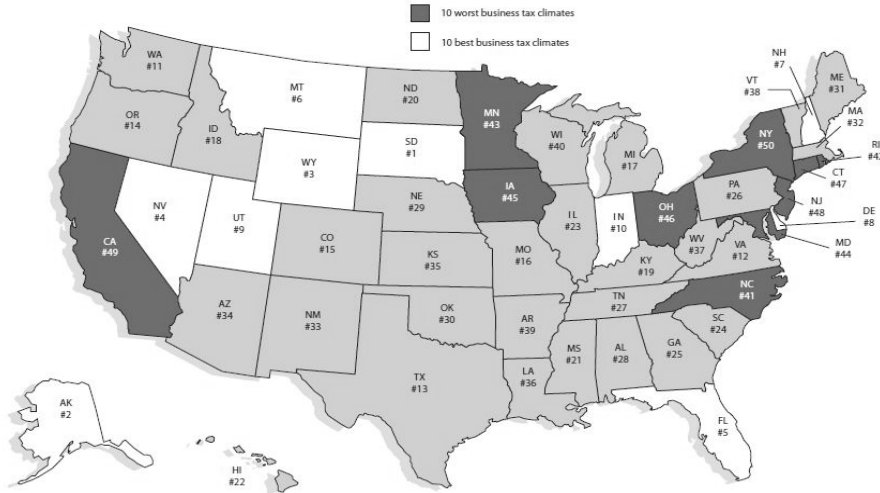


## State Business Tax Climate Index

- Assess the structure of a state's tax system
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- More than just "corporate" index
- Assesses 5 major areas of a state's tax system:  
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- Tiers up into a national ranking of "tax friendliness" to business

# CA Ranks 49<sup>th</sup> on State Business Tax Climate Index

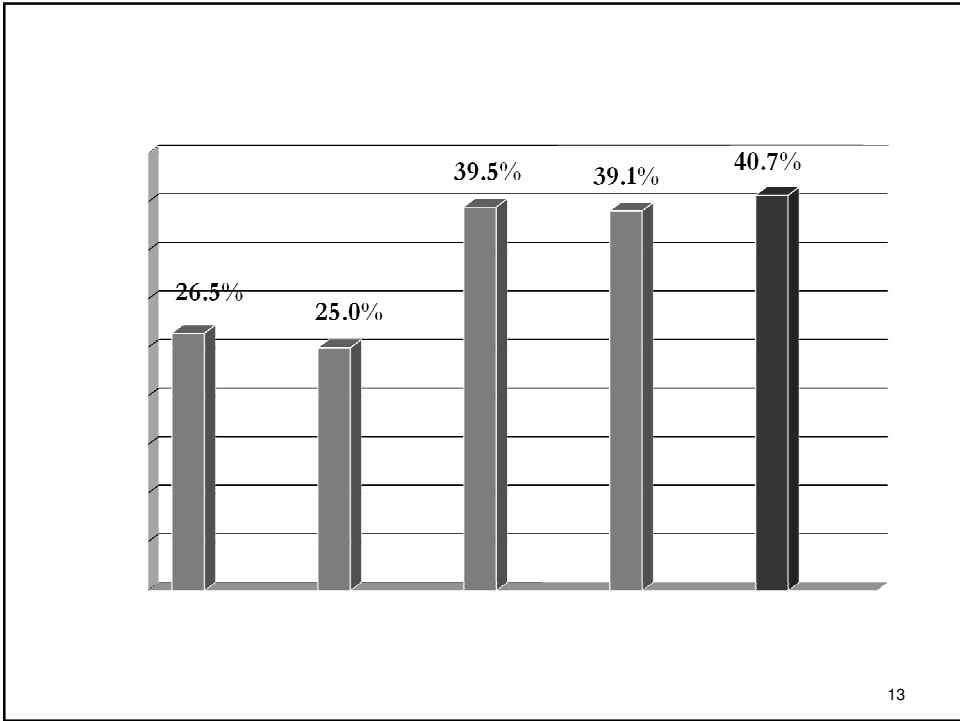
State Business Tax Climate Index, Fiscal Year 2011



## Corporate Income Tax: CA's Rate is Among the Nation's Highest



California	8.84%
Arizona	6.97%
Idaho	7.6%
Oregon	7.9%
Nevada	none
Utah	5.0%
Washington	none*



## Personal Income Tax: CA's Rate is Among the Nation's Highest



California	10.55%
Arizona	4.54%
Idaho	7.8%
Oregon	11.0 %
Nevada	none
Utah	5.0%
Washington	none

## Sales Tax: CA's Rate is Among the Nation's Highest



California	9.06%
Arizona	7.92%
Idaho	6.0%
Oregon	none
Nevada	7.59%
Utah	6.61%
Washington	8.78%



## Dreaming of a Better Business Tax Climate?

- ☑ Harmonize the corporate and individual rates.
- ☑ Follow Colorado/Utah model, uniform rate (say 5%) on both corporate and non-corporate firms.
- ☑ Broaden the tax base.
- ☑ Stay out of the incentive business. Lower rates for all are better and fairer than incentives for some.

## **Reasons to Cut California's Corporate Tax Rate**

### 1. Corporate Tax is Most Harmful for Growth

According to the OECD study *Tax and Economic Growth* (2008):

“Corporate taxes are found to be most harmful for growth, followed by personal income taxes, consumption taxes, then property taxes.”

“Evidence...suggests that lowering statutory corporate tax rates can lead to particularly large productivity gains in firms that are dynamic and profitable, i.e. those that can make the largest contribution to GDP growth.”

“Lower corporate and labour taxes may also encourage inbound foreign direct investment, which has been found to increase productivity of resident firms.”

17

## **More Reasons to Cut California's Corporate Tax Rate**

### 2. Workers Bear 45-75% Economic Cost of Corporate Tax (and share in benefit of lower corporate taxes).

- Tax Foundation (2009): “For every \$1 states raised corporate taxes, wages were found to fall by \$2.50.”
- Felix and Hines (2010): “The estimates imply that if a firm’s workforce is entirely unionized, then roughly 54 percent of the cost of higher tax rates is borne by union members in the form of lower wages.”
- Gyourko & Tracy (1989): A one percent higher state corporate tax rate is associated with one percent lower wages.

18

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- **Studies:** Fox & Murray (2004): "The results show that large firms fail to produce significant net benefits for their host regions, calling into question the high-stakes bidding war over jobs and investment."
- **Experience:** North Carolina gave millions to Dell to open a factory that closed within five years.
- **Bottom Line:** Incentives are to your economy what steroids are to the human body – short-term gain at the expense of long-term harm.

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## Act Now. Time is Running Out



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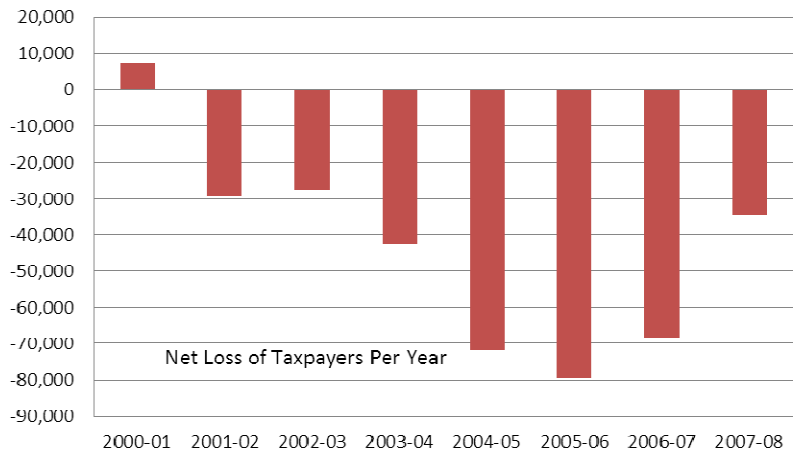
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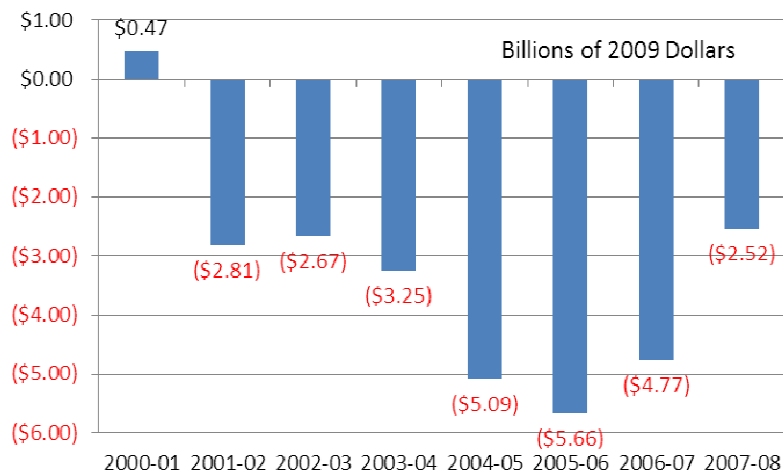
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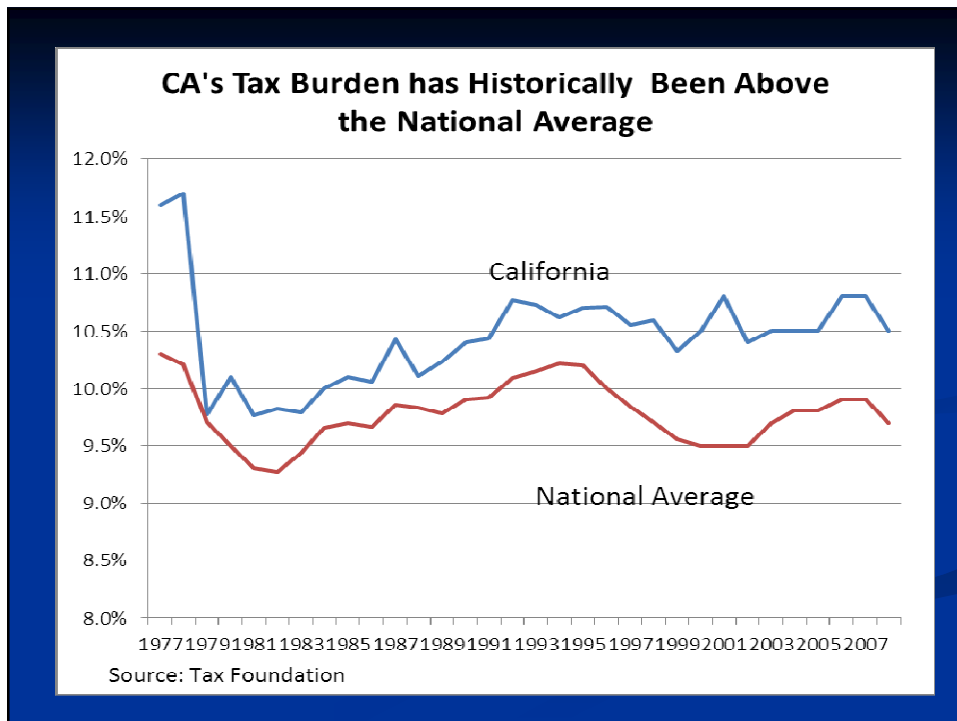


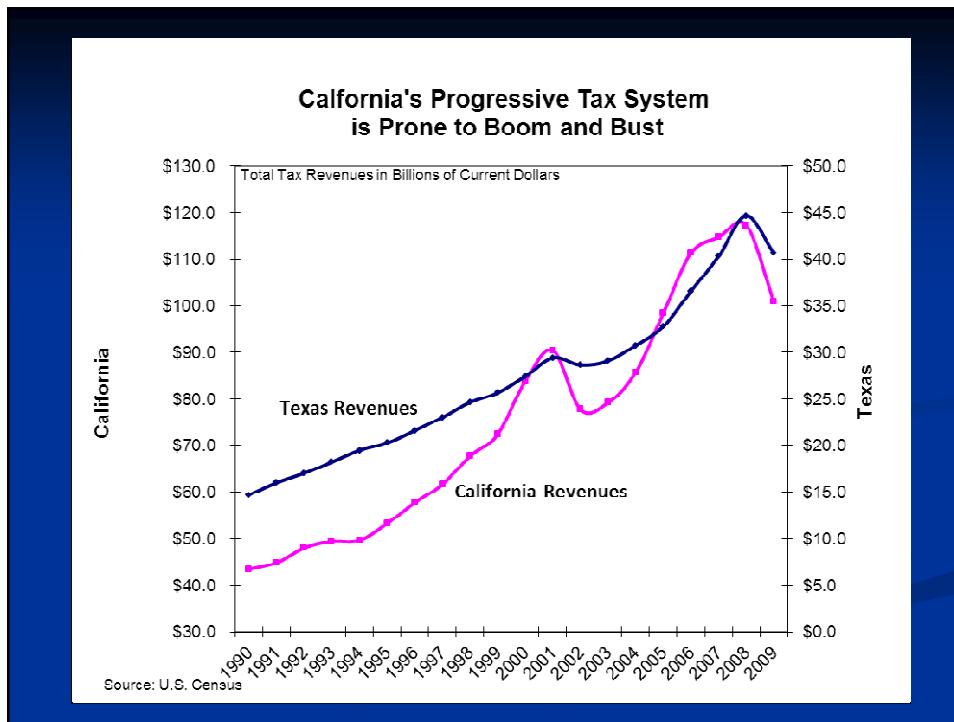
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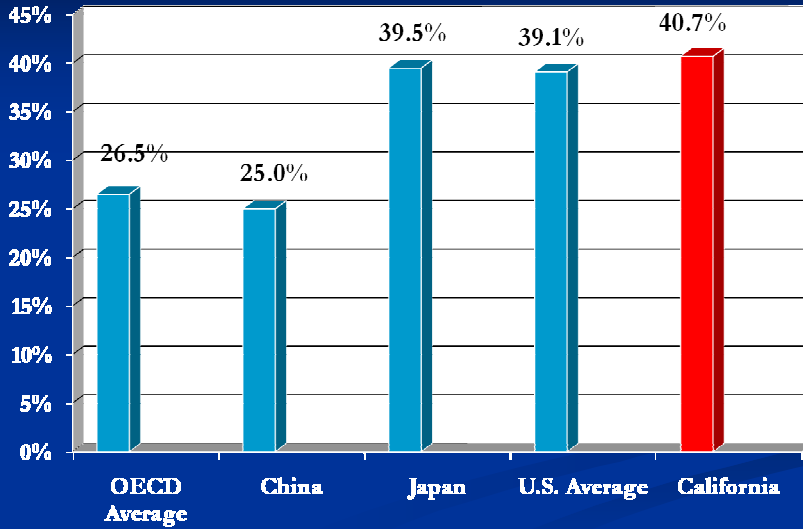


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## ...And is High Globally



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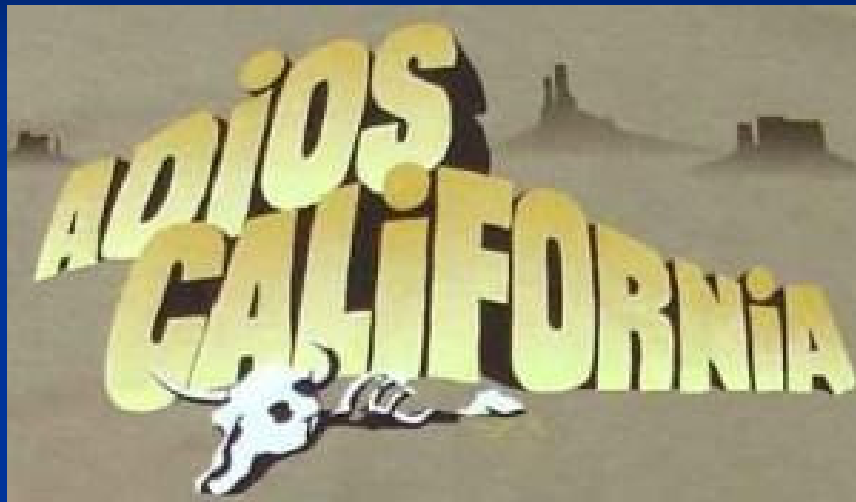
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19

## Act Now. Time is Running Out





## Getting started

TEI-SJSU Tax Policy Conference  
February 11, 2011

1

## What is tax policy?

- Considerations involved in design of a tax system and its components.
  - The appropriate type and mix of taxes.
  - Tax base.
  - Rate structures.
  - Who is the taxpayer?
    - Directly and indirectly.
  - Administrative and compliance structure.
  - Intergovernmental considerations.
- And ... there may be legal constraints (constitutional, statutory, judicial) that affect all of the above.

2

## Tax policy/design should lead to ...

- A “workable” tax system that ...
  - Taxpayers understand.
  - Allows for effective and efficient funding of the desired level of government spending.
  - Enables reasonable predictability for creating government budgets.
  - Considers the jurisdiction’s economic, societal, and environmental goals (it should not work in opposition to them).

3

## Goals for our conference

- Broaden our understanding and awareness of some of the many facets of CA’s fiscal structure.
  - Expand beyond technical understanding of tax rules.
  - Better enable us to engage in tax reform discussions.
  - Be better informed citizens/voters.
- Civil discourse
  - To engage in respectful discussion.
  - To learn from each other.

4

## Thank you ...

### *Planning Committee:*

- Greg Benz, PG&E
- George Famalett, pwc
- Dan Kostenbauder, Hewlett Packard
- Larry Langdon, Mayer Brown
- Annette Nellen, SJSU
- Pat Powers, Baker & McKenzie
- Kim Reeder, Morgan Lewis
- Ray Rossi, Intel

### *Event Organizers – SJSU Dept of Accounting & Finance:*

- Nathan Lee
- Huong Thu Nguyen
- Thao Pham
- Julie Ryan

### *Our presenters and their employers*

*Our sponsors  
(see front cover of  
notebook)*

5

## Save the Date ...

- **2011 TEI-SJSU High Tech Tax Institute**
  - November 7 & 8, 2011

[www.tax-institute.com](http://www.tax-institute.com)

**At the Crowne Plaza Cabana in Palo Alto**

6

TEI-SJSU Tax Policy Conference  
Friday, February 11, 2011

# RELEVANCE OF THE FEDS

Oksana G. Jaffe, Chief Consultant  
California Assembly Committee on Revenue and Taxation  
(916) 319-2098  
[oksana.jaffe@asm.ca.gov](mailto:oksana.jaffe@asm.ca.gov)

**TEI-SJSU TAX POLICY CONFERENCE  
THE STATE OF TAX POLICY IN CALIFORNIA**

- ◉ Overview of the State-Federal Relationship
- ◉ Monitoring Federal Tax Legislation
  - State tax agencies (Franchise Tax Board, Employment Development Department, Office of the State Treasurer)
  - Legislative committees (tax-writing committees)
  - Special interest groups
  - Constituents
  - Media
- ◉ Evaluation of Federal Tax Proposals in the Context of California's Tax Laws
  - Evaluation Criteria:
    - Purpose
    - Fairness
    - Effectiveness
    - Impact on taxpayer behavior

2

**TEI-SJSU TAX POLICY CONFERENCE  
THE STATE OF TAX POLICY IN CALIFORNIA**

- Revenue impact
- Political ramifications

○ **Tax Conformity**

- Several approaches to conformity:
  - “Rolling” conformity (automatic conformity to the latest version of the Internal Revenue Code (IRC)).
  - “Fixed” or “static” conformity (where the IRC is followed as of a certain, fixed date).
  - “Selective” conformity (adoption of only certain provisions or certain provisions as of certain dates). California is a “selective” conformity state.

○ **Advantages of State Tax Conformity**

- Uniformity and simplicity promotes ease of compliance and the efficient administration of taxes.
  - Exclusion for health care benefits provided to qualifying adult children.
  - Definition of “Subpart F” income.

3

**TEI-SJSU TAX POLICY CONFERENCE  
THE STATE OF TAX POLICY IN CALIFORNIA**

- Reduced compliance costs for both tax agencies and taxpayers.
- Increased predictability when taxpayers and state administrative personnel can rely on federal administrative guidance.
  - In California, where the California Revenue and Taxation Code conforms to the IRC, federal administrative guidance governs the interpretation of conforming state statutes, “with due account for state terminology, state effective dates, and other obvious differences between state and federal law.” (FTB Information letter 2010-5).
- Minimization of Tax Avoidance.

○ **Challenges of State Tax Conformity**

- Loss of legislative decision-making authority over state tax policy.
- Delays in legislative action when a state needs to conform to new legislation affirmatively (political gridlock).
  - The passage of Proposition 26 will make future conformity measures more difficult to enact due to a new 2/3 vote requirement.

4

**TEI-SJSU TAX POLICY CONFERENCE  
THE STATE OF TAX POLICY IN CALIFORNIA**

- Loss of control over state revenues.
- The acceptance of federal administrative guidance as persuasive authority in interpreting California statutes may lead to unanticipated results.
  - On October 20, 2008, the IRS issued Notice 2008-83 (stating that, after an ownership change, any deduction properly allowed to a bank with respect to losses on loans or bad debts would not be subject to the limitations of Section 382 of the IRC). The notice was later repealed by Congress but, potentially, it could have caused California to suffer a substantial revenue loss.
  - AB 11 and AB 692 were introduced in 2009 to deal with the impacts of Notice 2008-83 on California state tax law and state revenues.

5

**TEI-SJSU TAX POLICY CONFERENCE  
THE STATE OF TAX POLICY IN CALIFORNIA**

- California's Concerns with Federal Tax Law and Legislation
  - Temporary Tax Incentives (R&D Credit, Section 965, latest federal stimulus tax provisions) and their potential impact on California's tax policy and economy.
    - Taxpayer behavior
    - Economic activity in the state
    - State revenues
  - Can California influence the Feds and federal tax legislation?
    - Tax Shelter Legislation
    - Senate Joint Resolution 30 (urges Congress to allow all eligible state and local government employees participating in 457(b) deferred compensation plans to treat their elective deferrals as designated Roth contributions).
    - Assembly Joint Resolution 29 (urges IRS to defer to California law on the treatment of property belonging to same-sex spouses, so that beginning with the 2011 tax year, each same-sex spouse must include in his/her gross income one-half of the community's income when filing separate federal income tax returns).

6

**TEI-SJSU TAX POLICY CONFERENCE  
THE STATE OF TAX POLICY IN CALIFORNIA**

- But see Senate Joint Resolution 20 (urging Congress to increase the amount of capital gain excludable from a senior citizen's income, if it is realized on the sale of the senior citizen's principal residence).
- The impact of federal tax provisions on California's General Fund.
  - The health care reform acts (The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (P.C. 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152)).
  - Section 1603 of the American Recovery and Reinvestment Act (ARRA) of 2009 (P. L. 111-5) (federal energy grants in lieu of the federal energy credits).

7

**TEI-SJSU TAX POLICY CONFERENCE  
THE STATE OF TAX POLICY IN CALIFORNIA**

Questions?

8

# Principles of Sound State Tax Policy



Modern Tax Architecture

[www.21stcenturytaxation.com/](http://www.21stcenturytaxation.com/)

Annette Nellen, CPA, Esq.  
San José State University  
[www.cob.sjsu.edu/nellen\\_a/](http://www.cob.sjsu.edu/nellen_a/)  
TEI-SJSU Tax Policy Conference  
February 11, 2011

1

## Purpose of a Tax Policy Framework

1. To achieve a “high-quality state revenue system.” [NCSL]
2. To guide tax reform by helping to:
  - a. Identify weaknesses in the existing tax system.
  - b. To adequately analyze any proposal for change.
3. To allow for a more objective analysis approach.

2

## The Principles

1. Equity
2. Certainty
3. Convenience of payment
4. Economy of collection
5. Simplicity
6. Neutrality & efficiency
7. Economic growth and efficiency
8. Transparency, visibility & accountability
9. Minimum tax gap
10. Appropriate government revenues

Presentation of principles based on AICPA and NCSL principles of good tax policy and a high-quality revenue system.

3

## Equity

**Similarly situated taxpayers should be taxed similarly.**

- “Fairness” tied to notions of ...
  - Horizontal equity
  - Vertical equity:
    - Minimize regressivity.
    - Minimize burden on low-income individuals.
  - The *perception* of fairness.

4

## Additional equity considerations

- Consider:
  - Entire range of taxes a taxpayer is subject to.
  - Ability to pay.
  - Benefits received.
- Query: What does “similarly situated mean”?
  - How to factor in age, health, regional differences in cost-of-living, family size, nature of income or assets, type and size of business, etc.?
- Query: How to tie concept to tax mix decisions?
  - EX – income tax versus consumption tax, polluter-pays taxes versus other taxes.

5

## Certainty

**Tax rules should specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.**

- Certainty, rather than ambiguity.
- Ability to determine tax base, rate and taxpayer.
- Basically, the level of confidence that exists that the tax is being calculated correctly.
- Keep changes to a minimum.
- Ties to *stability* because greater certainty in the tax system means fewer changes needed.
- Ties to *economy in collection* because uncertain system is costly to comply with.

6



## Convenience of Payment

**A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.**

- Helps ensure compliance.
- Appropriate payment mechanism depends on amount of liability and ease of collection.
- Also consider at which level to collect tax in the chain of parties (for example, distributor versus final consumer).

7

## Economy of Collection

**The costs to collect a tax should be kept to a minimum for both the government and taxpayers.**

- What is administrative cost as percent of tax generated annually? Will agency need to hire more employees?
- Will costs be so high as to deter people from entering a particular industry?
- Calls for efficient, uniform and fair administration of the tax.
- Closely related to *simplicity* principle.

8

## Simplicity

**The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.**

Simplicity:

- Reduces the amount of errors.
- Increases respect for the system.
- Enables taxpayers to understand tax consequences of their transactions.
- Should exist in both the law and compliance process.

9

## Neutrality & Efficiency

**The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.**

- Primary purpose of tax system is to raise revenue.
- Taxpayers should not be unduly encouraged or discouraged from engaging in certain activities due to the tax law.
- Tax break for some taxpayers means higher taxes for others.
- When non-neutrality approach is used, purpose should be explicit.
- Special rules should be reviewed regularly to determine if still needed or if changes are warranted.

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## Economic Growth & Efficiency

**The tax system should not impede or reduce the productive capacity of the economy.**

- Tax system should be aligned with the economic goals of the jurisdiction imposing the tax.
  - Should be aligned with state's goals for economic growth, capital formation, interstate and int'l competitiveness.
  - Consider broad bases that keep rates low to improve competitive position to other states.
  - Should not favor one industry or type of investment at the expense of others.

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## Transparency, Visibility & Accountability

**Taxpayers should know that a tax exists and how and when it is imposed upon them and others; system should be accountable to taxpayers.**

- Taxpayers should be able to see the true cost of transactions.
- Taxpayers should know when tax is being assessed or paid and to whom.
- Requires regular review of tax expenditures, special tax rules, and earmarked funds.

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## In a Transparent Tax System ...

### Taxpayers:

- can easily calculate liabilities
- grasp logic behind tax laws and rates
- know their own tax burden and that of others
- are aware of extent of compliance by others

[GAO, *Understanding the Tax Reform Debate: Background, Criteria and Questions*, GAO-05-1009SP (2005), pages 47-48;  
<http://www.gao.gov/new.items/d051009sp.pdf>]

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## Minimum Tax Gap

### **A tax should be structured to minimize noncompliance.**

- Tax gap = amount owed less amount collected.
- Procedural rules needed to attain compliance.
- Generally, is a need to strike a balance between:
  - (a) desired level of compliance, and
  - (b) costs of enforcement and the level of intrusiveness of the tax system.
- [General Accounting Office (GAO), *Reducing the Tax Gap – Results of a GAO-Sponsored Symposium*, June 1995, GAO/GGD-95-157, page 13]

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## Techniques to reduce the tax gap

- Information reporting.
- Sharing of information between various government agencies and with federal government.
- Tax education to reduce unintentional mistakes and help people see the cost to them of the non-compliance of others.

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## Appropriate Government Revenues

**The tax system should enable the government to determine how much tax revenue will likely be collected and when.**

- Predictability, sufficiency, reliability, stability.
- Better stability with a mix of taxes.
- Should support healthy budget process:
  - Minimize use of earmarked taxes.
  - Have mechanism for occasional windfall revenues (e.g. Rainy Day Fund).
- Consider local and federal relationships:
  - Is state tax deductible for federal individual income tax purposes?
  - What federal rules and proposals support or harm state revenues?
    - Monitor federal tax rules and proposals and be involved.
  - State tax policy should not impede local tax policy.

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## Additional policy/design considerations

### 1. Strategic planning

- Identify state's economic, societal and environmental goals and how tax system can support them and where current rules work against the goals.

### 2. Modernization

- Check regularly to consider changes in ways of doing business and living, improved technology
- Plan ahead
  - EX – Oregon's 2001 task force on alternatives to gas tax

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## Additional policy/design considerations

### 3. Transition in major changes

- Phase-in or phase-out.
- Allow taxpayers sufficient time to get ready to deal with a new tax.
  - Successful example – Ohio CAT
  - Unsuccessful example – Michigan expansion of sales tax to selected services effective in 2 months

### 4. Pursue public education on taxes

- Low understanding of taxes:
  - Impedes ability to make changes or leads to voters enacting less than ideal rules.
  - Increases tax gap (example – use tax).

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## Challenges

- Too easy to overlook principles in dealing with budget shortfalls and short time frames.
- Lack of unified support or awareness of benefits of considering principles of good tax policy.
- Desire to use the tax law for more than raising revenue.
- Frequent changes to the federal tax laws.
- Not all principles can be achieved to same degree for all proposed changes - need to strike a balance.

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## SWOT Analysis for PIT and Sales/Use Tax



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## Personal Income Tax (PIT)

- Equity –
  - More individuals subject to PIT today than in 2008
    - 2010, family with 2 children, claiming renter's credit, won't owe any tax until income exceeds \$36,590
      - 2008, that figure was \$51,334 due to higher exemption amount for dependents, and slightly lower tax rate
    - 2010 – top rate of 9.55% starts when taxable income reaches \$93,532 for MFJ
  - No special rate for capital gain income.
  - Deductions and exclusions worth more to higher bracket individuals.
  - Some “tax expenditures” may be unnecessary:
    - Does CA need to provide subsidy if already given by feds?
    - Why is Social Security income not taxable by state?
    - Why a senior exemption based on age rather than income?

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## PIT changes 1991 v 2008 v 2009

Table 5: Tax Threshold for a Family of Four, 1991-2009

State	1991	2000	2007	2008	2009	Change 1991-2009	Change 2008-2009
California	20,900	36,800	46,100	\$48,300	\$31,000	\$10,100	-\$17,300
Colorado	14,300	27,900	24,300	\$24,900	\$26,000	\$11,700	\$1,100
New York	14,000	23,800	37,200	\$38,300	\$40,300	\$26,300	\$2,000
Average	\$11,736	\$18,474	\$24,026	\$25,500	\$26,307	\$14,571	\$807
Federal Poverty Line	\$13,924	\$17,603	\$21,203	\$22,017	\$21,947	\$8,023	-\$70

- Only 2 states had lower tax threshold in 2009 than 2008 – CA at \$17,300 and Montana at \$200; 7 states had no change.
- Source: Center on Budget & Policy Priorities, *The Impact of State Income Taxes on Low-Income Families in 2009*, 4/29/10; <http://www.cbpp.org/cms/index.cfm?fa=view&id=3173>.

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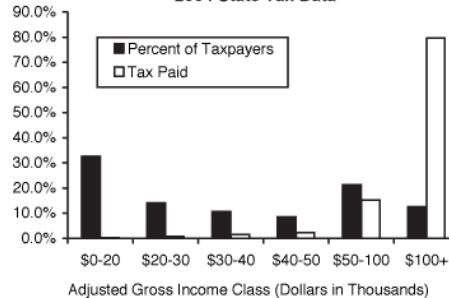


## 2004 – 80% of PIT was paid by individuals with AGI over \$100,000

Today, that percentage would be lower.

Query – What is the right distribution?  
Need to consider mix of taxes paid, mix of deductions, exclusions and credits, and more.

Figure REV-03  
Percent of Taxpayers and Percent of Tax Paid by Adjusted Gross Income Class  
2004 State Tax Data



Source: Governor's Budget 2007-2008, General Fund Revenue.

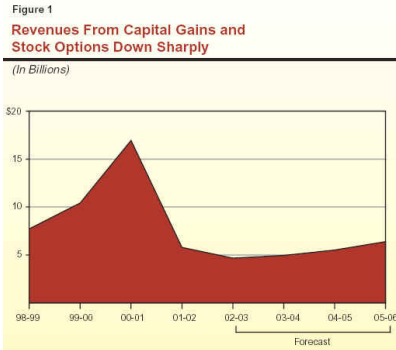
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## Personal Income Tax (PIT) - more

- Certainty
  - Conformity legislation lags
  - Effect of Prop 26 for 2010
- Simplicity
  - Conformity lags
  - Starting point for PIT is federal AGI
- Economic growth and efficiency
  - Volatility in PIT can harm state budget
  - CA PIT rate (9.55%) higher than many other states
    - CA Mental Health Tax = 1% above \$1 million
    - Top rates for 2010 in: [[http://www.taxadmin.org/fta/rate/ind\\_inc.pdf](http://www.taxadmin.org/fta/rate/ind_inc.pdf)]
      - Hawaii and Oregon 11%
      - New York 8.97%
      - Arizona 4.54%

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## Personal Income Tax (PIT) - more



LAO, California's Fiscal Outlook, LAO Projections, 2002-03 Through 2007-08, 11/14/02;  
[http://www.lao.ca.gov/2002/fiscal\\_outlook/fiscal\\_outlook\\_2002.html](http://www.lao.ca.gov/2002/fiscal_outlook/fiscal_outlook_2002.html).

- Appropriate gov't revenues
  - Volatility due to large portion of PIT generated from small number of high income individuals + state's high reliance on PIT

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## Sales & Use Tax

- Equity
  - High state and local rate
    - Santa Clara County = 9.25%
  - Regressive
  - Many items of high end consumption not taxable
    - Personal services
    - Entertainment
    - Digital goods
    - Utilities
- Neutrality
  - Modern era can affect decision-making and create inequities:
    - Music or software on CD – sales tax
    - Music or software via digital download – NO sales tax
    - ... and no sales tax if see the performer in concert or use software in the cloud.

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## Sales & Use Tax - more

- **Certainty**
  - Numerous exemptions require specific definitions.
  - Sellers with CA customers may not be clear as to whether they have nexus or if the item is taxable.
- **Economic growth and efficiency**
  - Businesses pay sales tax on tangible personal property unless is sale for resale.
    - Pyramiding problem.
  - Too expensive to manufacture in CA
    - Only sales tax break is if qualify for California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) procedures.

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## Sales & Use Tax - more

- **Minimum tax gap**
  - Over \$1 billion / year use tax uncollected
- **Appropriate government revenues**
  - Broader base should reduce any volatility.
  - Better use tax collection system needed particularly as number of remote vendors increases and e-commerce continues to grow.
- **Simplicity**
  - Broader base leads to more filers
    - Simple approaches to compliance are possible.

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## For more information

- Analysis of weaknesses in CA taxes and possible improvements analyzed against principles of good tax policy:
  - [http://www.21stcenturytaxation.com/California\\_Tax\\_Reform.html](http://www.21stcenturytaxation.com/California_Tax_Reform.html)
- Examples of application of principles of good tax policy:
  - CA Commission on Tax Policy in the New Economy - <http://www.library.ca.gov/crb/catax/>
  - Vermont 2010 - <http://www.leg.state.vt.us/jfo/Tax%20Commission/assessment%20tool.pdf>

## Policy Approach to Analyzing Tax Systems

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**Overview:** This analysis is based on testimony presented by Professor Nellen on 4/21/03 to the Commission on Tax Policy in the New Economy,<sup>1</sup> at the California State Capitol Building in Sacramento, CA. It is based on the AICPA Tax Policy Concept Statement 1 – *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*. The ten principles laid out in that statement are compared to frameworks used by other groups including government agencies and tax reform panels. The comparison list has subsequently been expanded. The purpose is to illustrate that there is a core set of tax principles that can effectively be used to evaluate tax proposals and existing tax systems. At the state and local level, additional principles may be included such as the possible effect on interstate competition.

**Tax Policy Perspectives:** Analyses of tax systems almost always looks at tax principles as criteria for understanding and critiquing tax systems. The principles are typically the same although terminology, emphasis and sequencing may differ. Listed below are some examples of tax system analyses that have applied principles of good tax policy and effective tax systems.

**American Institute of Certified Public Accountants (AICPA) – Tax Policy Concept Statement 1 – *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals***  
<http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/Advocacy/DownloadableDocuments/Tax%20Policy%20Concept%20Statement%20No.%201.doc>.

This report, issued in 2001,<sup>2</sup> lays out ten principles of good tax policy that had been used by lawmakers and others for decades, if not centuries. The purpose of the statement was to provide a tool for policymakers to evaluate existing tax rules or systems, as well as reform proposals to determine where improvements were needed to make the rule or system more effective. The ten principles are summarized below.

- **Equity and Fairness** - Similarly situated taxpayers should be taxed similarly.
- **Certainty** - The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.
- **Convenience of Payment** - A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.
- **Economy in Collection** - The costs to collect a tax should be kept to a minimum for both the government and taxpayers.
- **Simplicity** - The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.

<sup>1</sup> The Commission used the AICPA version of the principles in their final report;  
<http://www.library.ca.gov/crb/catax/>.

<sup>2</sup> The author of this report (Annette Nellen) was the lead author for both the AICPA and Joint Venture documents noted here.

- **Neutrality** - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.
- **Economic Growth and Efficiency** - The tax system should not impede or reduce the productive capacity of the economy.
- **Transparency and Visibility** - Taxpayers should know that a tax exists and how and when it is imposed upon them and others.
- **Minimum Tax Gap** - tax should be structured to minimize non-compliance.
- **Appropriate Government Revenues** – The tax system should enable the government to determine how much tax revenue will likely be collected and when.

**Joint Venture: Silicon Valley Network** - In 2001, the Tax Policy Group of Joint Venture: Silicon Valley Network turned the AICPA's 10 principles into a workbook to help elected officials and others in applying the 10 principles to analyze tax proposals. In doing so, they reorganized the 10 principles into three categories as follows (<http://www.jointventure.org/images/stories/pdf/taxworkbook.pdf>):

- Fairness
  - Equity and Fairness
  - Transparency
- Operability
  - Certainty
  - Convenience of Payment
  - Economy of Collection
  - Simplicity
  - Minimum Tax Gap
  - Appropriate Government Revenues
- Appropriate Purpose and Goals
  - Neutrality
  - Economic Growth and Efficiency

**Joint Committee on Taxation** – *Description and Analysis of Proposals To Replace the Federal Income Tax*, JCS-18-95, 6/5/95, pages 58 – 59. <http://www.house.gov/jct/s-18-95.pdf>

Excerpt:

“Analysts generally judge tax systems in term so how well the tax system answers four different questions.

- First, does the tax system promote or hinder economic efficiency. That is, to what extent does the tax system distort taxpayer behavior? Does the tax system create a bias against the domestic production of goods and services? To what extent does it promote economic growth?
- Second, is the tax system fair? Does the tax system treat similarly situated individuals similarly? Does the tax system account for individuals' different capacities to bear the burden of taxation?

- Third, is the tax system simple? Is it costly for taxpayers to determine their tax liability and file their taxes?
- Fourth, can the tax system be easily administered by the government and can it induce compliance by all individuals? Is enforcement costly? Can some individuals successfully avoid their legal liabilities?

The design of a tax system involves tradeoffs between these different goals. Measures designed to ensure compliance may increase the complexity of taxation for individual filers. Measures designed to promote simplicity may create distortions in individual choice of investments. Measures designed to promote growth may alter the distribution of the tax burden.”

**Government Accountability Office (GAO)** – *Understanding the Tax Reform Debate: Background, Criteria and Questions*, GAO-05-1009SP (9/05); <http://www.gao.gov/new.items/d051009sp.pdf>.

Excerpt:

“Long-standing” criteria for evaluating tax policy:

1. Equity – including principles of:
  - a. Ability to pay
    - i. Horizontal equity
    - ii. Vertical equity
  - b. Benefits received
2. Economic Efficiency
  - a. Efficiency costs include (1) taxes owed, (2) “efficiency cost” (costs that reduce well-being – effect of taxes on decisions to do or not to do something), and (3) compliance costs.
3. Combination of simplicity, transparency, and administrability
  - a. Simplicity:
    - i. Compliance burden
  - b. Transparency of
    - i. Tax calculations
    - ii. Logic behind the rules
    - iii. Tax burden
    - iv. Compliance
  - c. Administrability
    - i. Processing returns
    - ii. Enforcing the law
    - iii. Providing taxpayer assistance

**National Conference of State Legislatures (NCSL)** – A set of nine principles were developed by a bipartisan group of legislators, staff and others from both the public and private sectors in 1991.<sup>3</sup>

These principles of a “high-quality state revenue system” are:<sup>4</sup>

<sup>3</sup> Scott Mackey, *Tax Policy Handbook for State Legislators*, NCSL, 12/97, pg. 7.

<sup>4</sup> NCSL, *Principles of a High-Quality State Revenue System*, updated 6/07; <http://204.131.235.67/programs/fiscal/fpphqsr.htm>.

“Principles of a High-Quality State Revenue System:

1. A high-quality revenue system comprises elements that are complementary, including the finances of both state and local governments.
2. A high-quality revenue system produces revenue in a reliable manner. Reliability involves stability, certainty and sufficiency.
3. A high-quality revenue system relies on a balanced variety of revenue sources.
4. A high-quality revenue system treats individuals equitably. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.
5. A high-quality revenue system facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.
6. A high-quality revenue system promotes fair, efficient and effective administration. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.
7. A high-quality revenue system is responsive to interstate and international economic competition.
8. A high-quality revenue system minimizes its involvement in spending decisions and makes any such involvement explicit.
9. A high-quality revenue system is accountable to taxpayers.”

**California Legislative Analyst’s Office** – *The 2003-04 Budget Bill: Perspectives and Issues – The Governor’s Tax Proposal: Evaluation and Alternatives*, February 2003,  
[http://www.lao.ca.gov/analysis\\_2003/2003\\_pandi/pi\\_part\\_5a\\_taxes\\_anl03.html](http://www.lao.ca.gov/analysis_2003/2003_pandi/pi_part_5a_taxes_anl03.html).

“Excerpt (Figure 2)

Essential Criteria for Evaluating The Governor’s Tax Proposals:

- *Growth Performance*—Will the new tax revenues grow along with the economy and/or the program responsibilities they are expected to fund?
- *Reliability and Volatility*—Are new revenues raised by the taxes relatively stable over time or are they excessively volatile and difficult to predict?
- *Distributional Effects*—Is the additional burden or “incidence” from the increased taxes distributed among taxpayers in a manner that the Legislature believes is appropriate?
- *Tax Administration*—Are the new taxes simple to collect and administer or do they add additional complexity to the existing administrative structure?
- *Federal Interaction*—Would the increased taxes be deductible for federal purposes, allowing the state to “shift” some of the additional tax burden to the federal government?
- *Economic Climate*—What effects are the proposed tax increases likely to have on the business climate and overall economic activity?”

**Washington State Tax Structure Study Committee** – *Tax Alternatives for Washington State: A Report to the Legislature*, November 2002, Chapter 2  
<http://dor.wa.gov/Content/AboutUs/StatisticsAndReports/WAtaxstudy/wataxstudy.htm>.



The charge of the committee was to study Washington's existing tax structure and recommend alternatives to improve the system. The extensive report issued in 2002 begins with an explanation of tax principles for a "well-designed tax system." It also explains the existing structure and where it does and does not meet the tax principles. The study also explains various constraints to change that exist in the U.S. and state constitutions and local government funding limitations. Such constraints are important in reform efforts as they are limitations that likely can't be changed.

Various proposals are analyzed including major ones such as replacing a portion of the tax structure with some type of value-added tax or adding a state income tax (currently, Washington imposes no income tax). Incremental proposals such as continuing to impose an estate tax even after repeal of the federal tax, are also made. Additional proposals include extending the sales tax to consumer services, compensating vendors for collecting the sales tax, periodically reviewing exemptions and business incentives, and exempting construction labor from the sales tax. Each proposal made is analyzed in terms of it would allow the system to better meet the tax principles and what problems it might create in terms of not completely meeting particular tax principles.

The tax principles used to guide the committee's work were as follows.<sup>5</sup>

- Adequacy/stability/elasticity
- Equity/fairness
- Economic vitality and harmony with other states
- Economic neutrality and efficiency
- Transparency and administrative simplicity
- Home ownership

**Hawaii 2001-2003 Tax Review Commission – Report, 2003,**  
[http://www.state.hi.us/tax/trc/docs2003/trc\\_rpt\\_2003intro.htm](http://www.state.hi.us/tax/trc/docs2003/trc_rpt_2003intro.htm).<sup>6</sup>

The Commission used a set of principles for "sound tax policy" provided by the National Conference of State Legislatures (NCSL) that were compiled in 1988 with input from lawmakers and academics. The five principles are:

- 1) Provision of appropriate revenues – this principle focuses on sufficiency, stability and certainty of revenues produced.
- 2) Neutrality
- 3) Equity
- 4) Easy and economical to administer
- 5) Accountability – the focus is at three key levels: (i) taxpayers being accountable for paying their taxes, (ii) tax agencies accountable to administer and enforce the tax laws efficiently and fairly, and (iii) lawmakers accountable for the integrity of the tax laws.

Note: The NCSL list was expanded to nine principles by 2007 (see earlier description and chart below).

<sup>5</sup> The principles were provided to the committee in ESSB 6153 (likely some type of legislative directive).

<sup>6</sup> Hawaii's Tax Review Commission, 2005-2007 used the following principles: fairness, efficiency, simplicity, transparency and accountability, adequacy and stability, and competitiveness;  
[http://www.state.hi.us/tax/trc/docs2007/trc\\_rpt\\_2007intro.htm](http://www.state.hi.us/tax/trc/docs2007/trc_rpt_2007intro.htm).

**Georgia 2010 Special Council on Tax Fairness for Georgians<sup>7</sup> – Final Report, 2011**  
<http://fiscalresearch.gsu.edu/taxcouncil/index.htm>

This Georgia Council was formed in 2010 via legislation. Its final report was released in January 2011. The Council established seven principles to guide its work:

- 1) Growth Enhancing – "Tax policy should foster strong economic growth, job creation, and a rising standard of living for all Georgians."
- 2) Efficient – "Tax structures should minimize distortions of both household economic choices and of capital and labor allocations by business."
- 3) Stable – "The system of taxation should be stable such that changes in state revenue occur in line with changes in the general level of economic activity so that frequent changes in tax rates and severe changes in the delivery of government services are avoided."
- 4) Clear – "Tax structures should be simple, understandable, and predictable."
- 5) Fair and Equitable – "Tax burdens should recognize the ability to pay or benefits received. Similarly situated taxpayers should pay approximately the same amount of tax."
- 6) Properly Developed – "The Tax Reform Council should conduct its business openly and should develop its recommendations based on an analysis of the issues and options."
- 7) An Avenue for Resolution – "The system of taxation should include an avenue for resolving tax disputes that is unbiased, transparent, cost-effective for all parties, and easily accessible."

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<sup>7</sup> The Council was created through legislation in 2010 (HB 1405; [http://www1.legis.ga.gov/legis/2009\\_10/sum/hb1405.htm](http://www1.legis.ga.gov/legis/2009_10/sum/hb1405.htm)). Information on the Council and its final report released January 7, 2011 are available at <http://fiscalresearch.gsu.edu/taxcouncil/index.htm>.

## Comparing Sets of Tax Principles

As noted above, reports of governments and various tax organizations and committees have used a set of tax principles to analyze tax structures and tax proposals. A logical question arises from looking at all of this – is there a common set of principles? The answer is yes. While terminology and layout may vary, the concepts are the same. Some reports either ignored a principle that others used or did not find it to be as important, perhaps, in its particular analysis. The following chart helps to illustrate the similarities among the principles utilized.

AICPA	Joint Committee on Taxation	GAO	NCSL	CA Legislative Analyst's Office	Washington	Hawaii	Georgia
Equity and fairness	(2) Is the tax system fair?	Equity	(4) Treat individuals equitably; minimizes regressivity and taxes on low-income individuals	Distributional effects	Equity/fairness	Equity	Fair and Equitable
Certainty	(4) Can the tax system be easily administered?		(2) Certainty; number and types of changes kept to minimum.			Easy and economical to administer	Clear
Convenience of payment					Transparency and administrative simplicity		
Economy of collection		Administrability	(6) Promotes fair, efficient and effective and professional administration	Tax administration			Clear An Avenue for Resolution
Simplicity	(3) Is the tax system simple?	Simplicity	(5) Easy to understand and minimizes compliance costs				Clear
Neutrality	(1) Does the tax system promote or hinder economic efficiency?		(8) Minimizes effect on spending decisions; any influences are explicit		Economic vitality and harmony with other states  Economic neutrality and	Neutrality	Efficient

<sup>8</sup> This principle is an unusual one in that it is so specific or narrow. It appears that the state has made this such an important goal that it is something to be followed in the design of their tax system to help ensure that individuals are able to “purchase and maintain a home consistent with their standard of living” (page 5).

					efficiency		
Economic growth and efficiency		Economic efficiency	(7) Responsive to interstate and international competition  (3) Broad bases and balanced variety (mix) of revenue sources to improve competitive relative to other states	Growth performance  Economic climate	Home ownership <sup>8</sup>		Growth Enhancing
Transparency and visibility		Transparency	(9) Accountable to taxpayers; information on proposals publicized and debated.		Transparency and administrative simplicity	Accountability	Clear
Minimum tax gap	(4) Can the tax system be easily administered?					Easy and economical to administer	Clear
Appropriate government revenues			(2) (3) Stability of revenues with mix of taxes.  (2) Sufficiency so budget is balanced.  (1) Complementary elements including finances of both state and local governments	Reliability and volatility  Federal interaction	Adequacy/stability/elasticity	Provision of appropriate revenues	Stable
<b>AICPA</b>	<b>Joint Committee on Taxation</b>	<b>GAO</b>	<b>NCSL</b>	<b>CA Legislative Analyst's Office</b>	<b>Washington</b>	<b>Hawaii</b>	<b>Georgia</b>

TEI-SJSU Tax Policy Conference:  
THE STATE OF TAX POLICY IN CALIFORNIA  
Friday, February 11, 2011

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## THE RELEVANCE OF THE FEDS

Is There a VAT in Your Future?

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## VAT

Is there a VAT in California's future?

Federal and State enormous budget shortfalls

National Debt

Over \$14 trillion dollars

2011 Budget Deficit:

\$1.5 trillion

California:

\$25 billion (?)

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## VAT

Doubtful that conventional taxes (income, sales, property, customs duties, etc.) can be increased sufficiently to cover the shortfall

In 2005, net revenue of \$50 billion would have been raised for each 1% of VAT

Administrative costs of VAT comparatively low measured as a percentage of revenue yield

Generally VATs have relatively good compliance rates

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## Concept of Value Added Tax

Tax levied at each stage of production on firm's value added

Value added is difference between firm's sales and firm's purchase of inputs from other firms

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## VAT: Types and Calculation Methods

There are different types of VAT and different methods of calculating VAT

All 29 OECD countries with VAT use the consumption VAT, whereby purchase price of capital equipment is treated same as any other input – *i.e.*, deducted at time of purchase. Other types are income VAT and gross product VAT

## VAT: Types and Calculation Methods

Credit-invoice method:

- Firm is required to show VAT separately on all sales invoices

- Each sale is marked up by the amount of the VAT

- To determine liability firm aggregates VAT on sales invoices and then subtracts total VAT shown on its purchase invoices and remits balance to government

## VAT: Types and Calculation Methods

### Subtraction method:

- Firm subtracts the cost of its taxed inputs from its sales
- Firm determines VAT liability by multiplying its VAT liability by the VAT rate.
- Most flat tax proposals are modified subtraction method VATs

### Addition method:

- The firm calculates its value added by adding all payments for untaxed inputs (e.g., wages and profits), and then multiplying by VAT rate to determine amount of VAT to be remitted to government

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## VAT: Types and Calculation Methods

### Credit invoice method:

- Used by 28 of 29 OECD nations with VATs  
(Economists differ on how to classify Japan VAT)
- Consensus view preference for credit-invoice method
  - More auditable
  - Tends to be self-policing
  - Possibly higher administrative cost than subtraction methods
  - Can accommodate multiple rates

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## Exemption Versus Zero Rating

Special tax treatment can be given by exemption or zero rating

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## Estimates of Revenue That VAT Would Raise

Brookings Institution and Urban Institute estimate that each percentage point of VAT would raise 0.4% of gross domestic production (GDP)

In 2005 each 1% VAT rate would raise \$50 billion – so 5% rate would have raised \$250 billion

*Cf.* Individual income tax was \$927 billion in 2005

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## Estimates of Revenue That VAT Would Raise

U.S. reliance on consumption taxes is lower than any other OECD nation

Spread of VAT has been most important development in taxation over last half century

- In 1960s 10 countries had VAT

- Now approximately 136 countries with VAT

- On average, VAT produces 1/5 of total tax revenues

## Balance of Trade

All nations with VAT zero rate exports and impose VAT on imports

- This procedure for taxing trade flow is referred to as destination principle

GATT compliance:

- Indirect taxes were rebatable on exports, but direct taxes (e.g., incomes taxes) were not rebatable

## State Impact

Encroachment on a state tax source

or

Joint collection of a VAT

Encroachment:

- No constitutional barrier

- Actual history shows states collecting increasing revenues (38.5% in 2003) from income tax – so argument could be that states are imposing on traditional federal source

- Many examples of state imposing excise taxes on same items as federal excite taxes apply too

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## State Impact

Joint Collection:

- States could piggyback off federal VAT

- To do so, states would need to replace sales tax with VAT and adopt federal tax base

- States may desire to retain greater fiscal independence

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## What Can We Learn From Canada

GST  
GST/HST  
Retail Sales Tax  
QST

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Questions?

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TEI-SJSU Tax Policy Conference:  
THE STATE OF TAX POLICY IN CALIFORNIA  
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## THE RELEVANCE OF THE FEDS

Is There a VAT in Your Future?

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**THE RELEVANCE OF THE FEDS**

**State Nexus Proposals Pending Before Congress:  
H.R. 1083 (111<sup>th</sup> Congress)  
H.R. 5066 (111<sup>th</sup> Congress)**

February 11, 2011  
TEI-SJSU Tax Policy Conference  
Palo Alto, California

**Carley A. Roberts, Partner  
Morrison & Foerster LLP**

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**Federal Tax Conformity vs.  
Federal Legislation of State Tax Issues**

Federal Tax Conformity

- States choose whether or not to conform

Federal Legislation of State Tax Issues

- Congress enacts a law dictating what a State can or cannot do
- For example:
  - P.L. 86-272 (1959), prohibiting States from imposing a tax on net income derived by a taxpayer from the sale of tangible personal property in interstate commerce if the taxpayer's activities in the state do not exceed "solicitation"
  - P.L. 104-95 (1996) and P.L. 109-264, prohibiting States from imposing an income tax on certain pension income

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## Federal Legislation of State Tax Issues: Concerns by the States

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### Overriding Concern: Principles of Federalism

- State sovereignty
- Congress should not interfere in how a State chooses to structure its own tax system

But What About Situations Where States *Want*  
Congress to Step In?

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## H.R. 5660 – Main Street Fairness Act

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### Key Points

- Introduced July 1, 2010
- Applies to Sales & Use Taxes
- Allows Streamlined Sales & Use Tax Agreement (“SSUTA”) Member States to Require Remote Sellers to Collect & Remit Sales & Use Taxes on Remote Sales
- “Remote Sale” Defined As: Sale of Goods or Services Attributed to A Member State & Seller Does Not have Adequate Physical Presence to Establish Nexus
- Small Seller Exception
- 18 “Minimum Specification Requirements”

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## Impetus to H.R. 5660

- *National Bellas Hess, Inc. v. Illinois* (1967)
- *Quill Corp. v. North Dakota* (1992)
- E-Commerce Boom (1994 forward)
- Internet Tax Freedom Act (1998, expires 2014)
- Streamlined Sales Tax Project (“SSTP”) (2000)
- SSUTA (2002, 25 amendments through 2010)

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## H.R. 5660: Impact (Direct & Indirect) on California

- Use Tax – CA’s Largest Tax Gap
  - Significant and costly collection efforts
  - Voluntary compliance by purchasers has proven difficult
- Efforts to Legislatively Expand Nexus
  - AB 153 – Click-Through New York-Style Nexus Legislation
    - Similar legislation (S.B. 17) vetoed in 2009
  - AB 155 – Notice & Reporting Legislation
    - Similar legislation in Colorado (H.B. 10-1193) found likely to be unconstitutional in federal court preliminary injunction ruling (1/26/11)
- Efforts to Challenge Nexus in Court

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## H.R. 5660: Impact (Direct & Indirect) on California

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- SSUTA Membership?
- Inequity Between Businesses?
- Inequity Between Consumers?
- State Budget Deficit?
- Avoid Other Tax Increases?

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## H.R. 1083 – Business Activity Simplification Act

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### Key Points

- Introduced February 13, 2009
- Applies to Income Tax & Other State Taxes Measured by In-State Activity
- Modernization and Expansion of P.L. 86-272
  - Physical presence nexus standard
  - Applies to all sales and transactions, not just sales of TPP
  - Protected activities in addition to solicitation, such as furnishing information to customers or affiliates and similar activities leading to a potential or actual purchase
- *De Minimis* Physical Presence Standard (15 days or less per year)

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## Impetus to H.R. 1083

- *Northwestern Cement v. Minnesota* (1959)
- P.L. 86-272 – “Stopgap” (1959)
- Shift from Predominant Manufacturing Economy to Heavy Services & Intangibles Economy
- No Protection Under P.L. 86-272 for Sales of Services & Intangibles
  - Constitutional Due Process & Commerce Clause Govern Outside Parameters of P.L. 86-272
- Mixed Judicial Outcomes In Applying *Quill*
  - Is physical presence required in the income tax context?
  - Is economic presence sufficient for constitutional nexus?

## H.R. 1083: Impact (Direct & Indirect) on California

- California’s Shift to Economic Nexus
  - Effective 1/1/2011 California has a new doing business standard for purposes of the Corporation Tax Law (Rev. & Tax. Code § 23101)
- Ensure Fairness?
- Minimize Litigation?
- Create Certainty that Would Encourage Business Expansion and Investment?
- Create Disparity Between In-State Corporations and Out-of-State Corporations?
- Marriage of H.R. 5660 and H.R. 1083?

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## Takeaways

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- **No Easy Answers**
- **Improvement Is Not Impossible, Albeit Challenging**
- **Key: Raise People's Understanding of Current System**
- **Identify Strengths and Weaknesses**
- **Approaches for Improvement to Any Tax System Demand a Holistic Outlook**

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# **THE RELEVANCE OF THE FEDS**

## **PENDING MULTISTATE NEXUS PROPOSALS:**

**H.R. 1083 (111<sup>th</sup> Congress) – Business Activity Tax  
Simplification Act**

**H.R. 5660 (111<sup>th</sup> Congress) – Main Street Fairness Act**

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# H.R. 1083 (111<sup>TH</sup> CONGRESS)

## BUSINESS ACTIVITY SIMPLIFICATION ACT<sup>1</sup>

Over fifty years ago, Congress enacted Public Law 86-272 in response to a United States Supreme Court decision regarding a state’s ability to tax purely interstate activities. Public Law 86-272 prohibits states and localities from imposing income taxes on a business whose activities within the state are limited to soliciting sales of tangible personal property, if those orders are accepted outside the state and the goods are shipped or delivered into the state from outside the state. Despite the stated intention of Congress that Public Law 86-272 was to be a temporary solution and the undeniable shift in the focus of the economy from goods to services and intangibles since 1959, Public Law 86-272 remains on the books, a seemingly permanent fixture in the ever-changing landscape of state taxation. H.R. 1083, the Business Activity Tax Simplification Act, would modernize Public Law 86-272.

### I. BACKGROUND

“Unless immediate action is taken at this time, it is feared that the States will amend their laws to further encroach upon interstate commerce.”<sup>2</sup>

So spoke Senator Byrd of Virginia on August 11, 1959, in response to the United States Supreme Court’s opinion in *Northwestern Cement v. Minnesota*<sup>3</sup> and on behalf of Public Law 86-272 (“P.L. 86-272”). Over fifty years later, the disquieting significance of Senator Byrd’s plea is more pertinent than ever. While prohibiting a state from imposing an income tax upon a corporation whose only activity carried on within the state is “solicitation” of orders for the sale of tangible personal property, P.L. 86-272 to many taxpayers is an anachronism, a static solution for a dynamic problem that needs to be revisited. The Business Activity Tax Simplification Act (“BATSA”)<sup>4</sup> modernizes P.L. 86-272 and responds to continuing concerns in an effective and contemporary manner.

#### A. P.L. 86-272

##### 1. *The Impetus: Northwestern Cement v. Minnesota*

In 1959, the U.S. Supreme Court upheld a state’s power to tax income generated from purely interstate activities in *Northwestern Cement v. Minnesota*.<sup>5</sup> *Northwestern Cement* arose when two state supreme courts, considering similar factual scenarios, arrived at diametrically opposed conclusions regarding whether a state statute may properly tax income generated from activities

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<sup>1</sup> A special acknowledgement and thank you to Timothy Gustafson of Morrison & Foerster LLP, for his valuable research and writing efforts relating to H.R. 1083 and its history.

<sup>2</sup> Sen. Byrd (VA), Cong. Rec. (Aug. 19, 1959) at 16354.

<sup>3</sup> 358 U.S. 450 (1959).

<sup>4</sup> H.R. 1083 (2009).

<sup>5</sup> 358 U.S. 450 (1959).

exclusively in furtherance of interstate commerce.<sup>6</sup> In each case, a company had within the taxing state a permanent office and one or more salesmen who actively solicited within the state orders for the purchase of the company's products. However, all orders were accepted at, and filled from, the company's head office in another state. The Supreme Court of Minnesota had upheld the validity of a state statute taxing such transactions.<sup>7</sup> The Supreme Court of Georgia, on the other hand, had held that a similar statute, as applied, violated both the Due Process Clause and the Commerce Clause of the Federal Constitution.<sup>8</sup> Making a determination that the net income derived from the operations of the companies within the taxing states provided a sufficient nexus with Minnesota and Georgia for taxing purposes, the U.S. Supreme Court affirmed the former, reversed the latter and held that such state taxes violate neither the Commerce Clause nor the Due Process Clause of the Federal Constitution.

Specifically, the Court found such a tax to be valid if it does not discriminate against interstate commerce and is properly apportioned to the taxpayer's activities within the state that create nexus. Moreover, the Court held that such a tax was within the Due Process clause of the U.S. Constitution because fair apportionment led to only taxing income arising in the taxing state. The Court referred to its earlier decision, *Wisconsin v. J.C. Penney Company*,<sup>9</sup> stating, "the 'controlling question is whether the state has given anything for which it can ask return.' Since by 'the practical operation of [the] tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred . . .' it 'is free to pursue its own fiscal policies, unembarrassed by the Constitution.'"<sup>10</sup>

## 2. *The Response: The P.L. 86-272 "Stopgap"*

The "broad language"<sup>11</sup> found in the *Northwestern Cement* decision raised many concerns for businesses and Congress.<sup>12</sup> Of particular concern for businesses was how to determine the type of activities in a state that would give rise to sufficient nexus so as to subject a business to income tax there. If such determination could be made, the question remained of how to fairly apportion income of a multistate business among states in which it had nexus under *Northwestern Cement*. Moreover, the Court's latitudinous language allowed for non-uniform rules among the states, the costs of compliance with which might even exceed the tax owed in some cases, and the practical effect of which might cause income from a single sale to be attributed to more than one state.

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<sup>6</sup> *State v. Northwestern States Portland Cement Co.*, 250 Minn. 32 (1957); *Stockholm Valves & Fittings, Inc. v. Williams*, 213 Ga. 713 (1957).

<sup>7</sup> 250 Minn. at 44.

<sup>8</sup> 213 Ga. at 721.

<sup>9</sup> 311 U.S. 435, 444 (1940).

<sup>10</sup> *Northwestern Cement*, 358 U.S. at 465. Prior to that time, there had been a "well-settled rule, stated in *Norton Co. v. Illinois Dep't of Revenue*, 340 U.S. 534 (1951), that solicitation in interstate commerce was protected from taxation in the State where the solicitation took place." (*Wisconsin Dep't of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 238 (1992) (Kennedy, J., dissenting).)

<sup>11</sup> SEN. RPT. NO. 658 (Aug. 11, 1959) to S. 2524.

<sup>12</sup> As did the Court's refusal to hear *Brown-Forman Distillers Corp. v. Collector of Revenue*, 234 La. 651 (1958), *appeal dismissed and cert. denied*, 359 U.S. 28 (1959), a case which found that the imposition of the Louisiana net income tax upon a Kentucky distiller did not hinder interstate commerce, despite the fact that the distiller's only activity in Louisiana was the presence of "missionary men" who called on wholesalers but did not solicit orders.

Of concern for Congress was that such uncertainty and the burden of compliance that inevitably followed could lead some businesses, particularly small businesses, to limit their interstate activities.<sup>13</sup> There was even concern that states would use *Northwestern Cement* to assess taxes for past years.<sup>14</sup>

Congress responded swiftly. Just seven months after *Northwestern Cement* was decided, P.L. 86-272 was enacted. The intended goal was a more certain rule for when a multistate business would be subject to income tax in any particular state. The articulated rule prohibited a state from imposing a net income tax (direct or indirect) upon a taxpayer if that taxpayer's only in-state activity is "solicitation" of orders for the sale of tangible personal property, where the orders are sent outside the state for approval or rejection and, if approved, are filled and delivered from a stock of goods located outside the state.

The Senate Report noted that the legislation was "not a permanent solution to the problem."<sup>15</sup> Rather, the legislation was intended to "serve as an effective stopgap or temporary solution while further studies are made of the problem,"<sup>16</sup> despite the absence of a termination date.<sup>17</sup>

## **B. Application of P.L. 86-272**

Shortly after its passage, state courts wrestled with the new legislation. In *International Shoe Co. v. Cocreham*,<sup>18</sup> the Louisiana Supreme Court revisited its pre-P.L. 86-272 decision in *International Shoe Company v. Fontenot*,<sup>19</sup> in which it had found under an identical set of facts that the company was liable for state taxes upon its net income arising from its operations in Louisiana. The court in *International Shoe Co. v. Cocreham*, however, held that the activities of the company carried on within the state<sup>20</sup> were now protected by P.L. 86-272, and thus, the company was not taxable in the State of Louisiana. In effect, the second *International Shoe* decision deemed P.L. 86-272 a valid enactment by Congress.

Similarly, the Supreme Court of Missouri applied the protections afforded by P.L. 86-272 to a foreign corporation in *CIBA Pharmaceutical Products, Inc. v. State Tax Commission*.<sup>21</sup> The court held that the State of Missouri may not burden interstate commerce and tax a foreign corporation whose only activities (solicitation of orders) were protected under the new federal law.

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<sup>13</sup> See Annette Nellen, "The 50th Anniversary of Public Law 86-272" (March 27, 2008).

<sup>14</sup> See *id.*

<sup>15</sup> SENATE RPT. NO. 658 (Aug. 11, 1959).

<sup>16</sup> *Id.*

<sup>17</sup> CONG. REC. (Aug. 19, 1959) at 16357.

<sup>18</sup> 246 La. 244 (La. 1964).

<sup>19</sup> 236 La. 279 (La. 1959), *cert. denied* 359 U.S. 984 (1959).

<sup>20</sup> The company's only business activities carried on within the State of Louisiana were the use of travelling salesmen in the state for the "solicitation" of orders for shoes that were forwarded to the company's home office in St. Louis, Missouri, and then, if accepted, were filled and the merchandise shipped from outside the State of Louisiana. 246 La. at 251

<sup>21</sup> 382 S.W.2d 645 (Mo. 1964).

Despite the state court decisions suggesting that P.L. 86-272 was a constitutionally valid exercise of Congress' power to regulate interstate commerce, the legislation and its proposed progeny were not without their critics. A study<sup>22</sup> completed in 1964 by the House Committee on the Judiciary Special Subcommittee on State Taxation of Interstate Commerce addressed the inherent tension between "protecting businesses from uncertainty and multiple taxation and preserving state tax authority and revenues."<sup>23</sup> The study, which concluded that, among other things, businesses should not be subject to direct taxes where business merely have customers but no physical presence,<sup>24</sup> resulted in a series of proposed yet ultimately unsuccessful bills,<sup>25</sup> the revisions of which reflected the competing interests of the business community at large and the state taxing authorities.

The language of P.L. 86-272 limits its scope. The law applies only to income taxes, not to other business taxes such as gross receipts taxes.<sup>26</sup> The law applies only to sales of tangible personal property, not to sales of services or intangibles. Thus, companies engaged exclusively in interstate commerce (albeit of a different type) found themselves and continue to find themselves subject to state taxation.

With the "temporary" solution in place, constitutional nexus issues affecting all corporations not protected by P.L. 86-272 were battled out in the state courts, with the U.S. Supreme Court intervening from time to time to offer a modicum of clarity. Shortly after the passage of P.L. 86-272, the U.S. Supreme Court issued its decision in *Scripto Inc. v. Carson*,<sup>27</sup> articulating principles of attributional, or agency, nexus and leaving no doubt that activities performed in a state on behalf of a taxpayer may establish nexus to tax.<sup>28</sup> In the seminal case of *National Bellas Hess, Inc. v. Department of Revenue*,<sup>29</sup> the U.S. Supreme Court held that a state imposes an unconstitutional burden on interstate commerce when it attempts to force tax collection or

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<sup>22</sup> P.L. 86-272 directed Congress to ". . . make full and complete studies of all matters pertaining to the taxation by the States of income . . . from the conduct of business activities which are exclusively in furtherance of interstate commerce . . . for the purpose of recommending to the Congress proposed legislation providing uniform standards to be observed by the states in imposing income taxes on income so derived."

<sup>23</sup> Annette Nellen, "The 50th Anniversary of Public Law 86-272" (March 27, 2008). The study is known as the Willis Commission report.

<sup>24</sup> Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary of the U.S. House of Representatives, *State Taxation of Interstate Commerce*, H.R. REP. NO. 1480, 88th Cong., 2d Sess. (1964).

<sup>25</sup> See, e.g., H.R. 11798 (1965); H.R. 16491 (1966); H.R. 2158 (1967).

<sup>26</sup> The protections of P.L. 86-272 do not apply where a state's corporate tax includes a non-income component. See *Bantam Doubleday Dell Publishing v. Dep't of Treasury*, No. 243672 (Feb. 24, 2004) (holding P.L. 86-272 does not apply to the single business tax).

<sup>27</sup> 362 U.S. 207 (1960).

<sup>28</sup> Following *Scripto*, state tax agencies and state courts found attributional nexus where the activities of an in-state representative or affiliate were attributable to an out-of-state company. See, e.g., *In re Dart Indus., Inc.*, N.M. Taxn. and Rev. Dep't., No. 04-03, 2/26/04; *Western Acceptance Co. v. Dep't of Revenue*, 572 So.2d 497 (Fl. 1985); *Avco Consumer Servs. Consumer Discount Co. One, Inc. v. Director, Div. of Taxation*, 100 N.J. 27 (N.J. 1985). Over 25 years after its decision in *Scripto*, the U.S. Supreme Court's decision in *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987) affirmed the agency principles established in *Scripto* and agreed with the Washington Supreme Court that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." 483 U.S. at 250 (internal citation omitted). As discussed below, BATSA adopts similar language in providing for attributional nexus.

<sup>29</sup> 386 U.S. 753 (1967).



remittance responsibilities on an out-of-state entity that lacks any “physical presence in the taxing State.”<sup>30</sup> In 1977, the Court in *Complete Auto Transit, Inc. v. Brady*,<sup>31</sup> a decision that applies equally to income, franchise or transaction taxes, established a four-part test to determine whether a state tax imposed on transactions in interstate commerce violates the Commerce Clause.<sup>32</sup> The Court decided, in relevant part, that in the absence of congressional action, the Commerce Clause permits taxation of out-of-state businesses only where, *inter alia*, the tax “is applied to an activity with a substantial nexus with the taxing State.”<sup>33</sup> And in 1992, the Court in *Quill Corp. v. North Dakota*<sup>34</sup> applied this test in the context of sales and use taxes and reaffirmed *Bellas Hess*, holding that a taxpayer, in addition to the activity, must have a “substantial nexus” with the state for purposes of state taxes and that for sales and use taxes, such a standard could be met only where the corporation has a “physical presence” in the taxing state.<sup>35</sup>

Even P.L. 86-272 required some clarification. P.L. 86-272 does not define the term “solicitation.” After state court decisions interpreted the term in inconsistent ways, from very broad to very restrictive, the U.S. Supreme Court weighed in. In *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*,<sup>36</sup> the Court defined the term “solicitation of orders” to include “not just explicit verbal requests for orders, but also any speech or conduct that implicitly invites an order” and afforded immunity to activities that are “entirely ancillary to requests for purchases.”<sup>37</sup> The Court also ruled that a *de minimis* rule applied to activities that may exceed solicitation, not wanting to abandon the principle in the context of a law such as P.L. 86-272, “which operates in such stark, all-or-nothing fashion.”<sup>38</sup> The Court’s guidance in *Wrigley* notwithstanding, state courts and revenue departments continued to examine whether certain taxpayer activities qualify for protection under P.L. 86-272.

## II. PRESENT DAY STATE APPROACHES TO TAXATION OF INTERSTATE ACTIVITIES

The American economy has changed dramatically since the enactment of P.L. 86-272 in 1959. There has been a clear shift in the focus of the economy from manufacturing and selling tangible personal property to producing and selling services and intangibles, income from which is not protected under P.L. 86-272. Also, some states have enacted business taxes that are not income taxes and instead look to gross receipts as their tax base (and, as such, are more akin to sales and

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<sup>30</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 314 (1992).

<sup>31</sup> 430 U.S. 274 (1977).

<sup>32</sup> Under *Complete Auto*, a state tax does not violate the Commerce Clause of the Federal Constitution where the tax (1) is applied to an activity with a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state.

<sup>33</sup> 430 U.S. at 279.

<sup>34</sup> 504 U.S. 298 (1992).

<sup>35</sup> *Id.* at 314. The Court in *Quill* demarcated the purpose of the Commerce Clause nexus analysis, to “limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce,” from that of the Due Process nexus analysis, which was based on “the fundamental fairness of governmental activity.” 504 U.S. at 312 – 313.

<sup>36</sup> 505 U.S. 214 (1992).

<sup>37</sup> *Id.* at 223, 228.

<sup>38</sup> *Id.* at 231.

use taxes). When a business is not covered by the “protection” of P.L. 86-272, Due Process and Commerce Clause guidance governs whether a state may tax the income of a multistate business. Most states have provided nexus guidance either legislatively or administratively, but as was the situation decades ago, such guidance is far from uniform among the states.

### **A. Legislative Potpourri (Economic Nexus Legislation)**

Whereas the U.S. Supreme Court has spoken on nexus in the past, to date it has kept mum regarding the rapidly evolving issue of economic nexus.<sup>39</sup> Many states have heard the U.S. Supreme Court’s silence loud and clear. Energized by the growing trend toward economic nexus, a number of states have recently flexed their constitutional muscles through the enactment of legislation to determine what activity of a business in that state makes that business subject to tax therein.

New Hampshire, for example, adopted an economic nexus standard for purposes of its business profits tax, amending the statutory definition of business activity to include “a substantial economic presence evidenced by a purposeful direction of business toward the state.”<sup>40</sup> In considering the underlying legislation, the New Hampshire Senate had deferred consideration of this particular provision while the economic nexus question was pending before the U.S. Supreme Court.<sup>41</sup> On the day the Court denied certiorari, the legislation was amended and the economic nexus provision enacted.<sup>42</sup>

In California, “doing business” was recently redefined in accordance with the Multistate Tax Commission’s proposed “factor presence” nexus test for tax years beginning on or after January 1, 2011.<sup>43</sup> Thus, a taxpayer is considered to be doing business in California, and therefore subject to California’s corporation franchise tax, if it meets any of the following conditions: (1) the taxpayer is organized or commercially domiciled in California; (2) the taxpayer’s sales in

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<sup>39</sup> See, e.g., *Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007); *Capital One Bank v. Comm’r of Revenue*, 453 Mass. 1 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009); *A & F Trademark, Inc. v. Tolson*, 167 N.C. App. 150 (N.C. Ct. App. 2004), *cert. denied*, 359 N.C. 320, *cert. denied*, 546 U.S. 821 (2005); *J.C. Penney Nat’l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Geoffrey, Inc. v. S.C. Tax Comm’n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993); *Tax Comm’r v. MBNA Am. Bank, N.A.*, 220 W. Va. 163 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007).

<sup>40</sup> N.H. REV. STAT. ANN. § 77-A:1.XII. Along these same lines, the Oregon Department of Revenue adopted Administrative Rule 150-317.010, which states, “[s]ubstantial nexus exists where a taxpayer regularly takes advantage of Oregon’s economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state.” The rule looks to the regularity of contacts in the state, deliberate marketing to or solicitation of Oregon customers, and gross receipts attributable to Oregon customers or to the use of intangible property in the state.

<sup>41</sup> See *Lanco*, *supra*, and *MBNA*, *supra*.

<sup>42</sup> See Chris Sullivan, *News Analysis: New Hampshire Adopts Economic Nexus Standard*, STATE TAX TODAY, 2007 STT 137-13 (July 17, 2007).

<sup>43</sup> See *Factor Presence Nexus Standard for Business Activity Taxes*, Multistate Tax Commission (approved Oct. 17, 2002; updated Sept. 2003). According to the proposal summary, the “factor presence nexus standard is intended to represent a simple, certain and equitable standard for the collection of state *business activity taxes*” (emphasis added). Ironically, the proposal summary attributes the “idea of factor presence nexus” and the elaboration of the concept to an article in the December 2000 edition of *National Tax Journal* entitled, “Implementing State Corporate Income Taxes in the Digital Age” (emphasis added).

California exceed the lesser of \$500,000 or 25% of the taxpayer's total sales; (3) the value of the taxpayer's real and tangible personal property in California exceeds the lesser of \$50,000 or 25% of the taxpayer's total real and tangible personal property; or (4) the taxpayer pays compensation in California exceeding the lesser of \$50,000 or 25% of the total compensation paid by the taxpayer.<sup>44</sup>

Connecticut also recently adopted an economic nexus standard for corporate income taxation effective for tax years beginning after 2009.<sup>45</sup> Specifically, “[a]ny company that derives income from sources within this state, or that *has a substantial economic presence within this state*, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of a company's economic contacts with this state, *without regard to physical presence*, and to the extent permitted by the Constitution of the United States, shall be liable for the tax imposed under chapter 208 of the general statutes.”<sup>46</sup>

## **B. Judicial Potpourri (Economic Nexus Decisions)**

State courts have validated this legislative approach. Starting in the early 1990s and proliferating in recent years, some states have attempted to expand their tax base by assessing business activity taxes (i.e., non-income taxes) against out-of-state companies that have customers or intangibles but no property or employees in the taxing state. Under these circumstances P.L. 86-272 does not apply. As a defense in these cases, many businesses have argued the physical presence nexus standard established by the U.S. Supreme Court in *Quill* must apply.

Several court decisions, which recognized the U.S. Supreme Court's decision in *Quill* necessitated addressing the issue of “substantial nexus,” have nevertheless ruled the physical presence standard established by *Quill* is only relevant for sales and use tax nexus and does not apply with regard to other types of taxes.<sup>47</sup> In these cases, the courts have held the existence of “economic presence” is enough to create nexus for purposes of the Commerce Clause. Conflicting holdings exist in several jurisdictions and the U.S. Supreme Court has yet to grant review.

For example, in *J.C. Penney National Bank v. Johnson*, the Tennessee Supreme Court upheld on its merits a decision that state taxing authorities could not impose upon out-of-state corporations with no in-state physical presence excise and franchise taxes on corporate earnings or profits.<sup>48</sup> The Tennessee Court of Appeals held that no valid distinction can be drawn for Commerce Clause purposes between excise and franchise taxes and the sales and use taxes at issue in *Bellas Hess* and *Quill*:

The only real issue is whether there is any reason to distinguish the present case from *Bellas Hess* and *Quill*. The Commissioner

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<sup>44</sup> CAL. REV. & TAX. CODE § 23101 (2009). The threshold amounts used in this test will be adjusted annually for inflation.

<sup>45</sup> Public Act No. 09-3, Sec. 90, 2009 Ct. ALS 3. *Cf.* Regs. Conn. St. Agencies § 12-214-1.

<sup>46</sup> *Id.*, (emphasis added).

<sup>47</sup> *See, e.g., Geoffrey, Inc. v. S.C. Tax Comm'n, supra.*

<sup>48</sup> 19 S.W.3d 831, 838-39 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000).

argues that those cases are distinguishable because they involved use taxes, whereas the present case involves franchise and excise taxes. We must reject the Commissioner’s argument. While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case. In fact, the Commissioner is unable to provide any authority as to why the analysis should be different for franchise and excise taxes.<sup>49</sup>

The Tennessee Supreme Court issued an Order denying review and allowing the Court of Appeals decision to be published.<sup>50</sup> Under Tennessee law, denial of review by the Tennessee Supreme Court – unlike denial of certiorari by the U.S. Supreme Court – establishes agreement with the result below. The U.S. Supreme Court subsequently denied review.

In contrast, and most recently, the Washington Supreme Court affirmed the decision that a taxpayer without physical presence in the State of Washington nevertheless has “substantial nexus” with the state for business and occupation tax purposes where the activities of the taxpayer’s employees were significantly associated with the taxpayer’s ability to establish and maintain its market there.<sup>51</sup> The taxpayer, an out-of-state manufacturer, unsuccessfully argued physical presence was required to show substantial nexus. The court found that the taxpayer’s practice of sending sales representatives, albeit infrequent, to meet with its customers within Washington was significantly associated with its ability to establish and maintain its market.<sup>52</sup>

### III. BATSA

#### A. The Legislation

BATSA would establish a bright-line “physical presence” standard for the imposition of state and local “business activity taxes.” In codifying this standard, no state would have the power to impose, assess, or collect a net income tax or other business activity tax on any person relating to such person’s activities in interstate commerce unless the person has a physical presence in the taxing state during the relevant taxable period. Carve-outs to the physical presence standard include a *de minimis* physical presence exception (i.e., presence in a state for less than 15 days in a taxable year)<sup>53</sup> and presence in a state to “conduct limited or transient business activity.”<sup>54</sup>

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<sup>49</sup> 19 S.W. 3d at 839.

<sup>50</sup> See *J.C. Penney National Bank v. Johnson, Comm’r of Revenue*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000) (per curiam). By allowing the Court of Appeals opinion to be published, the Tennessee Supreme Court gave it precedential effect. As the Tennessee Supreme Court has explained, “the published opinions of the intermediate appellate courts are opinions which have precedential value and may be relied upon by the bench and bar of this state as representing the present state of the law with the same confidence and reliability as the published opinions of this Court, so long as either are not overruled or modified by subsequent decisions.” *Meadows v. State*, 849 S.W. 2d 748, 752 (Tenn. 1992). Thus, it is settled law in Tennessee that taxes upon income are subject to the *Bellas Hess/Quill* physical-presence rule.

<sup>51</sup> *Lamtec Corp. v. Washington Dep’t of Revenue*, 2011 Wash. LEXIS 77 (2011).

<sup>52</sup> *Id.* at \*21.

<sup>53</sup> Prior versions of this legislation mandated a 21-day threshold.

<sup>54</sup> The legislation does not define “limited” or “transient” for purposes of this exclusion.

BATSA would also modernize P.L. 86-272<sup>55</sup> so it would apply to all “business activity taxes,” which are defined as “any tax in the nature of a net income tax or measured by the amount of, or economic results of, business or related activity conducted in the State.” Notably, transaction taxes, such as sales and use taxes, are excluded from this definition. P.L. 86-272’s limitation to solicitation of “sales” of “tangible personal property” would be removed and the law would apply to the solicitation of orders (which are sent outside the state for approval or rejection) or of “customers ... for sales or transactions.” The bill would also amend P.L. 86-272 to protect certain other “business activities” from the imposition of state “business activity taxes,” including “the furnishing of information to customers or affiliates” in the state; the “coverage of events or other gathering of information” in the state, “which information is used or disseminated from a point outside the State”; and “business activities directly related to [the taxpayer’s] potential or actual purchase of goods or services within the State if the final destination to purchase is made outside the State.”

## **B. The Business Perspective**

Many businesses believe they should continue to pay business activity taxes in those states where they receive direct benefits and protections, such as police, fire, sanitation, public schools, etc., from the state government, i.e., where they have substantial nexus with the taxing state in the form of physical presence as constitutionally sanctioned by the U.S. Supreme Court in *Bellas Hess* and *Quill*. Many businesses thus support federal legislation, such as H.R. 1083, that would modernize current law and provide definite, specific standards to govern when states may impose a business activity tax. BATSA’s nexus standard would, from the business perspective:

- ensure fairness;
- minimize litigation;
- create the kind of legally certain and stable business climate that encourages businesses to make business investments, expand interstate commerce, grow the economy, and create new jobs; and
- ensure a level playing field for taxpayers by using a bright-line standard analogous to the permanent establishment standard used by the United States in international treaties.<sup>56</sup>

Moreover, the legislation would modernize current law and establish a clear and equitable bright line standard. Specifically:

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<sup>55</sup> According to the terms of the legislation, nothing in the section of the bill relating to the physical presence standard shall be “construed to modify, affect or supersede the operation” of P.L. 86-272.

<sup>56</sup> BATSA establishes a threshold that is even lower than that set by the “permanent establishment” standard used by the federal government in international tax treaties with its trading partners. See OECD Model Tax Convention, Article 5. Under the terms of the convention, a “permanent establishment” is generally defined as “a fixed place of business through which the business of an enterprise is wholly or partly carried on.” OECD Model Tax Convention, Articles 5, 7.

The legislation would modernize P.L. 86-272 by amending the law to apply to all sales and transactions, not just sales of tangible personal property and to all business activity taxes, not just net income taxes.

The legislation would establish a physical presence nexus standard, whereby states and localities would be authorized to impose direct business activity taxes only on those businesses that have a physical presence (employees, agents, or property) within the taxing jurisdiction. Moreover, the legislation would define “physical presence” to include businesses that assign one or more employees to the state, use an exclusive agent in the state or lease or own tangible property or real property in the state.

The legislation would cover those taxes imposed directly on a business such as corporate income taxes, gross receipts taxes, franchise taxes, single business taxes, capital stock taxes, and business and occupation taxes. It does not apply to personal income taxes, direct or indirect transaction taxes (e.g., sales and use taxes based on gross receipts) or to state taxes based on gross insurance premiums.

The legislation would identify certain taxable activities giving rise to sufficient nexus, such that states and localities would be authorized to impose business activity taxes only on companies that lease or own property, employ employees, or use certain services of an in-state person in a taxing jurisdiction.

The legislation would protect certain activities in addition to solicitation. The legislation would protect from taxation businesses that merely furnish information to customers or affiliates in the state, cover events or gather information in the state, or engage in business activity directly related to the potential or actual purchase of goods or services within the state if the final decision to purchase is made outside the state. In other words, protections primarily apply to situations where the business is patronizing the local market (i.e., being a customer), and thereby generating economic activity in the state that produces other tax revenues for the state, rather than exploiting that market.

The legislation specifies the circumstances governing the attribution of presence to a corporation. The activities and/or presence of an in-state person may be attributable to a business only when the in-state person performs activities that enhance or maintain the market in the state for the out-of-state business on an exclusive basis.<sup>57</sup>

Lastly, the legislation allows for *de minimis* physical presence so that physical presence under the law would not include presence in a state for less than 15 days in a taxable year, or presence in a state to conduct limited or transient business activity.<sup>58</sup>

### **C. The State Perspective**

In considering previous iterations of the present bill, states have raised a number of questions regarding federal legislation in this arena. For example:<sup>59</sup>

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<sup>57</sup> H.R. 1083 § 3(b)(1)(B).

<sup>58</sup> H.R. 1083 § 3(b)(2)(A).

*Do not the principles of federalism preclude congress from interfering in how a state chooses to structure its own tax system, particularly by altering the constitutional standard that governs when a state may tax companies conducting business within its borders?*<sup>60</sup>

Certainly, tension exists between the authority of Congress to regulate interstate commerce and a state's authority to tax. Nevertheless, despite the fact the U.S. Supreme Court has never required a physical presence standard for imposing business activity taxes, Congress "retains ample power to modify ... [] any ... rule the Court has articulated under the Commerce Clause[] in forging a legislative solution to the problems of state taxes affecting interstate commerce."<sup>61</sup> This is because Congress has been given the authority to ensure that interstate commerce is not burdened by state action.<sup>62</sup> A state, on the other hand, is free to determine what type of tax to impose, how to apportion the income that is taxed in the state, and which types of expenses will result in credits or deductions, among other things, within these jurisdictional standards.

*By limiting a state's tax base, small, would not in-state corporations bear a disproportionate tax burden when compared to large out-of-state corporations that could compete for customers and earn revenue in a state without incurring tax liability?*<sup>63</sup>

As stated above, businesses, including small businesses, generally want to pay their fair share of taxes where they receive direct benefits and protections, i.e., where they have substantial nexus with the taxing state in the form of physical presence. BATSA would not require small businesses to pay *more* tax to a particular state in which they have physical presence. Instead, the bill would eliminate the considerable variations between state business activity taxes which small businesses are finding "inordinately burdensome and difficult to anticipate" and which "significantly inhibit their ability to engage in commerce."<sup>64</sup>

*Lastly, could not the legislation result in a loss of state tax revenue? (One survey released by the National Governors Association in 2005 found that a similar bill would cost states in the billions annually.)*<sup>65</sup>

Not surprisingly, different studies have touted different results.<sup>66</sup> Empirical data showing where the revenue losses would come from is hard to come by. One reason is that many states do not

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<sup>59</sup> The examples given are by no means exhaustive and are drawn from but one submission in opposition to one bill. Rather, the questions and the accompanying responses are merely modern manifestations of the arguments at play since the passage of P.L. 86-272 and the issuance of the Congressional Willis Commission report.

<sup>60</sup> See Ltr. from the National Governors Association to the Senate Finance Committee, dated June 1, 2006. A similar argument was raised during a 2010 hearing before the House of Representatives Subcommittee on Commercial and Administrative Law. See Statement of R. Bruce Johnson, Chair, Utah State Tax Commission, Appearing on Behalf of the Federation of Tax Administrators, Before the Subcommittee on Commercial and Administrative Law (Feb. 4, 2010).

<sup>61</sup> Testimony of Walter Hellerstein, Before the Subcommittee on Commercial and Administrative Law, *A Primer on State Tax Nexus: Law, Power, and Policy* (Feb. 4, 2010).

<sup>62</sup> See U.S. CONST. art. I, § 8, cl. 3.

<sup>63</sup> See Ltr. from the National Governors Association to the Senate Finance Committee (June 1, 2006).

<sup>64</sup> Hon. Nydia M. Velázquez, Chairwoman, News from the Committee on Small Business, *Committee Examines Business Activity Taxes and their Effects on Small Firms* (Feb. 14, 2008).

<sup>65</sup> See *Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, on States*, National Governors' Association (Sept. 26, 2005).

impose income taxes on businesses absent physical presence in the state. Another is that states will certainly enact legislation responding to BATSA in order to capture revenue from out-of-state corporations which are enhancing or maintaining a market within the state.

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<sup>66</sup> See, e.g., *Response to the National Governor Association Estimates of the State and Local Tax Impact of H.R. 1956*, Council on State Taxation (Oct. 6, 2005); Ernst & Young, *Estimates of Impact of H.R. 1956 on State and Local Business Tax Collections* (July 25, 2006). But see Congressional Budget Office Cost Estimate, *H.R. 1956 Budget Activity Tax Simplification Act of 2005*.



# H.R. 5660 (111<sup>TH</sup> CONGRESS)

## MAIN STREET FAIRNESS ACT

Sales and use taxes collection as it pertains to remote sellers has been a subject of heightened interest to states, businesses and Congress for nearly two decades. Facing an eroding tax base and mounting revenue losses, state tax administrators have battled to recover lost collections from remote sellers. Many states have come together to streamline their sales and use taxes regimens through the Streamlined Sales and Use Tax Agreement. Still other states have steered an independent course seeking, among other tactics, state legislation to expand their nexus reach. Businesses have been sharply divided on the issue, and Congress has remained remarkably silent.

### I. BACKGROUND

In 1966, the U.S. Supreme Court first confronted the issue of a state’s constitutional nexus with remote mail-order sellers in *National Bellas Hess, Inc. v. Department of Revenue*.<sup>67</sup> Ultimately, the Court held that a state imposes an unconstitutional burden on interstate commerce when it attempts to force tax collection or remittance responsibilities on a remote (i.e., out-of-state) entity that does nothing “more than communicate with customers in the State by mail or common carrier as part of a general interstate business.”<sup>68</sup> In 1992, the Court again confronted the constitutional nexus issue with remote mail-order sellers in *Quill Corp. v. North Dakota*.<sup>69</sup> Although the Court reaffirmed its decision in *National Bellas Hess*, the Court drew a distinction between due process nexus and commerce clause nexus. Whereas the Due Process Clause does not require that a remote seller have a physical presence in a state, the Commerce Clause does.<sup>70</sup>

In establishing the bright-line physical presence standard in *Quill*, the Court acknowledged that Congress might not only be better qualified to resolve this nexus issue, but that Congress has the ultimate power to resolve the issue. Specifically, the Court stated:

This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. See *Prudential Insurance Co. v. Benjamin*, 328 U.S. 408, 90 L. Ed. 1342, 66 S. Ct. 1142 (1946). Indeed, in recent years Congress has considered legislation that would ‘overrule’ the *Bellas Hess* rule. Its decision not to take

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<sup>67</sup> 386 U.S. 753 (1967).

<sup>68</sup> *Id.* at 758.

<sup>69</sup> 504 U.S. 298 (1992).

<sup>70</sup> *See id.* at 308, 312-313.

action in this direction may, of course, have been dictated by respect for our holding in *Bellas Hess* that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes. [Internal footnotes omitted.]<sup>71</sup>

To date, the bright-line physical presence test in *Quill* is still the law, the U.S. Supreme Court has refused to take any additional cases on the issue, and Congress has not acted. As the marketplace for retail e-commerce experienced rapid expansion in the mid-1990s and 2000s, states continued to watch their sales and use taxes revenue attributable to remote sellers dwindle. This became the impetus to the Streamlined Sales Tax Project (“SSTP”) and the resulting Streamlined Sales and Use Tax Agreement (“SSUTA”). In turn, the SSTP and SSUTA became the impetus to H.R. 5660, the Main Street Fairness Act, currently pending before Congress and other similar bills introduced in prior congressional sessions.

## II. SSTP AND SSUTA

In 2000, the Advisory Commission on Electronic Commerce made recommendations to Congress regarding the simplification of sales tax collection. The proposal established the framework for the SSTP. The stated goal of the SSTP is to “find solutions for the complexity in state sales tax systems that resulted in the U.S. Supreme Court holding (*Bellas Hess v. Illionis and Quill Corp. v. North Dakota*) that a state may not require a seller that does not have a physical presence in the state to collect tax on sales into the state.”<sup>72</sup> According to some commentators, the SSTP had two primary goals: (1) to create a simplified voluntary multistate sales tax collection system that would adopt the best practices from among the several states, seek to achieve multistate uniformity when appropriate, and encourage the development of technology models for sales tax collection; and (2) to build support for federal legislation that would allow states that participated in the voluntary system to require remote sellers to collect their sales and use taxes.<sup>73</sup>

The SSUTA was adopted as a result of the SSTP. The stated purpose of the SSUTA is to “simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance.”<sup>74</sup> The initial version of the SSUTA took effect on November 12, 2002 and has been amended 25 times since its adoption, with the most recent amendments made on December 13, 2010.<sup>75</sup> To date, 24 states have passed legislation conforming to the SSUTA.<sup>76</sup>

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<sup>71</sup> *Id.* at 318.

<sup>72</sup> Streamlined Sales Tax Governing Board, Inc., <http://www.streamlinedsalestax.org/index.php?page=About-Us>.

<sup>73</sup> See Robert D. Plattner, Daniel Smirlock, and Mary Ellen Ladouceur, *A New Way Forward for Remote Vendor Sales Tax Collection*, STATE TAX TODAY, 2010 STT 11-2 (Jan. 18, 2010).

<sup>74</sup> Streamlined Sales Tax Governing Board, Inc., <http://www.streamlinedsalestax.org/index.php?page=About-Us>.

<sup>75</sup> Streamlined Sales and Use Tax Agreement, adopted Nov. 12, 2002 and amended through Dec. 13, 2010.

<sup>76</sup> Streamlined Sales Tax Governing Board, Inc., <http://www.streamlinedsalestax.org/index.php?page=faqs>.

Despite the fact the SSUTA has been the most far-reaching effort ever to promote consistency and uniformity in sales tax practices across states, after over ten years since the SSTP was initiated and over 18 years since *Quill*, states still lack congressional authority to require sellers with no physical presence to collect and remit sales and use taxes.

### **III. MAIN STREET FAIRNESS ACT**

#### **A. The Legislation**

On July 1, 2010, the Main Street Fairness Act (“the Act”) was introduced under H.R. 5660. The legislation would allow states to impose sales and use tax collection obligations on remote sellers, i.e., sellers with no physical presence. In short, H.R. 5660 would allow any state that has adopted the SSUTA to require remote sellers, other than small sellers, to collect and remit sales and use taxes with respect to remote sales sourced to such state under the SSUTA. The Act would not compel any state to join the SSUTA.

The term “remote sale” is defined in the bill as “a sale of goods or services attributed to a particular Member State with respect to which a seller does not have adequate physical presence to establish nexus under the law existing on the day before the date of the enactment of this Act so as to allow such Member State to require, without regard to the authority granted by this Act, the seller to collect and remit taxes covered by this Act with respect to such sale.”<sup>77</sup>

The proposed legislation has 18 “minimum specification requirements,”<sup>78</sup> including:

- Creation of a multistate registration system for a seller to register under, with full privacy controls in place for consumers
- Creation of standard definitions of products and product-based tax exemptions
- Creation of a set of procedures to certify ecommerce software to be compliant and usable in light of new tax rules
- A single sales and use tax rate per taxing jurisdiction
- Uniform rules for sourcing and attributing transactions to particular taxing jurisdictions
- A requirement that each state provide “reasonable compensation” to reimburse sellers for expenses caused by administering, collecting and remitting sales and use taxes
- Uniform requirements for tax returns and remittances
- Consistent electronic and remittance methods
- A uniform rule to establish a small seller exception

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<sup>77</sup> H.R. 5660, § 10(5).

<sup>78</sup> *Id.* at § 7.

The Act would also make several findings, including that as a “matter of economic policy and basic fairness, similar sales transactions should be treated equally, without regard to the manner in which sales are transacted, whether in person, through the mail, over the telephone, on the Internet, or by other means.”<sup>79</sup>

## **B. The Business Perspective**

Businesses historically have been sharply divided on the remote seller nexus issue and are similarly divided on the Act. Pure online retailers with no physical presence in the vast majority of states strongly oppose the Act and any attempt to require remote sellers to collect and remit sales and use taxes in jurisdictions where physical presence is lacking. An obligation to collect and remit sales and use taxes on pure online retailers would represent, at a minimum, a higher cost of doing business for such retailers in addition to increased costs for the customers of such retailers. Pure online retailers and similarly situated remote retailers have followed the bright-line physical presence rule established by the U.S. Supreme Court in *Quill* and see any attempt to overturn that ruling as a violation of their constitutional commerce clause rights.

In stark contrast, online retailers with brick and mortar locations strongly support federal legislation such as H.R. 5660. As summarized by the Retail Industry Leaders Association:

‘This legislation is an important step forward for both our economy and retail industry, which employs nearly 15 million workers across the country,’ said Joe Rinzel, vice president for state government relations. ‘Leveling the playing field ensures that all Main Street businesses do not continue to face a significant competitive disadvantage by having to collect taxes on their sales, while Internet-only businesses escape that responsibility. This is an issue of fairness for both businesses and consumers.’

## **C. The State Perspective**

In contrast to the pending BATSA legislation, states are generally supportive of the Act. For example, the National Conference of State Legislatures has expressed strong support for the Act.<sup>80</sup>

‘Congressman Delahunt’s willingness to work with everyone involved in the sales tax simplification effort is to be commended,’ said Iowa Representative Christopher Rants, co-chair of the NCSL Task Force on State & Local Taxation of Communications and Electronic Commerce. ‘With the adoption of the Delahunt legislation, at a time when states are facing historic budget gaps, Congress can provide fiscal relief, \$23 billion, for the states without a single penny of cost to the federal government.’

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<sup>79</sup> H.R. 5660, § 3(2).

<sup>80</sup> “NCSL Expresses Support for Federal Main Street Fairness Legislation, STATE TAX TODAY, 2010 STT 127-6 (July 1, 2010).

Similarly, the Federation of Tax Administrators immediately expressed its support of the Act when it was introduced:<sup>81</sup>

The Federation of Tax Administrators applauds the introduction of HR 5660, the Main Street Fairness Act by Rep. Delahunt. This bill is an effort by the Congress to address an inequity in the ability of states and local governments to collect taxes on the sale of goods and services to residents of those states. The legislation would remedy an inequality of treatment of sellers and buyers that is no longer necessary or practical. The limitation on the state and local governments ability to require collection of these taxes results from a decades-old decision of the Supreme Court of the United States that has been by-passed by technology but remains the law as interpreted by the Court. States and businesses have been working for years to rectify this inequity.

Besides ensuring tax fairness between remote and brick-and-mortar sellers, some states believe the federal legislation would also help avoid tax increases as they look to balance their budgets. According to recent estimates, states could allegedly lose an estimated \$23 billion in uncollected sales taxes in 2012.<sup>82</sup>

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<sup>81</sup> *FTA Supports Federal Bill to Allow Tax Collection on Remote Sales*, STATE TAX TODAY, 2010 STT 127-3 (July 1, 2010).

<sup>82</sup> John Buhl and Sam Goldfarb, *Passage of Sales Tax Streamlining Bill Possible in the Fall, U.S. Rep Says*, STATE TAX TODAY, 2010 STT 146-2 (July 30, 2010).

## California Client Concerns

Todd Robinson  
Berger Lewis

- Conformity & Non-Conformity
- California Tax environment

## California Conformity & Non-Conformity

- California law based upon federal
- Conformity based upon reference date
- Prior to 2010 this date was January 1, 2005

## California Conformity & Non-Conformity

- SB 401 signed April 12, 2010
- Conformity Act of 2010
- Conforms to IRC as of January 1, 2009
- Still two years, all of 2009 and all of 2010 behind

## California Conformity or Non-Conformity

- Between January 1, 2005 and December 31, 2008 there were 17 major federal tax bills
- SB 401 significantly narrowed the conformity gap
- Lingering items of non-conformity

## California Conformity or Non-Conformity

- Major Federal acts in 2009 and 2010
  - Small Business Jobs Act, September 27, 2010
  - American Recovery and Reinvestment Act, February 17, 2009
  - The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, December 17, 2010

## California Conformity or Non-Conformity

- California returns begin with:
  - Federal Individuals, Federal AGI
  - Corporations, Federal Net Income
  - Pass through entities – Federal allocable items
  
- Then these items are adjusted to arrive at California taxable income



## California Conformity & Non-Conformity

- FTB's Instructions and Supplemental Guidelines for Individual Taxpayers:
  - 21 pages
  - 121 distinct items

## California Conformity or Non-Conformity

- More common areas of non-conformity
  - Section 179
  - Bonus Depreciation
  - Health Savings Accounts (HSA's)
  - Real Estate Professionals and PAL's
  - Filing status issues
  - Suspension of NOL's for 2010 and 2011
  - Domestic Production Activities Deduction
  - Capital Gains Rates

## Tax Environment

- California Individual tax rates:
  - 2009 was 9.3%
  - 2010 Increases .25% to 9.55%
  - 1% additional “Mental Health Services Tax”
  - 2011 ??%
  
- California Corporate tax rates:
  - 2009 was 8.84%
  - 2010 stays at 8.84%
  - 2011 ??%

## Tax Environment

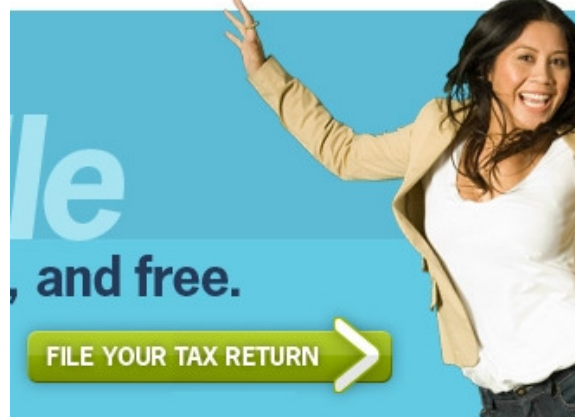
- California ranks 6<sup>th</sup> in USA in tax burden
  1. New York,
  2. New Jersey,
  3. Connecticut,
  4. Maryland
  5. Hawaii
  6. California

Source: The Tax Foundation, rankings as of 2008

## Tax Environment

- From 1977 to 2008 Tax Burden Rank:
  - Highest Ranking: 2nd (2001)
  - Average Ranking over period years: 8.81
  - Average Ranking last 10 years: 5.8

Source: The Tax Foundation



Picture from the FTB website  
Most Californians are NOT jumping for joy.

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## City Perspectives

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Sid Espinosa  
Mayor, City of Palo Alto

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## Budget, Tax, Reform, and More

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Dean Andal  
PwC; former member BOE and  
California Assembly

## ***UNDERSTANDING THE CALIFORNIA ECONOMY***

***TEI-SJSU Tax Policy Conference***

***February 11, 2011***

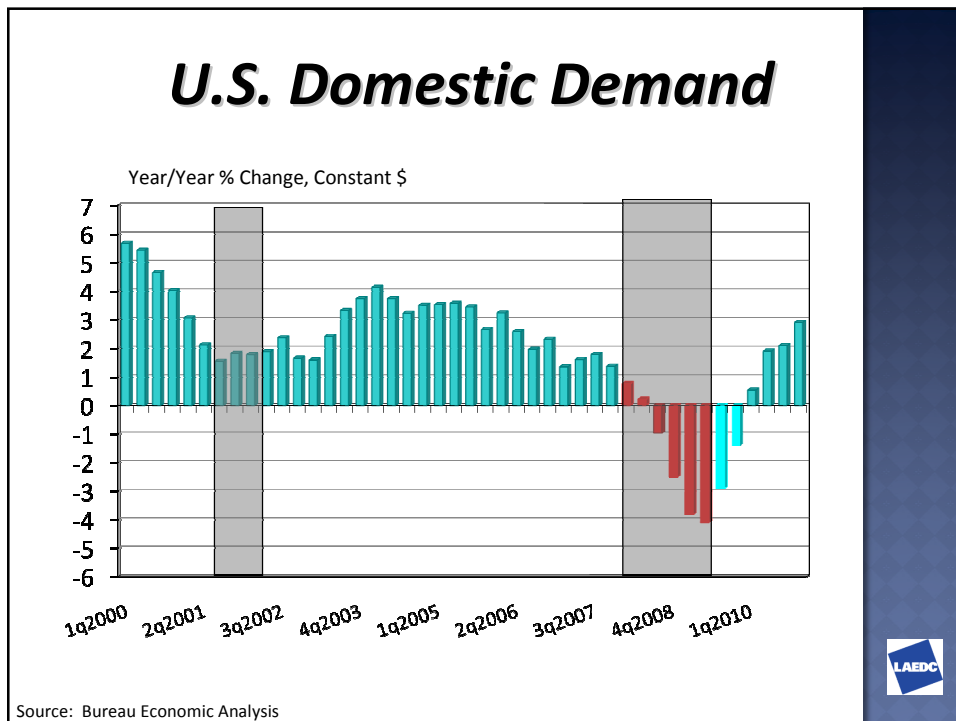
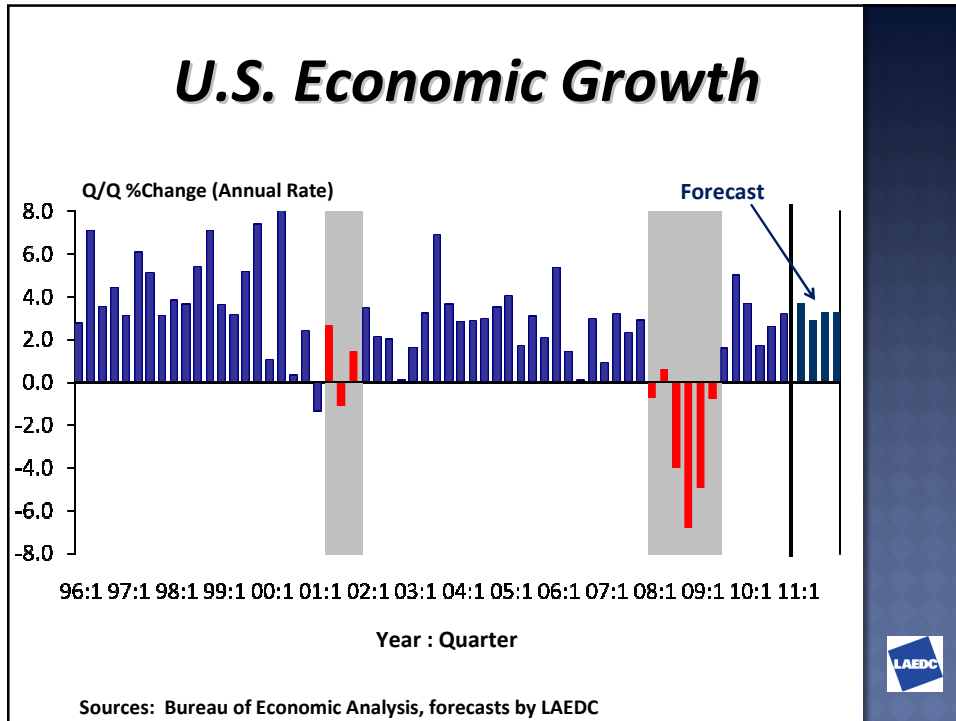
**Nancy D. Sidhu, Ph.D.  
Chief Economist  
L.A. Economic Development  
Corporation**

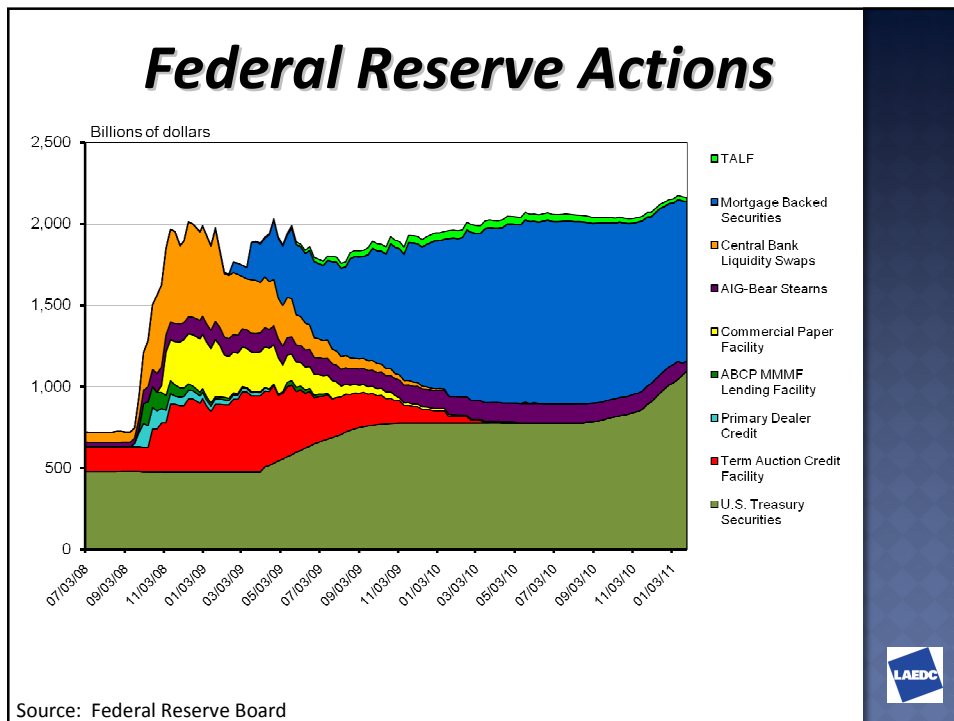
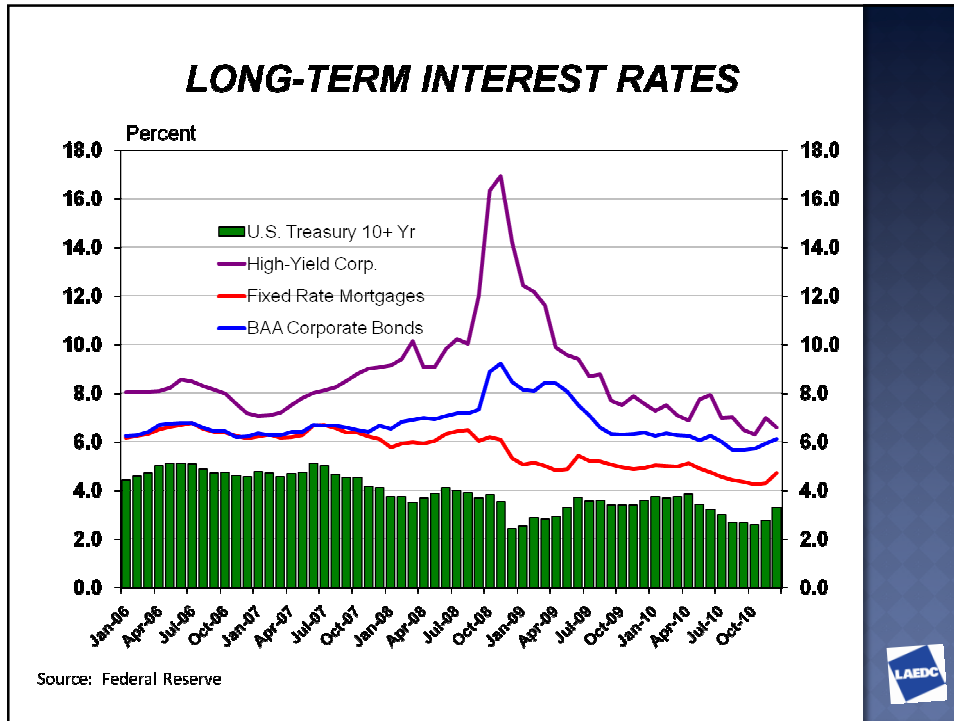


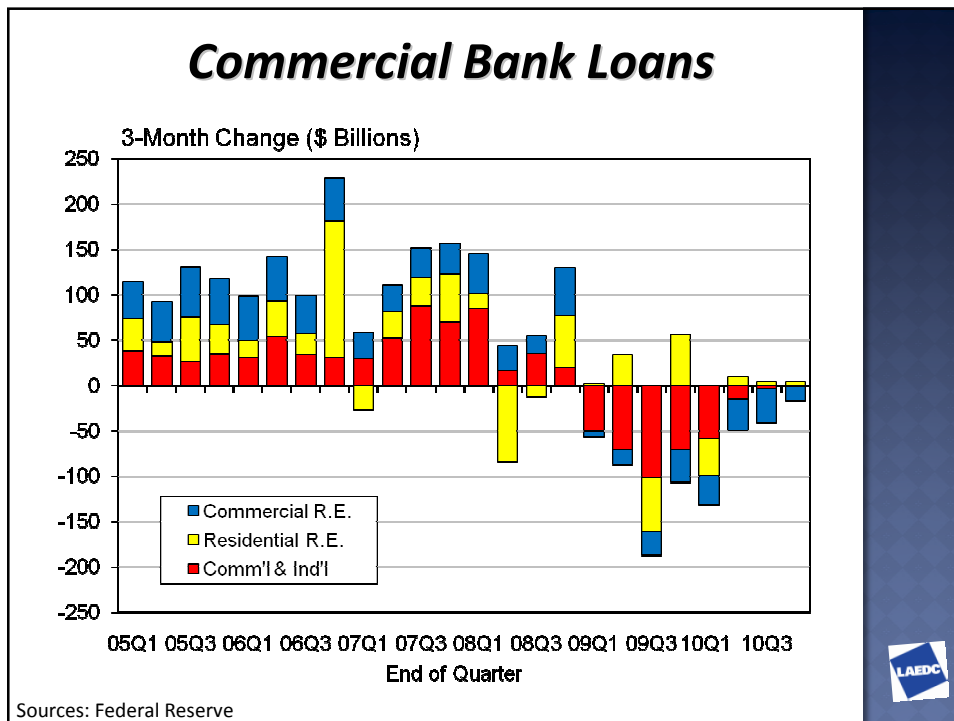
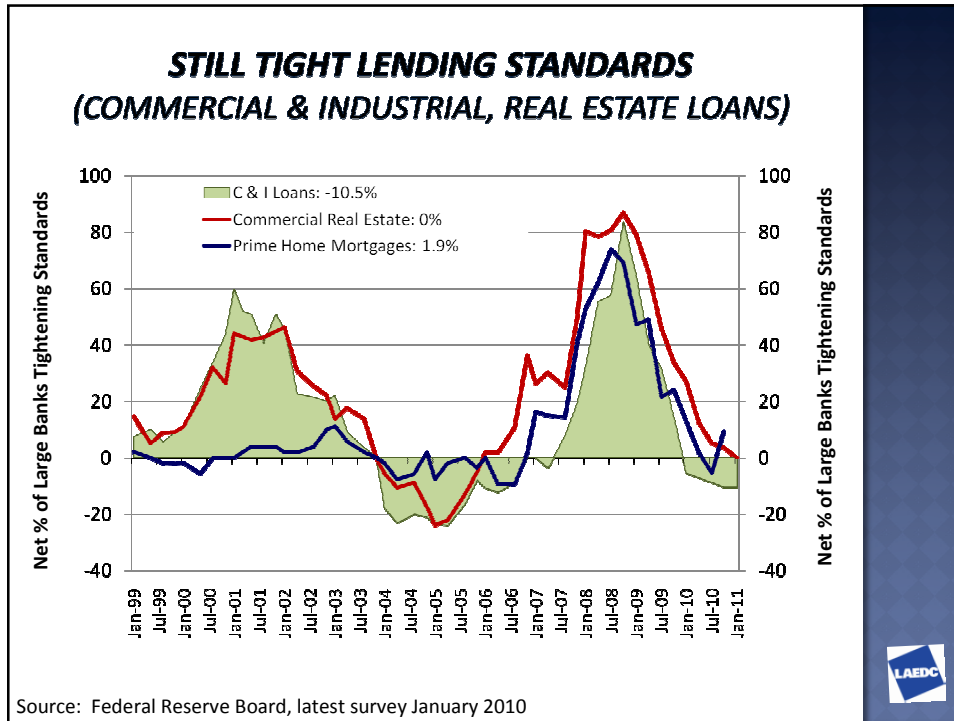
## ***Economic Summary***

- U.S. economic recovery is well under way
- California's upturn started in 2010
- Industry performance is mixed but improving
  - ☹️ Construction, government, manufacturing weak
  - ☺️ A number of key sectors are now growing











## CALIFORNIA'S ECONOMY -- 2011

### Positives

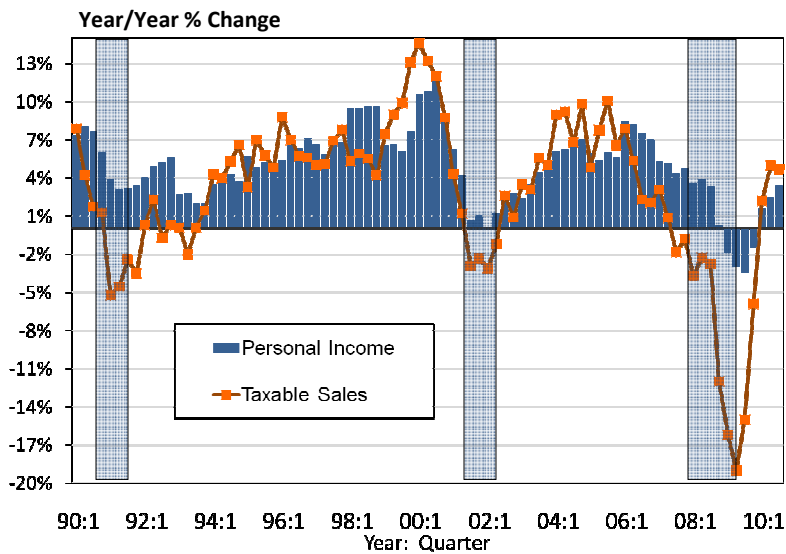
- ⦿ Economic upturn is here
- ⦿ Growth in several areas
- ⦿ Growth in several sectors
- ⦿ Better housing affordability

### Negatives

- ⦿ Record unemployment
- ⦿ Construction depressed
- ⦿ Manufacturing a struggle
- ⦿ State budget deficit
- ⦿ Credit squeeze hurts
- ⦿ Water supply?

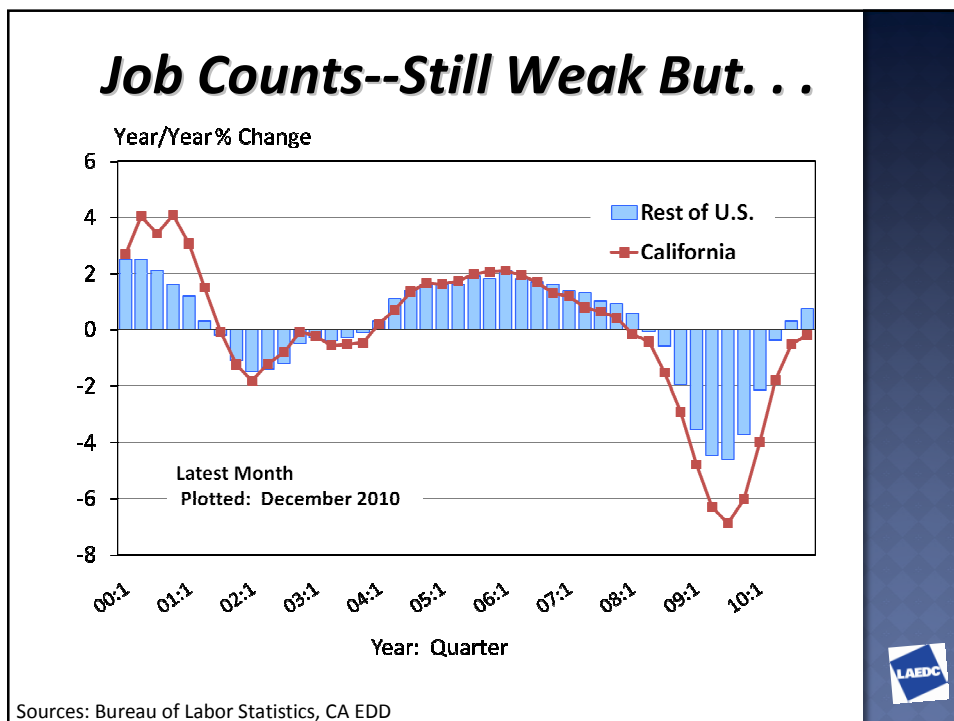
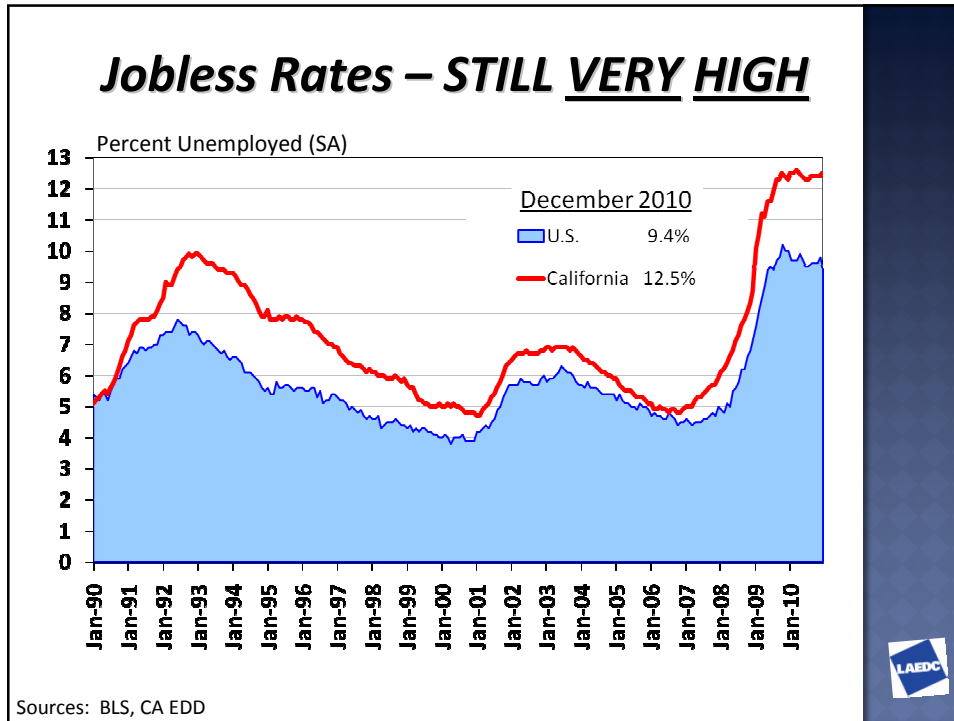


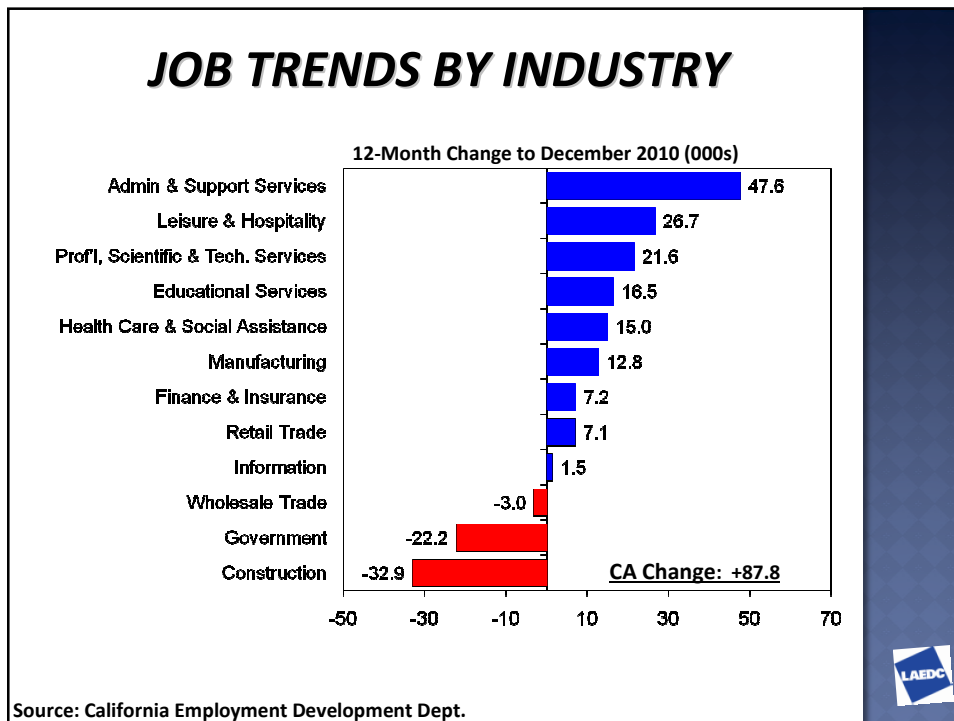
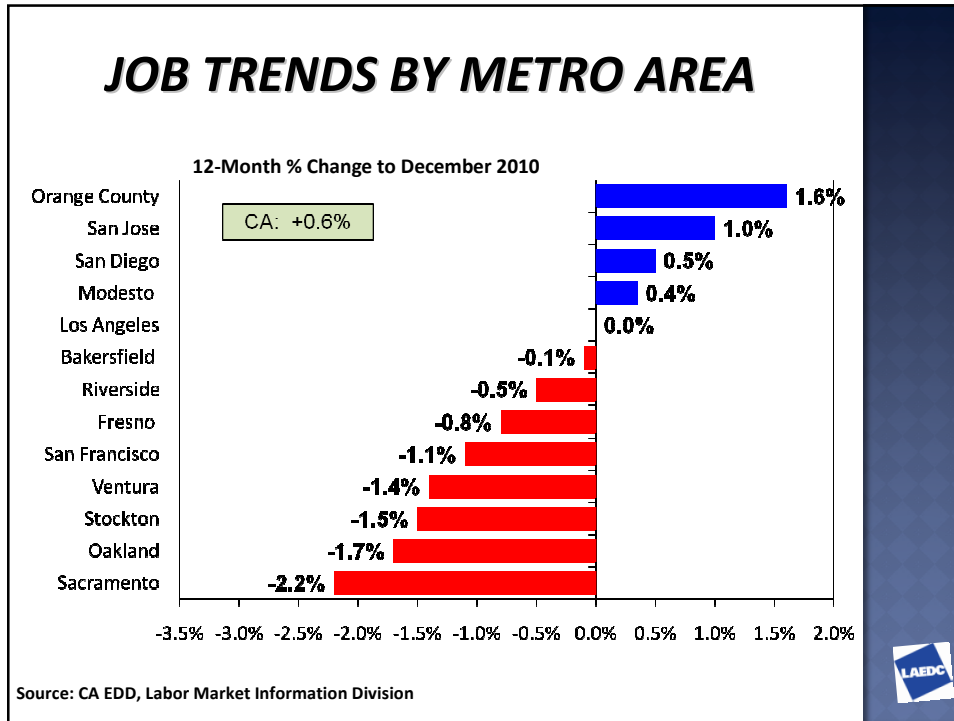
## California Personal Income & Taxable Sales

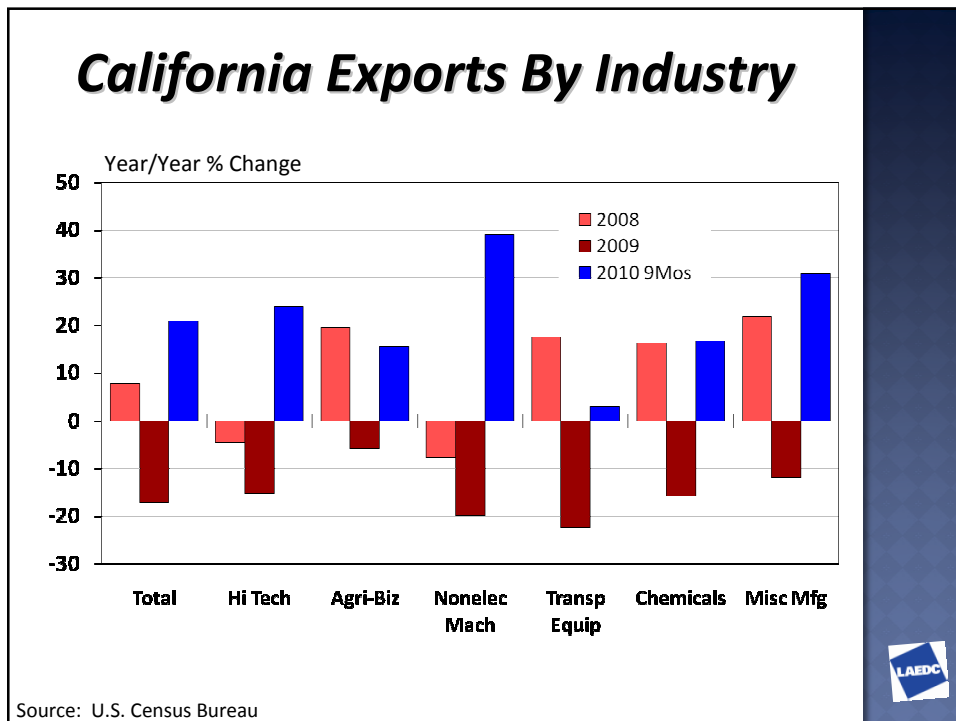
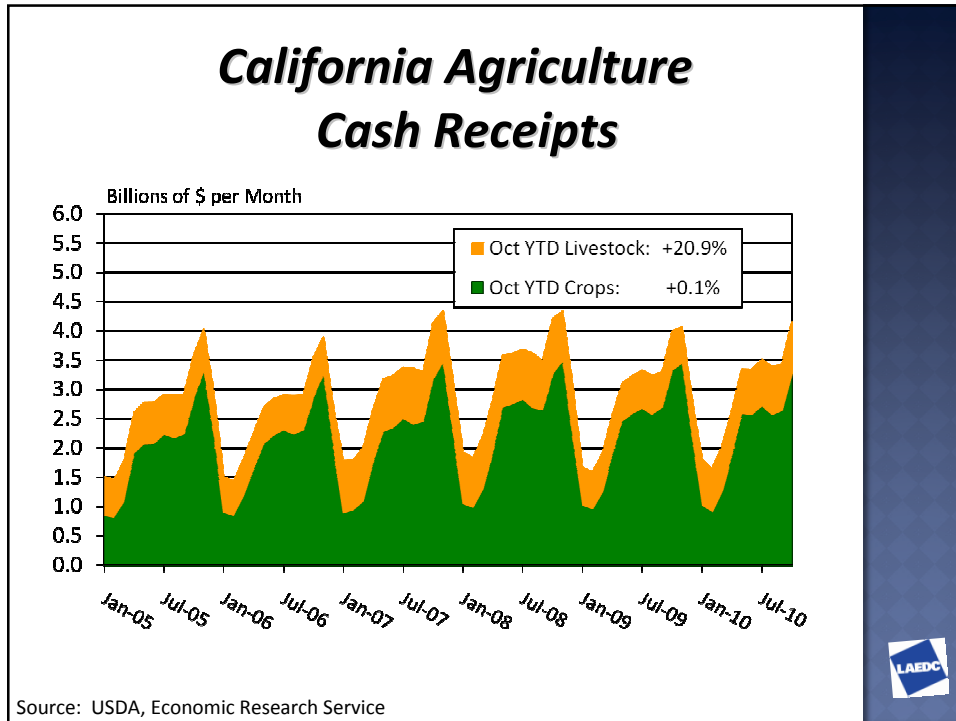


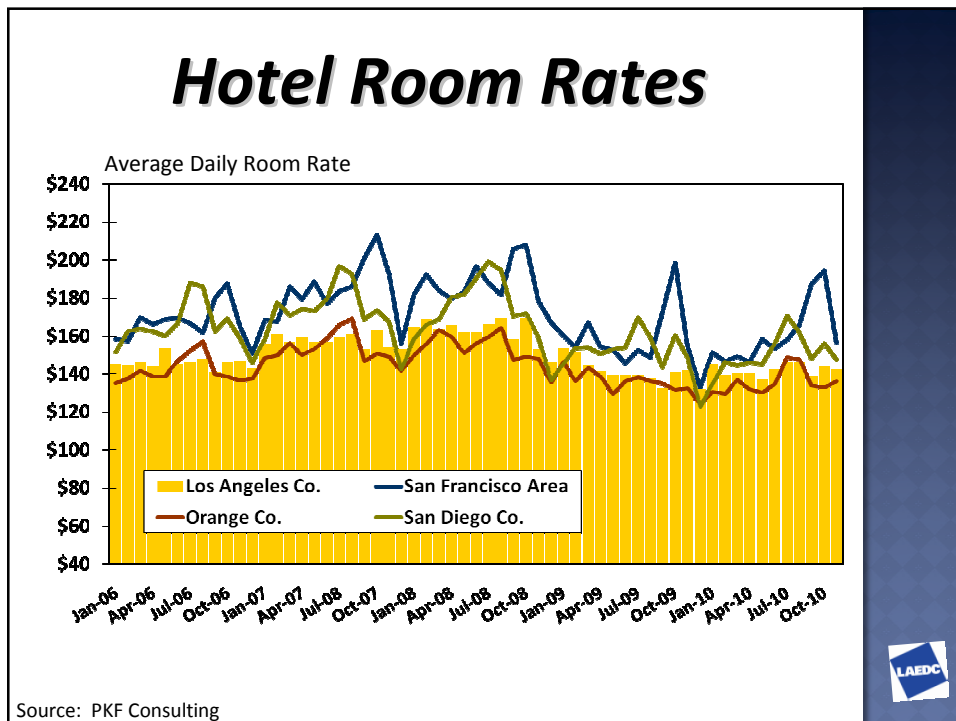
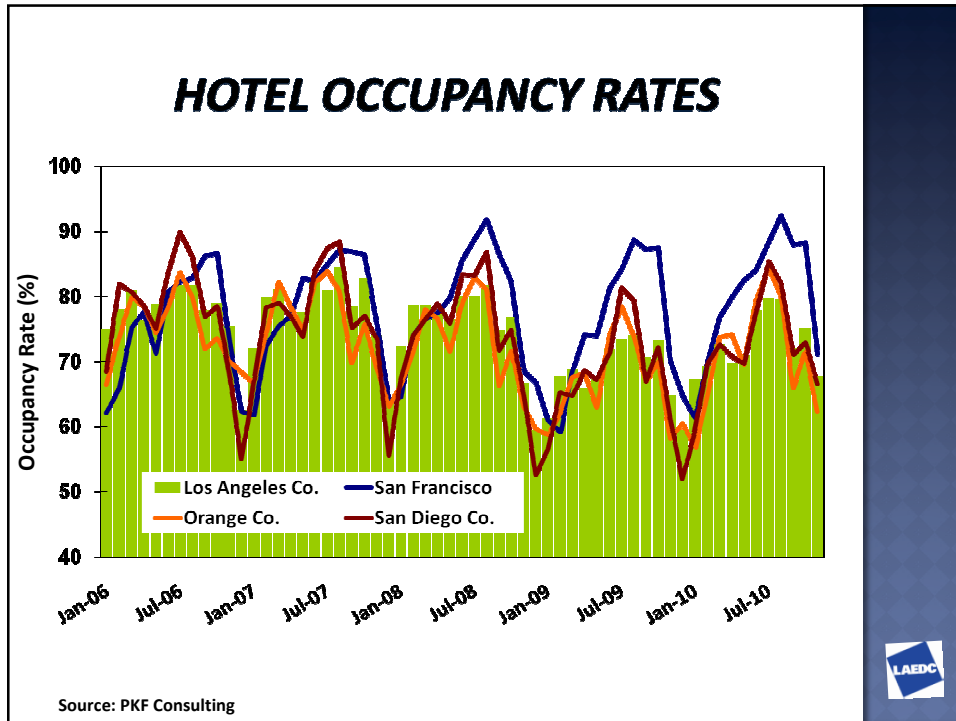
Sources: BEA, CA BOE

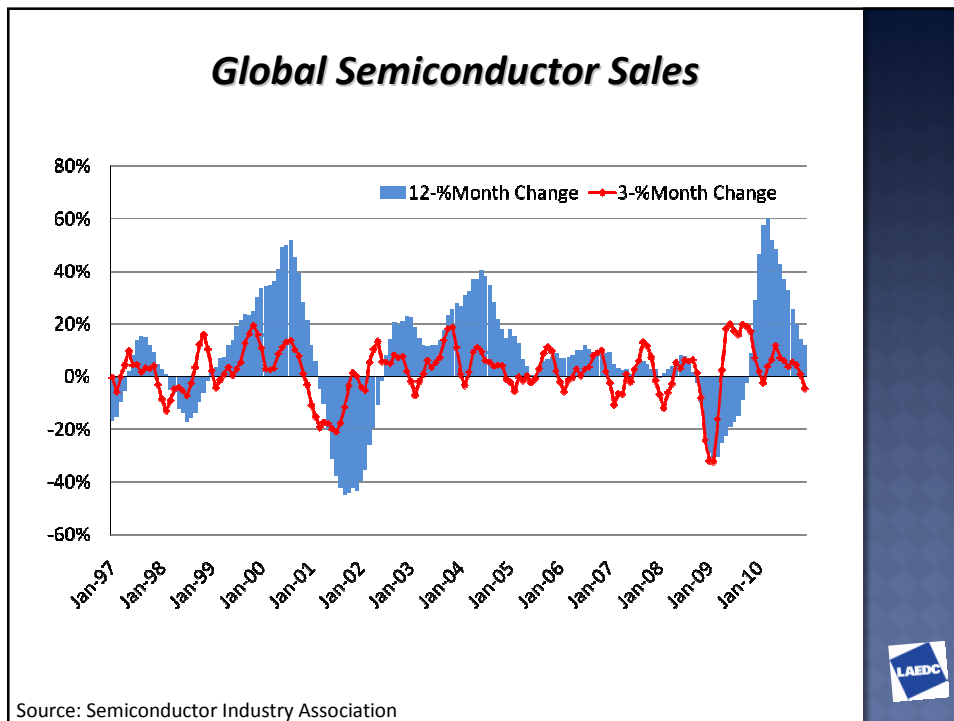
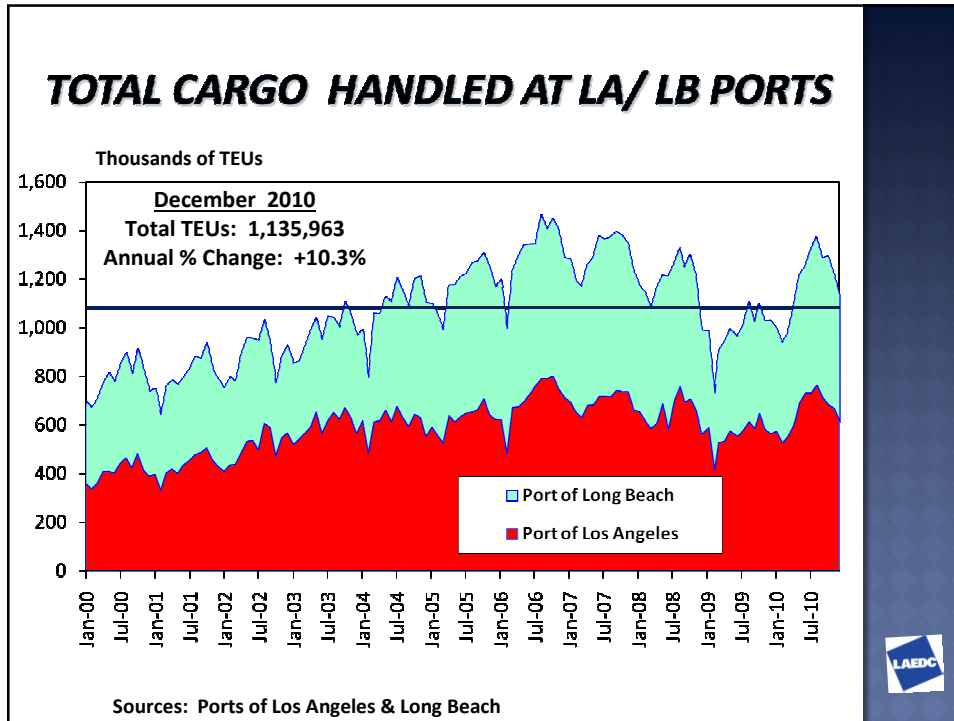


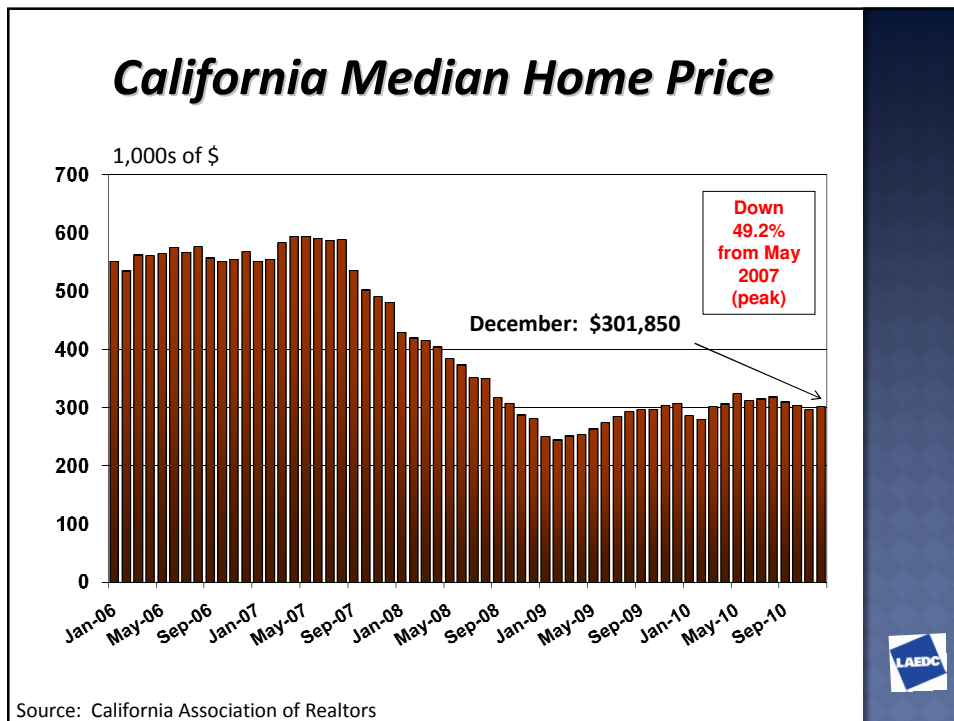
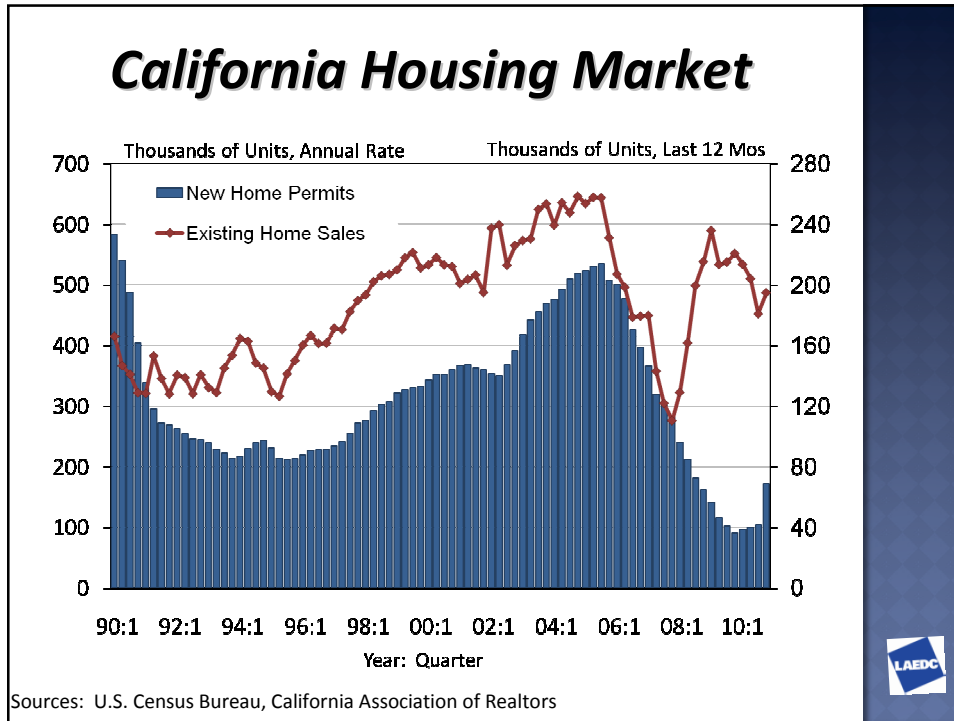


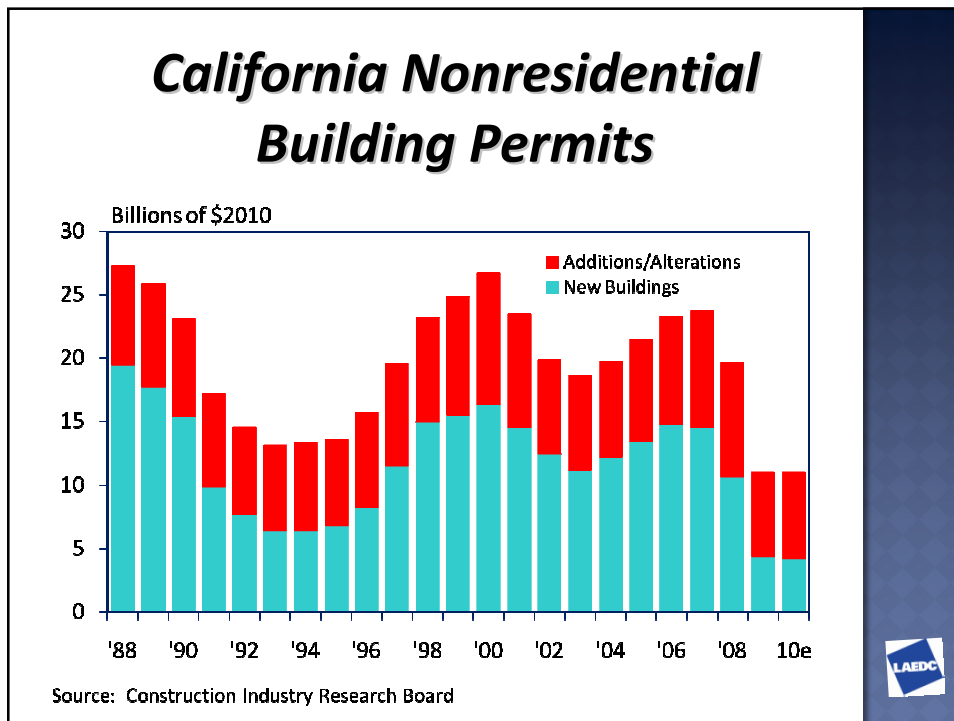
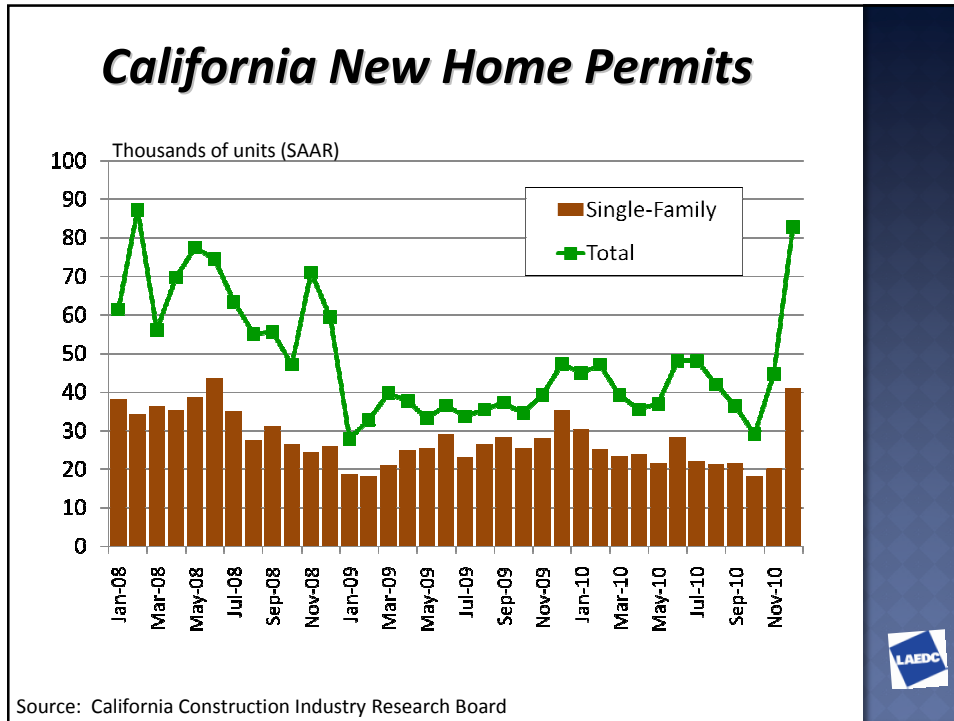




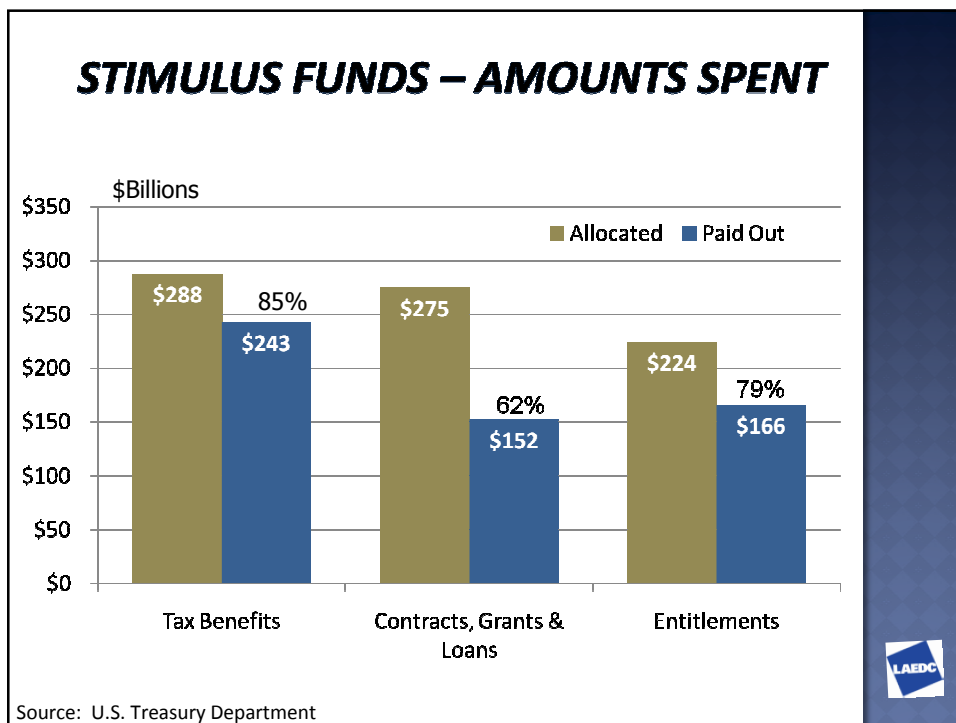
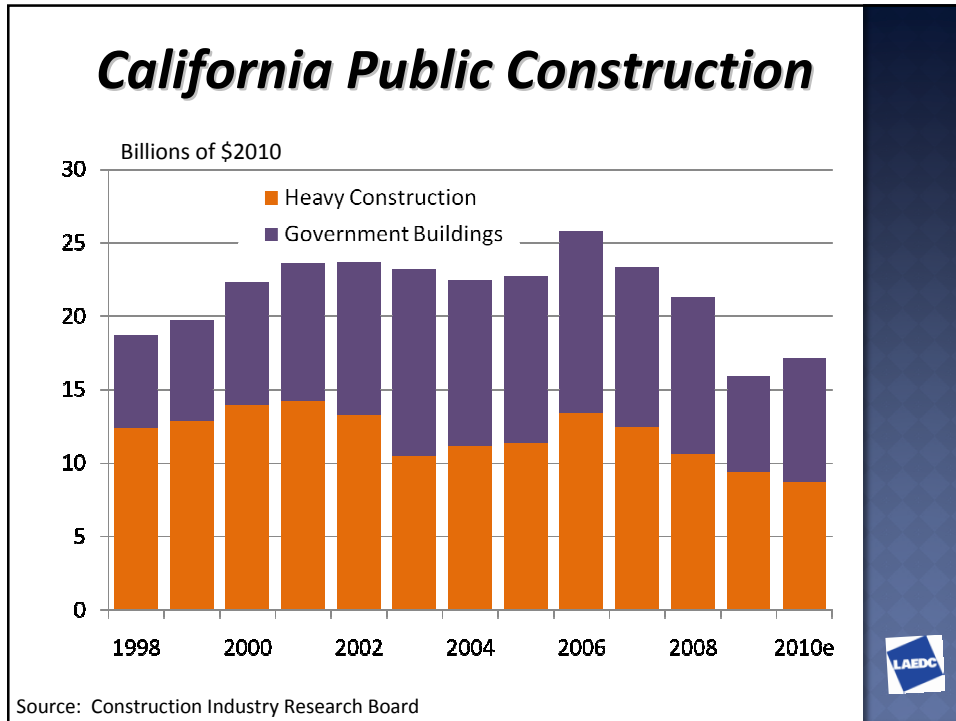










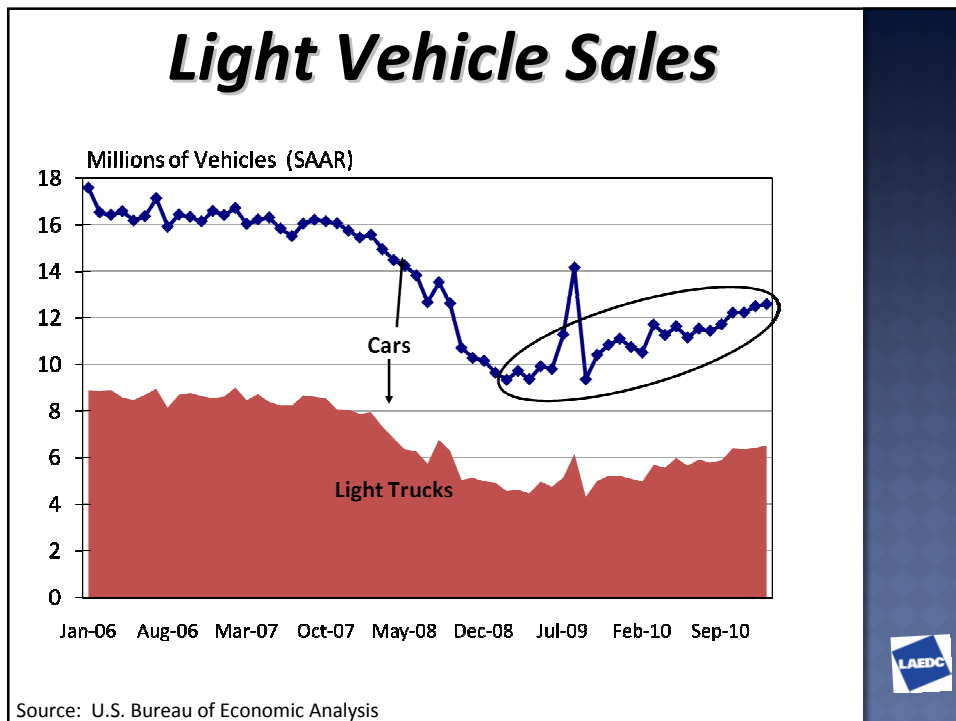
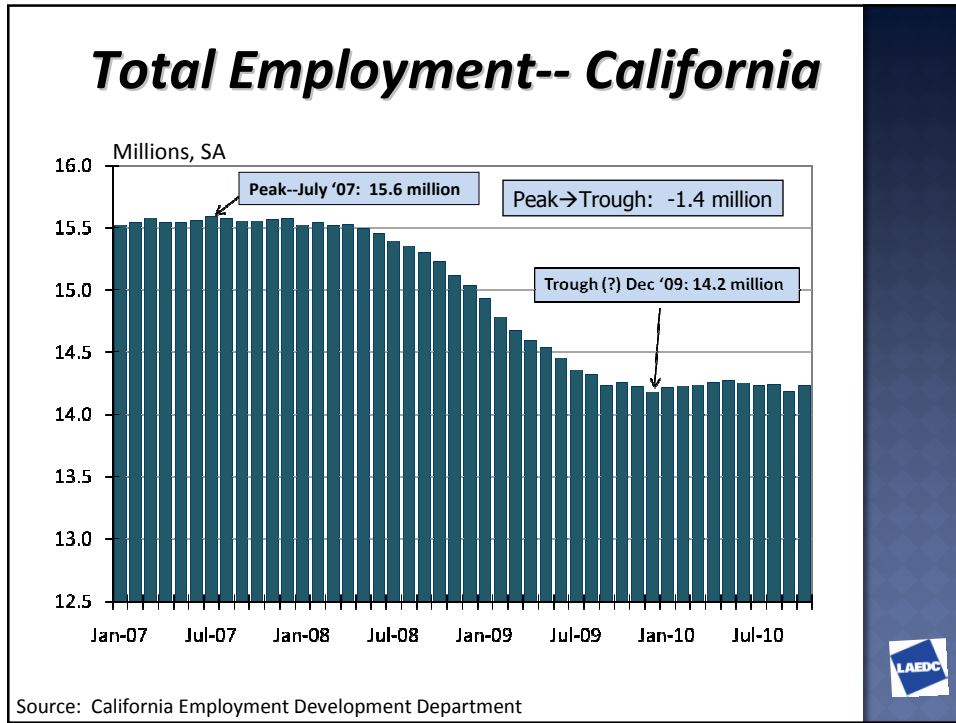


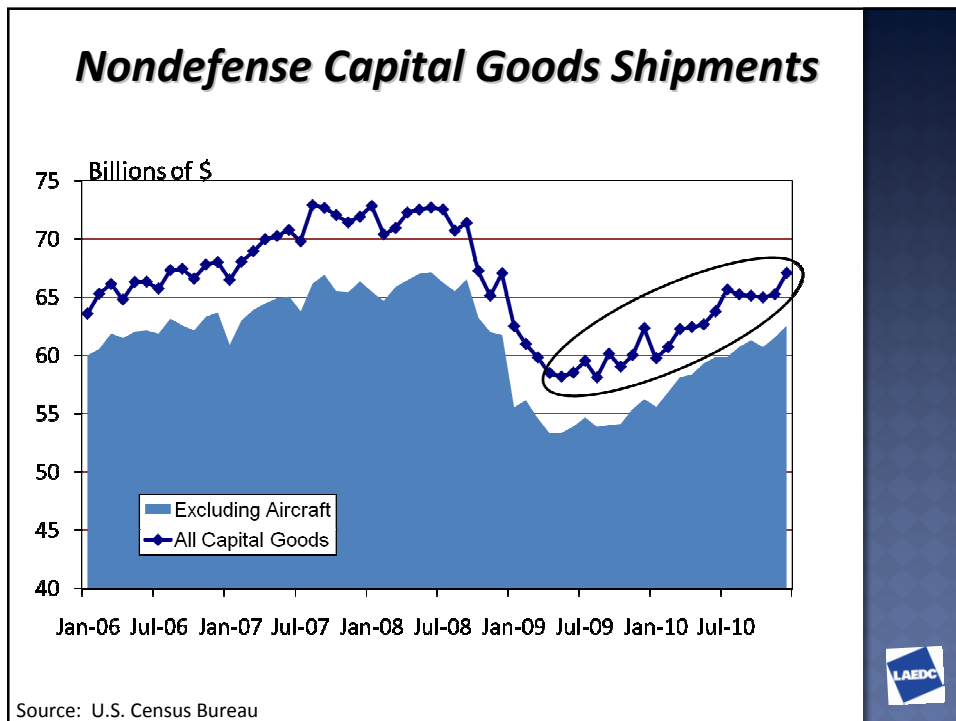
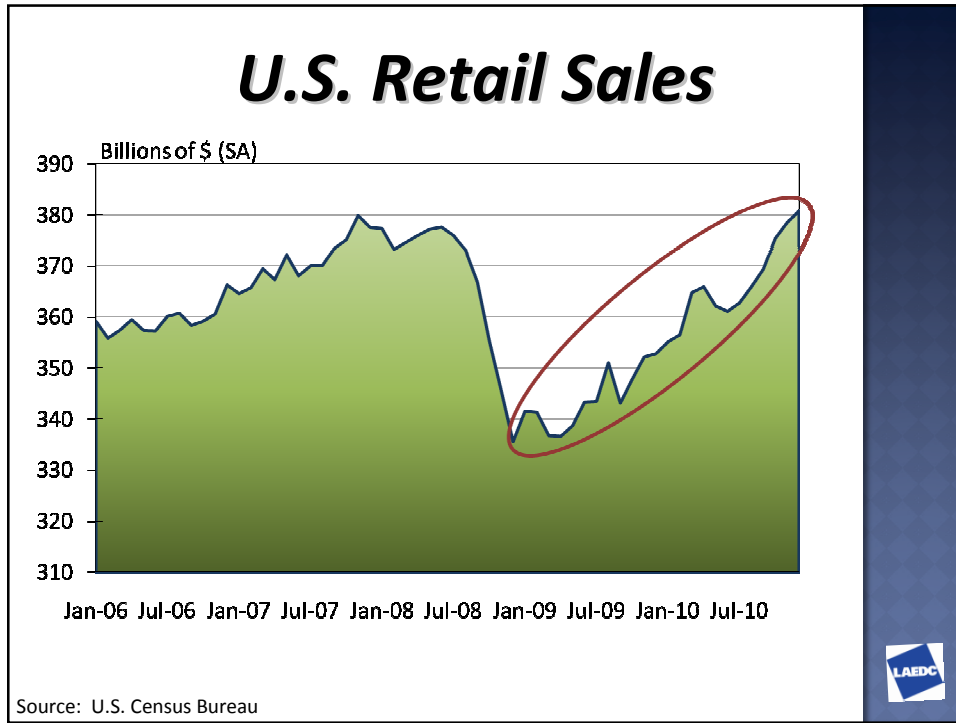


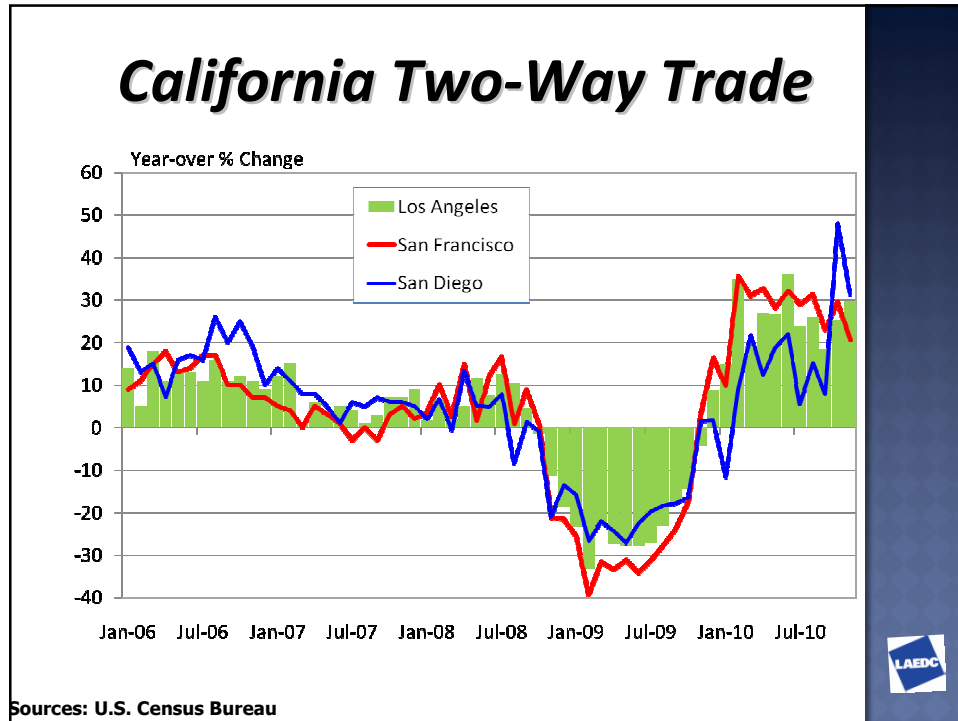
## ***The Recovery? What Recovery?***

- **Unemployment is still much too high**
- **Employment is still weak**
- **Housing indicators are mostly depressed**
- **Commercial real estate is awful**









## **Issues in the 2011 Outlook:** **Economic Policy**

- **Fed's quiver is nearly empty**
  - *QE2 --\$600 billion more asset purchases*
  - *Other moves?*
- **Stimulus program impacts are waning**
- **What will/won't the new Congress do?**



**Issues in the 2011 Outlook:**  
**Private Sector**

- **Inventory adjustment has ended**
  - **Business will return to the fundamentals**
  - **How fast will demand grow?**
  
- **Consensus—moderate growth in 2011**
  - **Consumer Spending** **C/C+**
  - **Business Equipment Investment** **B/B+**
  - **Private Construction** **D**
  - **Exports** **B**



**CALIFORNIA TAX REVENUES**  
**-- A CYCLICAL VIEW**

