California Commission on Tax Policy in the New Economy

Sunnyvale
March 20, 2002

Proceedings

MARCH 20, 2002; SUNNYVALE

√Characteristics of California's Tax System
Mark Ibele - California Legislative Analyst's Office

Financing Cities: A Status Report On California Cities and The Need For Serious Reform
Chris McKenzie - Executive Director, California League of Cities

Financing Cities and the Need for Tax Reform
John Russo - City Attorney, City of Oakland

Cities and the Future of Public Finance
Joe Hilson - Council Member, City of Hayward

Sales and Use Tax Considerations for Cities
Mary Bradley - Director of Finance, City of Sunnyvale

Sales Tax Challenges in the New Economy
Robert Locke - Finance and Administrative Services Director, City of Mountain View

Taxation of the Telecommunications Industry
Brian Moura - Assistant City Manager, City of San Carlos

Tax Policy, Trends and Issues
Annette Nellen - Professor, San Jose State University, Chair, Tax and Policy Group, Joint Venture: Silicon Valley Network

R & D Tax Credits and Tax Simplification
Terry Ryan - Director, State and Local Taxes, Apple Computer

California Tax Simplification, Conformity and Fairness
Matt Stolte - Partner, San Francisco Tax Practice for PricewaterhouseCoopers

MEETING MINUTES
California Commission on Tax Policy in the New Economy
Sunnyvale City Council Chambers
Sunnyvale, California
March 20, 2002
10:00 AM

Commissioners Present

- William J. Rosendahl, Chair
- Lenny Goldberg
- Lawrence Carr
- Glen Rossman
- Sean O. Burton
- William Weintraub
- Marilyn C. Brewer
- Scott Peters

Members Absent

- Bill Dombrowski

Ex-Officio Members Present

- John Thiella (Chief Deputy), for the Honorable John Chiang (Chair, Board of Equalization)
- Brian Toman (Chief Counsel), for Gerald Goldberg (Executive Officer, Franchise Tax Board)
- Marcy Jo Mandel (Deputy State Controller, Taxation), for the Honorable Kathleen Connell (State Controller)
- Robert Affleck (Deputy Director, Tax Branch), for Michael Bernick (Director, EDD)

Call to Order

Welcome Remarks

Mr. Rosendahl welcomed everyone to the second Commission meeting.

The Honorable Fred Fowler, Mayor of the City of Sunnyvale welcomed the Commission to Sunnyvale and commended the Commissioners on the work they have taken on.

INTRODUCTION OF MEMBERS

Review and Approval of Meeting Minutes from January 29, 2002

ACTION: Mr. Peters moved that the Commission approve the Minutes of the January 29, 2002 Meeting. Ms. Brewer seconded the motion. The motion was approved by unanimous vote.

Review and Approval of Working Groups

ACTION: Mr. Rossman moved that the Commission approve the Content & Presentations Working Group. Ms. Brewer seconded the motion. The motion was approved by unanimous vote.

ACTION: Mr. Burton moved that the Commission approve the Other Government Entities Working Group. Mr. Goldberg seconded the motion. The motion was approved by unanimous vote.

ACTION: Mr. Peters moved that the Commission approve the Public Input Working Group. Mr. Burton seconded the motion. The motion was approved by unanimous vote.

ACTION: Ms. Brewer moved that the Commission approve the Report Writing Working Group. Mr. Rossman seconded the motion. The motion was approved by unanimous vote.

Review and Approval of Future Meeting Locations and Dates

After a brief discussion of future meeting dates, it was decided that the Commissioners would look into possible additional meetings in August or October.

ACTION: Mr. Peters moved that the Commission approve the future meeting dates of May 16th, July 1st, September 24th, and November 12th. Ms. Brewer seconded the motion. The motion was approved by unanimous vote.

Expert Presentations

- Mark Ibele, Legislative Analysts Office

Mr. Ibele provided some background on California's tax system. Mr. Ibele noted that the state has a highly progressive Personal Income Tax and that the revenue is highly volatile, as it is dependent on capital gains taxes. In relation to other states, he commented that California is on the low-end in regards to income taxes. Mr. Ibele stated that there is a shift towards an economy based on services and intangible goods, and that this shift will cause the tax base to continue to erode.

Mr. Goldberg commented that when one is discussing state taxes, property taxes should be included as one of the sources of revenue. Mr. Ibele agreed, as he feels it is best to use as inclusive an analysis as possible. Mr. Peters stated that, from a local government perspective, he appreciated Mr. Goldberg's comment.

Mr. Ibele continued on to discuss tax burden. He stated California's tax burden is about average in comparison to other states. He continued that tax burdens are best when discussed in relation to expenditures. Mr. Ibele noted that business' burdens are difficult to measure because of various deductions, exemptions and credits available. He suggested looking at specific firms as representatives, and he referenced studies performed by the Federal Reserve Bank of Boston and the State of Wisconsin. These studies showed California in the middle of the pack in 1996. Mr. Ibele made note that the burden will vary by industry.

Mr. Ibele suggested the Commission work to first define the "New Economy" and then look at specific changes in the SUT tax system and/or the telecommunications tax system, as examples, from a public finance perspective. He mentioned some options might be to establish a broader base of gross receipts, a piecemeal approach to selected services in the base and a broader base of consumption. Mr. Ibele recommended the Commission adopt a "revenue neutral" approach and stay in a public finance mode.

Mr. Rosendahl inquired if the LAO has looked at other states' activities. Mr. Ibele mentioned that Tennessee and New York are both states that are looking into their state tax system. Mr. Rosendahl asked what the federal government's role has been in this process. Mr. Ibele commented that they have not gone in much direction on this and that the Commission cannot look to them as a guiding light. He stated that it is important for the state to stay aware of the activities of the Streamlined Sales Tax Project (SSTP), even if California is not a participant.

Ms. Brewer asked how California's business taxes have penalized the state's growth. Mr. Ibele stated that that is very difficult to answer, as it is not an isolated issue. He noted, however, that is possible to look at specific tax policies from a public finance point of view, such as the R&D Tax Credit.

Mr. Dombrowski inquired whether Mr. Ibele is aware of any policy by the Board of Equalization on how to implement an approach to SUT collection. Mr. Ibele referenced the BOE website, but he stated he is not aware of how they are enforcing the collection. Mr. Thiella commented that it is necessary to bifurcate the SUT. He mentioned there are over 1 million registered businesses with the BOE, and of those, about 14,000 comprise about 85% of the sales tax collection. Mr. Thiella commented that every taxpayer has an obligation to pay use tax, as this protects the state's businesses. He referenced a report from the Census Bureau citing 93% of Internet sales are business-to-business; therefore these businesses are probably already registered with the BOE and have an obligation to pay use tax. He felt it is not an issue of needing a new statute, but rather a need to enforce the existing one. Ms. Mandel mentioned there are some Internet sales that the BOE can enforce on an individual basis, such as the cigarette purchases over the Internet. She also commented there has been some discussion to include a use tax line on the Franchise Tax Board return.

Mr. Burton asked Mr. Ibele to expand on his suggestion to take a "revenue neutral" approach. Mr. Ibele clarified that the Commission should not look at whether taxes are too high or too low, but should instead apply public finance rules to ensure the system is efficient and equitable. He provided telecommunications as one example, where telephones and cable are treated differently when they sometime perform the same activity.

Mr. Goldberg commented that most tax policy is on the margins. For example, he noted that the Independent Booksellers Association handles sales on a small scale and is insignificant on a macro view, but it is important to level the playing field.

Mr. Toman stated that, from the FTB's perspective, these are issues of nexus, and it is therefore more a legal issue rather than a policy issue.

Mr. Rossman asked what is California's tax policy. Mr. Ibele suggested the Revenue and Taxation Committees answer that question, as they set the policy. He mentioned that the way taxes have evolved has not been part of a tax policy, and that, currently, the short-term tax policy is to raise revenue. Mr. Rossman commented that therefore the state has no tax policy. He inquired how the Commission could frame these as policy issues without looking at expenditures. Mr. Ibele responded that in terms of the Commission's charge, that is why he recommends using a revenue neutral approach. Mr. Rossman stated that if one is not reacting to policy or expenditures, then how could the questions be answered. Mr. Rossman thanked Mr. Ibele for his practical start to solving the problems.

Mr. Peters asked why taxes are not considered a big issue for business location. Mr. Ibele responded that access to trained labor, infrastructure and access to market are bigger issues, but it depends on the industry. Mr. Rossman commented that taxes can be a deciding factor if all other things are equal, especially as the labor force becomes more mobile.

Mr. Carr commented that he has concern for talking about taking a "revenue neutral" approach, as there is a need to take into account local/regional finance issues.

Mr. Goldberg suggested Mr. Ibele present on the LAO's report on California's Tax Policy and the Internet.

- ***Local Government***
  - ***Chris McKenzie, Executive Director for the California League of Cities***
    Mr. McKenzie stated that the local government presenters would begin with a 25-foot overview of cities' finance and then proceed down to specific topics.

  - ***John Russo, City Attorney for the City of Oakland***
    Mr. Russo commented that cities are general-purpose local governments, provide essential frontline municipal services tailored to meet the unique needs of the communities they serve, are funded mostly by locally enacted revenues, and provide land use planning and control. Mr. Russo stated that 4 in 5 of California's residents live in a city. He continued on to note that before 1978, California was one of the strongest home rule states in the nation, but that times have changed. Proposition 13, he continued, cut local government property tax revenues by 60%, thereby making the cities more dependent on the state's budget. In 1991-92, Mr. Russo said, property tax shares were cut an additional 24%, and this change costs $500 million after limited categorical funding from the state.

Mr. McKenzie provided a snapshot of intergovernmental revenues to cities. He made note of the Vehicle License Fee and the Gas Tax, as large percentages of the state money to cities. Mr. McKenzie then presented how different types of revenues have changed in their importance to the funding of cities, and that only 37% of a city's revenue is discretionary. He stated that, of these discretionary revenues, the majority of the spending is in parks, fire, and police expenditures. Mr. McKenzie commented that over the last 20 years, the cities are being squeezed, as there is an increase in police and fire spending, but a decrease in taxes and state/federal transfers. In the last 10 years, he noted, parks and libraries have taken the hardest hit, with 22% and 12% cuts, respectively. Mr. McKenzie stated that cities receive 14% of the property tax, about 13% of the sales tax, 17% of the VLF, and less than 1% of the state income tax.

Mr. Russo stated that the decline of city property tax revenue has left cities seeking other revenues. He noted that this promotes aggressive sales tax consciousness and that housing uses often cost more in public services than they generate in tax revenues. Mr. Russo commented that cities need more control of all basic municipal services and less interference from the state. He wants he more predictable and independent tax system, with constitution protection.

Mr. Goldberg asked about the status if the California League of Cities' initiative to provide this constitutional protection. Mr. Russo responded that, unless things change, the initiative will be on the March 2004 ballot.

- ***Joe Hilson, Council Member for the City of Hayward***
  "The struggle over sales tax on electronic and remote commerce has been a wake-up call for government to re-evaluate a broader set of problems. Remote sales are only one of many important challenges to the continued viability of municipal finance. Recognizing these challenges Cities are calling for a rethinking of the public finance system.

  We hold a perspective that 'no conventional ideas should go unchallenged an no heresies should go unexplored.' Our objective is to identify problems, pose questions and suggest solutions that should be pursued, and participate in the policy debate to meet the challenges to public finance.

  "We recognize and understand the emerging challenges in public finance and commit to take constructive steps locally. We welcome and encourage this Commission to engage partners and collaborators in calling attention to these issues and advancing the discussion. We look forward to working with you in developing a stable and equitable public finance system for all California stakeholders.

  "Municipal governments are confronted with trends that are fundamentally changing governance roles at the same time that demographic trends are creating a greater need for municipal services. New governance challenges include more agile economic actors, greater livability disparities among residents, and new metropolitan geographies. "Demographic changes include the simultaneous growth of the aging and youth populations, continued immigration, and more complex households. These and other governance challenges and demographic trends lead to a heightened need for traditional services and the need for new services.

"Heightened demand for traditional and new services consequently requires additional revenues and new revenue sources. Additional revenues are needed to keep pace with increasing demands for traditional services, such as public safety and infrastructure. New revenues are also needed to address demands for services not previously provided, such as anti-terrorism preparedness, e-government and after school programs. Municipalities have responded to these pressures partly by increasing the use of user charges and fees. But, these mechanisms often place a disproportionate burden on less advantaged communities. Without rethinking the current system of public finance, municipalities will increasingly be asked to do more with less.

"Many of the sources of economic growth and wealth have moved out from under public revenue mechanisms. The economy has shifted from one based on goods to one that is increasingly based upon knowledge and information. Yet, the current system of revenue generation remains largely dependent upon a traditional goods-based economy and its tax bases. Certain economic sectors, industries and workers are consequently shouldering a disproportionate share of the burden of financing government, while other sectors, industries, and workers contribute less than their fair share.

"While external economic trends threaten the system of public finance, the system is also threatened by competition, special treatment of various groups and voter resistance to tax policy. Increasingly, mobile economic actors place additional incentives on governments to compete against each other. This competition takes the form of financial giveaways, tax exemptions, and tax breaks given to businesses and individuals who have the ability to locate where they are offered the best deal. In many instances, this competition is a zero-sum game that simply shifts investment and jobs between locations. Special treatment of particular groups, through the granting of tax exemptions further erodes tax bases. Competitive deals and special treatment of particular groups also increase the complexity, decrease the accountability, and exacerbate inequities in the public finance system, all of which in turn fuels voter resistance to tax policy.

"These changes have intensified the stress on cities' revenue structures. Many cities face increasing constraints on their capacity to raise adequate funds to meet the needs of their residents, as well as deterioration in the fairness, neutrality, and administrative simplicity of their taxes. In short, dramatic economic change threatens to render local revenue systems increasingly inequitable and inadequate. To overcome these challenges, efforts are needed to measure economic activity for the purposes of extracting revenue from the new economy and diversifying local revenue sources.

"Changes in the intergovernmental system have simultaneously increased the roles and responsibilities of municipal governments and eroded municipal fiscal capacity and authority. These changes take several forms. Municipalities operate under state constraints that often subject municipal governments to the political and policy cycles of state governments. The transfer of program responsibilities from state and federal government, as well as the imposition of state and federal mandates, increase the roles and responsibilities of municipal governments, often without corresponding fiscal capacity or authority. While municipal responsibilities for programs and the costs of these programs have increased, federal and state aid to municipalities has either decreased or remained level. The resulting fiscal pressures are exacerbated by state and federal preemption of local revenue authority and changes in the state and federal tax structure that affect local tax structures.

"These changes necessitate the monitoring of the current state of the intergovernmental system and ongoing evaluation of fiscal and program responsibilities across the system. The first need requires organized collection of data and information about government responsibilities and finances, while the second need requires a neutral, independent forum to monitor and review the intergovernmental system. We need to work together on efforts to develop these capacities, with particular attention given to the fundamental interconnectedness of the system and various forms of revenue sharing.

"A brief look at a report from the Center for Business and Economic Research at the University of Tennessee shows the sales tax base shrinking from the effects of e-commerce and the shift from a goods base to a service based economy. Internet sales may reach $1.3 Trillion dollars before 2011.The loss for all states in 2001 is estimate to be $13 Billion dollars. California's loss is $1.75 Billion dollars. This is 41% greater than estimated in 2000. By the year 2006 States loss could total $45 Billion dollars and California could lose $5.9 Billion dollars. This loss would equal about 4.7% of the total taxes collected by the state. As you can see the revenue impacts are significant.

Impacts and Results

"Without changes to the tax structure, the information and technology revolution will drastically reduce local government revenues. The loss in revenue to the City of Hayward in 2001, directly attributed to e-commerce was $500,000 dollars. By the year 2006 it is estimated to exceed $2,000,000 dollars. Other shifts in revenues have taken their toll on city revenues too, exacerbating the effect of the recession. Hayward's ERAF shift for the year 1996 was $3.4 Million dollars. The shift had grown to 4.57 Million for 2001 and totals $19.7 Million dollars since 1996. City budgets are increasingly non-discretionary, 80% for Hayward, resulting in a potential deficit of $2.5 Million dollars this year. All of the government representatives and most of the business representatives to the NTA E-Commerce Tax Project agreed that a fundamental restructuring of the public financing system is imperative if local governments are to provide the services demanded by their constituents.

"A new system of public finance is needed to address the governance, economic and intergovernmental challenges facing municipal governments. State, federal and local governments, face many related challenges. New sources of revenue are needed that tap the new economy's growth in knowledge and service industries, and to end an inequitable and unsustainable reliance upon old economy mechanisms. Constraints on existing revenue sources must be reevaluated, redesigned, or eliminated. A new system of public finance should generate adequate revenues to meet public needs, while providing governments with the flexibility and autonomy to support new and evolving government roles.

"In calling for a rethinking of the public finance system, we have identified a number of challenges and issues. Our goal is to raise awareness and understanding around public finance challenges and to point to areas where further investigation, analysis and action are necessary. California cities are committed to continuing their own investigations and analyses and we welcome and encourage partners and collaborators in calling attention to the issues raised here and in advancing this discussion and debate toward constructive action."

- ***Mary Bradley, Director of Finance for the City of Sunnyvale***

  Ms. Bradley presented some of the technical aspects of the SUT. She mentioned that the sales tax is imposed on retailers for the privilege of selling tangible personal property in California, and that retailers are required to collect the tax from the purchaser and remit it to the BOE on a point of sale basis. Ms. Bradley stated that the law is very clear in California. Ms. Bradley then defined the Use tax and provided examples of it. She mentioned that generally the percentage of total SUT revenues is about 75% sales tax and 25% use tax. Ms. Bradley commented that most large business transactions are accrued, reported and collected, however there is limited use tax collection on small businesses and individuals. She referenced the case of National Bellas Hess v. Illinois Department of Revenue (1967), where the Supreme Court exempts businesses from collecting use taxes in states where they do not have a physical presence. Ms. Bradley also referenced Quill v. North Dakota (1992) where the Supreme Court reaffirms the mail order exemption, but signals a shift in policy. The court said Congress can pass legislation requiring that mail order companies pay SUT under certain circumstances, and thereby defines the concept of "Nexus." Ms. Bradley explained this concept of "Nexus." She commented that remote sales are subject to use tax by law, and that the issue is the Duty to Collect.

  Mr. Goldberg commented that he understood Congress' lack of response to these large court cases was a result of the cities and counties not being able to agree. Ms. Bradley responded that this was true in the past, but cities now stand ready to simplify the system.

- ***Robert Locke, Finance & Administrative Services Director for the City of Mountain View***

  Mr. Locke brought the conversation level down even lower into the issues. He mentioned some of the issues surrounding the application of sales tax to electronically transmitted software and digital products. Mr. Locke commented that the same software could be taxed differently, depending on the delivery method: on disk or electronic download. He defined "Tangible Personal

Property" according to California's Revenue and Taxation Code Section 6016, and provided specific examples. Mr. Locke mentioned that the tax system reflects 1960's era understanding of the nature of software and that this undermines the tax base. He noted that the method of conducting a transaction should not determine the taxability of the transaction.

- ***Brian Moura, Assistant City Manager for the City of San Carlos***

  Mr. Moura presented some specific issues as related to telecommunications. He mentioned that state and federal Internet Freedom Acts carve out phone and that it protects the city Utility User Tax. Mr. Moura commented that there are right-of-way and click-and-mortar issues to address. He mentioned that there needs to be a level playing field and that there will be great benefits if the system is simplified, as it would be easier to comply and there would exist an increased acceptance of the Duty to Collect.

  Mr. Peters asked whether there exists a policy reason behind the state not participating in the SSTP. Mr. Moura responded there was a bill by Senator Costa, but it was vetoed by Governor Davis. He mentioned that the cities and counties took a support position on the bill and that California should be participating in the project.

  Mr. Goldberg inquired whether telecommunications taxes distinguish between different types of activities and whether phone bill taxes are collected for Internet use. Mr. Moura responded that some cover the phone, some the phone plus others, but it varies. Mr. Goldberg asked if the Internet Tax Freedom Act affects telecom uses of the Internet. Mr. Moura stated that it does. Ms. Bradley commented that the CA League of Cites is forming a technical task force on utility user taxes.

  Mr. Rossman stated that is one considers simplification and not try to tax every transaction, what the panel would suggest. Ms. Bradley responded that the group is not looking for any new taxes, but rather just a better mix of the existing ones. Mr. Russo commented that his personal feeling is the sales tax is doomed, as the transactional tax is doomed. He said he could not think of a situation politically where taxing the Internet will level the playing field, but rather he foresees tangible sales taxes will be cut. He stated that the revenue streams should be matched to burdens.

  Mr. Rosendahl asked Mr. Russo what he meant earlier by moving "back to the future." Mr. Russo gave the VLF as an example and responded that the state needs to make a stable system or we will continue to do poor local decision-making. He offered property tax as the most logical source of revenue. Mr. McKenzie commented that the state needs to look at SSTP.

- ***Annette Nellen, Tax Professor at San Jose State University & Chair of the Tax Policy Group of Joint Venture: Silicon Valley Network***

  Ms. Nellen stated that current tax law has not moved forward with the changes that have occurred in society and the economy. She walked the Commissioners through a handout that summarized some of the current economic trends. Ms. Nellen noted that the United States' share of the world GDP is dropping, but that the federal tax rules are still based on those established in the 1950's and 60's. She also noted that the increase in the percentage of the population over the age of 85 years old would also change the shape of the economy. Ms. Nellen commented that the U.S. is the last industrialized country without a consumption tax, and that has the marketplace becomes more global it is a problem that out tax system is still so dependent on geography. Ms. Nellen mentioned the declining sales base as a result of the increase in the percentage of consumption in the form of services.

Ms. Nellen commented that the federal and state provisions should not hinder productivity and that the Silicon Valley Joint Ventures Group is looking into this and some other issues including: the increase in difficulty collecting use tax, the fact that the e-commerce business model does not align with the current tax system, how a state can impose taxes from a foreign company, and whether or not California should participate in the SSTP.

Ms. Nellen referenced a white paper produced by the Silicon Valley Joint Venture Group that outlines some guiding principles for examining e-commerce tax issues. Among the principles, Ms. Nellen commented on a few, including: the need to treat e-commerce the same as regular commerce in order to ensure equity; that changes should not just solve e-commerce issues as a lot of the problems have been around for decades; the examination should include telecom and income taxes in addition to sales tax, and; it is important to look at the transition that would be involved in shifting to a new model, as local government is dependent on sales tax.

Ms. Nellen then referenced another white paper that lists the ten principles of good tax policy. Among the principle, Ms. Nellen commented on the need for equity and fairness and the issues of neutrality.
Mr. Peters asked whether there exists any academic debate on these principles. Ms. Nellen replied that they are relatively well accepted. Mr. Peters recommended the Commission should adopt the principles and then discuss how they can best be implemented.

Ms. Brewer inquired whether Ms. Nellen is in support of the SSTP. Ms. Nellen responded that the project is making progress, but is getting held-up on the definitions. She commented that it would probably be good for California to be involved, and that she hoped the project will eventually give us trying to find consensus on the definitions and just broaden the base.

Mr. Weintraub asked if there is any consensus on California participating. Ms. Nellen said she did not know if there are any official positions or not. Mr. Rosendahl inquired why we don't participate, to which Ms. Nellen responded to perhaps there is the thought that we are already participating in other related multi-state activities.

- ***Terry Ryan, Director – State & Local Taxes for Apple Computer***
  Mr. Ryan commented on Mr. Rosendahl's earlier comment that he believes California is not participating in the SSTP because the Administration is opposed to Internet taxation. Mr. Ryan stated he believes the state should join the project in an effort to

get it back on track. He commented he believes the SSTP has become a vehicle for higher taxes.

Mr. Ryan stated the property tax should be given back to local government, and business supports this view. He also noted that cities are not incented to encourage R&D or manufacturing because of the way sales tax is allocated. He commented that the sales tax should be dependent on where people work, not where the sale takes place, as this is better aligned with the burden. Mr. Ryan stated that there is no viable software that can automate the SUT collection for businesses, and that the software that does exist, is prohibitively expensive for small businesses.

Mr. Ryan advocated one-rate per state for simplification purposes. He also mentioned that software should be exempt from taxation and that taxes are a major deciding factor for businesses in location, in response to earlier comments. He noted that Apple Computers moved some employees out of California and into Texas because of the tax benefits.

Mr. Ryan commented that the state needs to encourage high technology investment and reduce the tax burden on businesses. He stated that the R&D tax credit should be increased and that personal property tax should be eliminated for business. In order to balance this decrease in revenue, he suggested, the state could increase the rate on real property. He also recommended a single sales factor as a means for encouraging economic growth in the state. He stated business should get a refund for the sales tax it collects, and that the BOE, FTB and EDD should merge together in order to lessen the burden on business. Mr. Ryan noted the state needs better tax conformity with the federal income tax return.

Mr. Peters asked for some clarification on the Net-Operating-Loss (NOL) term. Mr. Ryan responded that business could carry forward about half of the NOL, however it forces the business to perform some odd activities thereby increasing the burden.

Mr. Weintraub recommended the BOE, FTB and EDD respond to some of the issues in future meetings. Ms. Mandel responded that many of the issues of conformity are legislative issues. Ms. Brewer commented that the FTB opposed previously introduced legislation for conformity, as it removed revenue. Ms. Brewer also commented that one-rate per state would not work unless the property tax is given back to local government. Mr. Ryan clarified that he suggests one-rate for the use tax only.

- ***Matt Stolte, West Region Practice Leader for the State Tax Consulting Group & Partner-in-Charge, San Francisco Tax Practice for PricewaterhouseCoopers***
  "I am the West Region Leader of the PricewaterhouseCoopers' State Tax Consulting practice. In that capacity, I lead a group of professionals located throughout California who consult with individuals and companies ranging from small start-ups to large multinational corporations, both based within California and otherwise, regarding the various state level and local level taxes that these business face within the State. My comments today will be focused primarily on the California income/franchise tax system.

There seems to be a consistent perception among our clients (large corporations, small businesses, individuals and other business entities) that California tax laws are simply too complex and compliance is too burdensome. This seems to be validated by the results of recent surveys by CFO magazine in 1996 and 2000. In these surveys, California did not fare well in the areas of fairness and predictability (ranking in the bottom 5 states). Also the state was ranked 44th among the 50 states with respect to being friendly to small business in the annual report of the Small Business Survival Committee. High taxes was one of the factors sited in this report. In a scorecard produced by the Committee on State Taxation (COST), it was concluded that California was one of the least fair states in handling tax appeals. This scorecard ranked the states according to the efficacy of their appeals systems and according to each states adherence to certain procedural elements.

To some degree, I don't believe this reputation is entirely deserved. For instance, California has made good strides in attracting and maintaining technology and manufacturing concerns through tax credits which incentivize the conduct of these important activities within the State. The talent pool in California is very rich and as a group, we believe the tax attorneys, auditors, senior management and top leadership of California's main Tax Administrative Agencies (FTB & SBE) are among the very best in the nation. Auditors are generally well trained and customer oriented. The administrative remedies available to taxpayers help ensure a fair resolution of tax disputes without incurring costly litigation. The FTB Settlement Bureau has been effective in resolving difficult cases and avoiding costly litigation. Lastly, the FTB Taxpayer's Advocate Program has been another very positive addition to the state's Tax Administration structure.

However, there ARE areas where the perception of the business community would certainly seem to be justified. We have outlined some of these areas, along with suggestions for change and/or improvements below:

Unlike most states, California does not truly conform to the IRC. Instead, the Revenue and Taxation Code is a patchwork of specifically adopted IRC statutes that are interwoven with unique and complex California provisions; the nuances of which are unclear for smaller businesses, many out-of-state businesses, foreign-based businesses and dynamic businesses within California that have growing and complex operations. Some specific examples of how California's conformity process creates problems are as follows:

- Timing of Conformity – Just trying to figure out which federal law is applicable for California purposes can be extremely difficult. We are already dealing with conformity to an IRC that is 4 years old…and then tax professionals have to dig through individual code sections to determine if there have been any "selective" conformity to provisions of federal tax acts in the intervening years…Finding California's tax treatment of an item of income or deduction can be extremely frustrating, time consuming and expensive.

- Application of Treasury Regs. and IRS Rulings, etc. – This can be problematic when the federal law has been changed, but California has not conformed to the latest version of the federal law…there is always the lingering question of whether the Ruling, Notice, etc. will be respected by the FTB. Another difficulty arises when the federal guidance relies on code sections or areas of law that California does not follow – this also makes it difficult to gain certainty as to the application of the guidance for state purposes.

California should take a critical look at the overall conformity process and determine whether to proceed down a path of full federal conformity or automatic federal conformity with "limited" exceptions.

- Specific examples:
  - California does not conform to federal depreciation (MACRS and ACRS) for corporations. The CA ADR depreciation is so outdated that many applications vendors (including several of the majors) do not offer the ADR method with their fixed asset modules. As such, many taxpayers simply CANNOT comply with the statutory requirements. Many taxpayers simply default to the federal or book method and "let the auditors spend as much time as they want auditing depreciation" because it is, after all, only a timing difference.
  - Recent areas of nonconformity or late conformity with federal law which have received negative publicity include taxation of certain retirement or deferred income, Roth IRAs, and certain REIT and Regulated Investment company provisions; and
  - Lack of full conformity to NOL provisions and general reduction of NOLs by 40%, to name but a few.

There are a variety of alternatives for California to consider in the area of conformity, most of which would be preferred to the existing scheme. Closer conformity would ease the administrative burden, reduce complexity and provide greater certainty to taxpayers.

There are many negative perceptions and some misconceptions in the business community concerning the nature of combined reporting which lend, fairly or unfairly, to California's reputation as being a tax unfriendly state in which to do business. Some of this perception is related to uncertainty caused by the delay in issuing regulations; some is simply due to the fact that most states do not require combined reporting; and some is due to the fact that combined reporting is based upon the "unitary concept," which is often a difficult and somewhat subjective determination in itself.

Examples:

- The Regulations under CRTC Section 25106.5, dealing with Intercompany Transactions, is a good example of how extraordinarily complex combined reporting can be under California's system. In its attempt to coordinate with the Treasury Regulation 1.1502-13 (consolidated return regs.), the FTB has overlaid multiple layers of complexity on an already difficult set of federal rules. Taxpayers must first master the exceptionally complex federal rules, then piggyback the equally complex California rules to arrive at a tax result. This almost always adds significant costs to the taxpayer, creates uncertainty in tax results and potential traps for the unwary for those who do not have the resources to understand and comply with the law. One particular "trap for the unwary" that is worthy of specific note is the following: If a subsidiary makes a distribution to its parent which is in excess of the parents' basis in the stock of the subsidiary, the resulting "realized gain" is deferred (not recognized) until a triggering event occurs. Under federal law, a non-taxable liquidation of the subsidiary into its parent would NOT be a triggering event. Under the California regulations, such a liquidation – even when both corporations are part of the same unitary/combined group – will trigger the deferred income. This is counter-intuitive (no real gain has been realized by the group and the group hasn't really changed) and, we believe, bad policy.

- Because combined reporting is dramatically different than federal consolidated reporting, incorporating "some" elements of the consolidated tax return scheme into California, without others, can create some surprising results. For example, corporate taxpayers often find themselves facing unexpected California tax liabilities (or large capital losses) after they sell subsidiaries, due to differences in basis rules for subsidiaries. For federal income tax purposes, adjustments are made to the stock basis of consolidated subsidiaries to prevent double taxation of subsidiary income when the subsidiary is sold. California does not conform to this aspect of the consolidated return regime. Increased capital losses which are sometimes recognized when an unprofitable subsidiary is sold will often go unused due to California's conformity to federal capital loss limitation provisions.

- Finally, companies that acquire new subsidiaries can also face somewhat unexpected tax consequences when dividend distributions are made following the acquisition. Such companies are often required to pay California tax on intercompany distributions received from recently acquired subsidiaries under unique California provisions which have no counterpart in the federal consolidated return regulations.

The above combined reporting issues stem primarily, but not entirely, from inconsistencies between federal and California law. While not all of the complexities are avoidable, a system that provides for "elective combination" and/or a federal consolidated tax return election (as does AZ), would be alternatives worthy of serious exploration.

Similar issues arise in the Water's-edge area. This body of law is very complex in its own right and should be simplified to be more readily understood and applied:

As an example, foreign subsidiaries with certain types of passive income and other types of income determined under the IRC are subject to inclusion in the water's-edge group in years that they are profitable. No relief via inclusion is allowed when these companies lose money. Further, the FTB has taken administrative positions which alter the amount of such income determined under the IRC. The complexity involved in this system creates a significant burden on both the taxpayer and the FTB.

Apportionment provisions are considered by most taxpayers to be somewhat outdated and not reflective of how businesses operate and generate income in today's environment. Greater use could be made of the CRTC Section 25137 provisions to remedy this problem, but it is a process not used to a great extent.

Good Tax Administration is Transparent – Public records requests often generate pages of documents which are not disclosed because of the "deliberative process privilege." If the tax agency prepares a document pertaining to a taxpayer or an issue impacting a taxpayer – we believe the taxpayer should be able to read that document regardless of its content. Often, challenging such an administrative determination to withhold relevant documents is cost prohibitive.

More timely guidance is desired. Big issues are breaking regularly and taxpayers are left in limbo more often than not.

There is a perception that California, in effect, gives with one hand and takes with another. This is particularly true with the Manufacturer's Investment Tax Credit ("MIC"), NOLs and credit utilization within combined reporting groups.
Enacted in 1994, the MIC was intended to promote manufacturing in the State by providing a credit of 6% of the cost of machinery and equipment, upon which California sales/use tax had been paid, as well as 6% of the cost of capitalized labor related to such.

However, Franchise Tax Board administrative regulations and pronouncements issued as many as six years after the statute was enacted seem to narrow the scope of these provisions. For example:

- qualified manufacturing activity conducted on predominantly non-manufacturing premises were disqualified;
- a more narrow federal definition of qualified property was adopted; and
- it was announced that only the portion of the labor costs paid to independent contractors which represent the <u>contractors'</u> cost of the labor qualified.

These administrative positions lessen the effectiveness of the MIC in attracting business expansion in the State by creating substantial uncertainty as to the tax benefits ultimately to be received.

Similar administrative positions concerning the use of credits in a combined report limit the overall effectiveness of credits in attracting expansion as well. For legal and other reasons it is common for businesses large and small to organize subsidiaries to conduct research or for other endeavors. While the general effect of California's combined reporting approach is to treat these subsidiaries essentially as divisions of a single entity for tax purposes, the Franchise Tax Board has taken the position that credits may not be utilized on a combined basis. Allowing credits to be utilized on a combined basis would go a long way towards dispelling negative taxpayer perception and improving the effectiveness of California credits in attracting business expansion.

The array of administrative remedies available to taxpayers in resolving tax disputes are not perceived as an advantage to doing business in California to the extent they could be. The overwhelming perception is that audits take too long, some assessments are arbitrary or unfair. It is not uncommon for the audit and protest process to reach final resolution 10 years or more after the returns in question were filed. During this time, regulations and administrative positions may be issued, changed, or withdrawn, and client and auditor turnover may occur causing the returns themselves and the subsequent audit proceedings to assume a provisional and uncertain quality. The proceedings can also absorb a significant amount of our client's internal personal and financial resources.

It is also not uncommon for clients to provide the same information to state auditors on repeated occasions. This may be due to auditor turnover or due to the information requests of different audit agencies. For example, the FTB will often request information to substantiate tax credits, which has already been provided to the SBE in connection with sales/use tax audits. The FTB is applauded for its efforts to improve coordination with the SBE in this area so far, but additional improvement can be made."

Mr. Rosendahl asked why some of these laws are still in effect. Mr. Stolte responded that they require legislative change.
Mr. Goldberg commented that an elective process would not work, as people will only elect to comply when it is in their best interests.

Mr. Rossman stated, that these laws have not changed because they would take away revenue. He also mentioned that the static scoring model hinders the system. Mr. Goldberg responded that many of the changes would be one-directional, but that the Department of Finance uses a dynamic scoring model. Mr. Goldberg also mentioned that multi-state complexities might be inevitable.

Mr. Toman mentioned that the conformity issue is a legislative process, as are many of the issues raised. Mr. Stolte agreed that they need legislative fixes. Mr. Rosendahl suggested Mr. Stolte submit his recommendations on how to solve the issues to the Commission at a later date.

Mr. Rossman recommended a future speaker on revenue scoring. Ms. Landingham commented that the DOF does use a dynamic model, and Ms. Mandel responded that the bill analyses the legislature conducts are static.

Scope of Work Discussion

Mr. Rosendahl invited Terri Sexton to comment on her suggestions for the Commission's scope of work (SOW). Ms. Sexton recommended the Commission look at Ms. Nellen's list of the principles of good tax policy as a start. She commented it is important to look at the trade-offs involved. She also suggested the Commission form the following task forces to take advantage of the expertise that already exists: a group to look at the important sectors of the state's economy, how they have changed, how they will evolve, and the revenue trends for various taxes; a group to examine the SSTP; one to examine telecommunications; another to look into income and property tax issues, and; a task force to investigate other states' activities and how California's system compares to others'.

Mr. Weintraub commented that there will always exist a "new economy" and that he recommends the Commission look into defining what is good tax policy. In terms of the SOW, Mr. Weintraub suggested that e-commerce is a good starting point and that he would like the Commissioners to send any information or suggestions to him on how to proceed. He also recommended that the legislators participate in the process. Mr. Rosendahl emphasized that the legislators and ex-officio members need to provide input. Mr. Toman commented that the Commissioners should be conscious of the Bagley-Keene Open Meeting Act in their discussions.

Mr. Rosendahl commented he would like elected officials, other states and other task forces to provide guidance in the process.

Mr. Peters suggested the Commission use Ms. Nellen's principles of good tax policy as a starting point for a task force, and that he views the first few hearings as fact finding meetings.
Mr. Carr suggested the Commission dedicate time in the next meeting to discuss what a good tax policy would be for California, but that legislators will need to help.

Mr. Goldberg commented that the SOW should be narrow and focused. He suggested the Commission focus on SUT and Internet issues, and telecommunications. He also mentioned it will be difficult for the Commission to get consensus on many of the issues.

Mr. Peters suggested that tax administration be included in the SOW.

Mr. Rossman stated that the Commission could take the list of the principles of good tax policy and evaluate the current taxes in the list's context. Mr. Burton responded that the list is a good start, but there are other issues to look at as well.

Ms. Brewer commented that it would not be the most productive use of the Commission's time to involve legislators. She also mentioned she would like to see a presentation on the SSTP.

Mr. Goldberg suggested the Commission take a look at the delta between the existing laws and the new economy. He recommended the list of good tax policies could be used as background.

Ms. Mandel offered some additional resources to look at tax policy from an academic perspective.

Mr. Peters commented the list of principles of good tax policy is just a starting point, and that the Commission should think about why cities are not being encouraged to build affordable housing. Mr. Rossman responded that this might be out of the Commission's SOW. Mr. Weintraub recommended putting the issue in the SOW outline.

Mr. Rosendahl stated that he in concerned that the property taxes are not going to local government. Ms. Brewer concurred, but commented that is an issue outside the Commission's SOW.

Mr. Burton noted that there is too much on the Commission's plate: SUT, Internet issues, compliance, SSTP, property tax, and income tax. He recommended the Commission pick a subset in order to be productive. Mr. Weintraub proposed he would draft an outline of the SOW for the May meeting.
Mr. Goldberg recommended a website be created in order to aid communication.

Mr. Burton commented that he agrees with Ms. Sexton's recommendation to establish task forces.

Mr. Weintraub again proposed that he would draft and distribute an outline of the SOW to discuss in the May meeting, as a starting point.

Public Comment

There were no public comments.

Adjournment

Financing Cities

A Status Report on California cities and the Need for Serious Reform

Prepared for the California Commission on Tax Policy in the New Economy
March 20, 2002

Chris McKenzie, Executive Director
John Russo, First Vice President and City Attorney, Oakland

Sales Tax Challenges in the New Economy

Presented to: The Commission on Taxation in the New Economy – March 20, 2002

Robert F. Locke, Finance Director
City of Mountain View
robert.locke@ci.mtnview.ca.us

Sales Tax and Software

- Application of sales tax to electronically transmitted software and digital products
- Taxable – when purchased on disk or other tangible media
- Non-taxable – when transmitted electronically

Application of Sales Tax

- **CA Rev & Taxation Code Section 6016**

“Tangible personal property means personal property which may be seen, weighed, measured**,** felt or touched, or which is in any other manner perceptible to the senses**.”**

What is Tangible?

- Software occupies disk storage space and can be measured
- BOE exemption focuses on means of transmission rather than tangible nature of product
- Misinterprets tangible nature of digital products

Adjusting to the New Economy

- Mass produced, electronically delivered software is new economy equivalent of old economy's manufactured product
- Tax exemption reflects 1960's era understanding of nature of software
- Custom software may be different
- Exemption undermines tax base

Adjusting to the New Economy

- **Method of conducting a transaction should not determine taxability of transaction**
- **Like transactions should be taxed in the same manner**
- **Exemption of a mass produced tangible product is difficult to justify**
- **Sales tax rules should be flexible enough to adjust to new technologies and transaction methods**

Testimony Before the California Commission on Tax Policy in the New Economy

March 20, 2002
Council Chambers
Sunnyvale, CA
by Annette Nellen, Esq., CPA
College of Business, San José State University
http://www.cob.sjsu.edu/facstaff/nellen_a/

Contents

Trends and Their Relevance to International, Federal and Subnational Tax Structures
DRAFT/Work-in-progress of Annette Nellen & Joint Venture Tax Policy Group Trends Tax Implications

A. U.S. faces increasingly greater competitive environment.

- Lower barriers to entry into markets due to technology and incentives
- Economic growth projected in non-OECD countries post-2000
- Reduction in trade barriers (NAFTA, GATT)
- E-commerce opportunities
- Double taxation of corporation income increases the cost of capital in the U.S. Many other countries have an integrated corporate/individual tax system.
- Many countries offer research incentives. U.S. research tax credit is a temporary measure.
- U.S. tax treaty network is not complete.

- Withholding taxes can be complex and burdensome for start-up companies, particularly where they have no current U.S. tax liability to apply a foreign tax credit against.
- Withholding rates should be evaluated to be sure they align with free trade policies.

B. Globalization

- Increased mobility of ideas, capital, investment and labor.
- Global communications capability and efficiency is increasing the ability to transact global business.
- May be some loss of local tax base as businesses, particularly new ones, find advantages in setting up operations outside of the U.S. (they are not incorporated or formed in the U.S.).
- Globalization increases competitiveness and can decrease economic life of patents and other intangibles, most of which today are amortized over 15 years for tax purposes.
- Worldwide-based U.S. taxation system may be outdated in light of increased competition from businesses in other countries and fact that tax rates are converging near the U.S. corporate tax rate of 35%.
- Tax law should not hinder key features needed by individuals and companies to participate effectively in the global market that drives productivity: education, R&D, headquarters activity, and low cost of capital.
- The consumption tax used by the U.S. states is unique in that most other countries use a VAT.

C. Merger of industries

- Airlines, trucking, telecommunications, power.
- Local government utility taxes and franchise fees should be reevaluated– may no longer provide horizontal equity (some industries may be taxed differently on similar services).

D. Shift from industrial age to information age

- Decrease in tangible goods as percentage of GNP, and growth in services.
- E-Commerce business model
- Eroding tax bases for state and local governments – typically property and sales tax bases do not include intangibles and services.
- The protections and clarifications of P.L. 86-272 (1959) only apply to income taxes and sales of tangible personal property.
- For many intangibles, 15-year life is often too long

TRENDS TAX IMPLICATIONS

E. Changes in business operations

- Growth of virtual workplaces and markets.
- Telecommuting and distant workers, global work teams.
- Increasing need for special expertise on an as-needed basis.

- Shorter product life cycles due to global competition.
- Changed production techniques: JIT, outsourcing, ability to address specialized customer needs.
- E-commerce business model.
- Some depreciation (MACRS) lives may be too long
- Inventory rules are complicated and inventory turns over quickly.
- Property tax valuation/obsolescence schedules may be too conservative.
- Nexus standards need to be reviewed and perhaps standardized among states to reduce complexity. For example, should location of a telecommuting employee in a state cause an employer to have nexus in that state? What about a server or leased phone lines?
- State sourcing of income from services and intangibles should be reviewed to consider/clarify nature of income (such as for software – product or intangible/service), "costs of performance," direct vs. indirect cost categorization, coordination of vendor state rule (majority of states) versus market-state rule to avoid double taxation of certain income, and whether different rules are needed for tangible goods versus other sales.
- Outdated and complex worker classification rules play too great a role in hiring practices which adversely affects both employers and workers.
- Tax law should not hinder alternative compensation techniques, including equity compensation.
- Telecommunication taxes may be outdated, as such services are the infrastructure of business today.

F. Societal changes

- Increasing gap between high-income and low-income individuals.
- Increasing life expectancy and improved financial condition of elderly.
- California and cities rely heavily on regressive sales tax and excise taxes for over 30% of their revenues.
- California has no earned income tax credit.
- Eroding sales tax base: retired individual's consumption tends to be more for non-taxable services and food than for taxable property.

G. Tax system developments

- Increased complexity at all levels.
- Continuing limitations on local government taxes and revenues (EX –Prop 218).
- Federal exemptions imposed on state and local governments (EX – Internet Tax moratorium).
- Competition among localities for business development.
- Continued desire for uniformity in multistate taxation.
- Increased compliance costs
- Narrower set of options for local governments to change tax base or rates; reduced control over revenue by local governments.

- Existence of approximately 30,000 subnational taxing jurisdictions means there is a large diversity of interests and concerns, and difficulties in obtaining consensus on simplifying and unifying systems and rules.
- Tendency for legislatures to focus on a subset of tax issues, rather than looking at the entire tax system (EX – focus in past few years on sales tax and the Internet, rather than also on sales tax issues in general and income tax issues).
- Need to determine how best to achieve uniformity. For example, how much uniformity does Congress think is appropriate to allow states adopting the SSTP to collect sales tax from remote vendors? What is the best mechanism for achieving and maintaining that level of uniformity? What is the proper role of Congress in reaching uniformity?

Examples of Tax & Fiscal Concerns of California and Local Governments Related to the Internet & E-Commerce

- Gradually eroding sales tax base due to conversion of some tangible goods into non-taxable digitized goods. Is a concern of local governments due to current heavy reliance on sales tax and limitations on generating alternative revenue sources?
- Increase in difficult to collect use tax as e-commerce makes it easier to sell to customers in California without having a physical presence in the state.
- Concerns of main street retailers over price competition resulting from California's inability (or lack of sufficient effort) to collect use tax from California consumers.
- Some companies consolidating sales offices as e-commerce sales increase resulting in some cities losing sales tax revenues.
- Difficulty of determining if a business has established an agent in the state through a related entity selling similar products and offering services to a common customer base.
- Federal-level restriction on the California and local tax base through the Internet Tax moratorium (which prohibits taxation of Internet access services), and state restriction on local governments through the California Internet Tax moratorium. Will such actions continue and expand?
- Complications due to Internet transactions and the nature of the e-commerce business model and existing tax structures – difficulty in providing guidance to taxpayers. For example: "A California software company has employees in California and Rhode Island and servers in Maine. Software is only transferred via the Internet and customers are in all states. Where is state income tax owed? Where are the costs of performance? Should costs of maintaining the servers be relevant since they can easily be moved? Where else might the company have nexus (states define this differently)? (The company must also determine if it must collect sales tax in Rhode Island or Maine on sales to customers in those states, and perhaps in other states depending on the state's treatment of software and whether the company licenses it or sells it.)
    - " If Congress were to allow states to impose sales and use tax collection obligations on remote vendors, how would the state impose such obligations on non-U.S. vendors?

  - “How broadly or narrowly do utility user taxes and franchise fees apply?” What is a “communication services” company today?
- Should California more actively participate in the SSTP? Is it a good use of time?
- If California were to adopt the SSTP, how would costs be covered by the state and local governments? If it requires a destination-based model, how will cities (which currently use an origin-based approach per Reg. 1802) be affected?
- Should the California sales tax base be broadened to cover digitized items (as many states do)? If yes, what would be the effect on the tax rate assuming revenue neutrality is desired? How would California know if a company sold a digitized product to a California consumer?

HOW TO ADDRESS TAXATION ISSUES RAISED BY E-COMMERCE

Joint Venture Tax Policy Group Position Paper, May 2000

We recommend that the following points be considered in evaluating any legislative proposal to address taxation of electronic-commerce.

1.Treat E-Commerce the Same as Other Forms of Commerce
E-commerce is commerce and in most situations, existing taxation rules adequately address its tax treatment. Thus, strong consideration must be given to any legislative proposal that calls for modifying an existing rule or creating a new rule to address e-commerce transactions, including specifically exempting e-commerce from taxation that applies to other forms of commerce.

2.Changes Must Not Solely Remedy E-Commerce Issues
Our existing sales and use tax had several flaws prior to today’s discussions about e-commerce and taxation. Sales and use taxes are regressive, they are a cascading tax, in most states they apply primarily to tangible personal property, there are numerous definitions and special rules and multiple rates that make the system complex, and these taxes cannot be collected from remote vendors, such as mail order or e-commerce businesses. Thus, it would be useful to work on resolving these problems as a whole, rather than isolating the debate to e-commerce. In addition, the global context of e-commerce and taxation must be considered.

3.It’s Not Just a Sales Tax Issue
While most e-commerce taxation discussions of the past few years have focused almost exclusively on sales and use taxes, issues also arise for income taxes and telecommunications taxes that must also be explored at the same time.

4.Any Tax Law Changes Must Adhere to Constitutional Principles
Any proposal that is contrary to case law or Constitutional principles should not be considered because enactment of such a law is doomed to court challenge and results in time lost that could have been used to improve the tax system.

5.Local Services Depend on Sales & Use Taxes

For California cities, sales and use taxes represent the largest source of revenue at 27%, a significant portion of which is from business-to-business sales. The issue of sales taxes and the Internet constitute a "double whammy" in that it has the potential to reduce both sales taxes from consumer purchases as well as taxes from business-to business transactions. This illustrates why local governments are concerned about maintaining sales and use tax revenues that provide core services.

6.There is a Need to Improve California's Fiscal Structure
There is a critical need to examine California's existing fiscal structure in a meaningful manner so that a long-term fiscal strategy can be developed for both state and local governments. This approach will better ensure that tax structures provide both adequate and appropriate revenues to allow for continued economic growth and prosperity.

Why this Issue is Important to Silicon Valley - The Internet and e-commerce are significant elements of the Silicon Valley economy. Many of the companies that enable e-commerce to flourish are located in Silicon Valley. Thus, issues surrounding taxation of e-commerce are a concern for many businesses, individuals, and local governments in Silicon Valley. Joint Venture has been actively involved in seeking to improve our current tax system, including ensuring that it does not hurt the competitiveness of businesses or the fiscal strength of local governments.

More Information: see http://www.jointventure.org/initiatives/tax/taskforce.html. Joint Venture: Silicon Valley Network is a non-profit dynamic model for regional rejuvenation. Our vision is to build a sustainable community collaborating to compete globally. Joint Venture brings people together from business, government, education, and the community to identify and act on regional issues affecting economic vitality and quality of life.

Principles of Good Tax Policy[1]

Questions about changing a tax system raise a fundamental question of how proposed changes should be effectively analyzed. This is a question the AICPA Tax Division's Tax Legislation and Policy Committee sought to answer. The Committee created a framework for effectively analyzing all types of tax proposals to determine if they incorporated principles of "good" tax policy. The framework is usable both to analyze proposals and to modify those proposals, if necessary, so that the changes will strengthen the tax system, rather than weaken it. The framework can also serve as a guide in identifying and designing improvements to the tax system so that the system better incorporates the principles of good tax policy. The framework is usable for analyzing tax proposals of any size, any degree and at any level of government. The framework, outlined in the AICPA's Tax Policy Concept Statement No. 1,[2] helps to answer the question: How should proposals to change existing tax rules be analyzed? The ten guiding principles of good tax policy contained in the framework are explained next followed by an example that applies the 10 principles to an e-commerce taxation issue.

The Ten Guiding Principles of Good Tax Policy

Following is a brief description of the ten principles of good tax policy. The principles should be viewed as being of equal importance and are presented in no particular order, although the first four stem from Adam Smith's maxims of tax policy.[3]

1. Equity and Fairness—Similarly situated taxpayers should be taxed similarly.
Equity refers to both horizontal and vertical equity. Horizontal equity describes the concept that taxpayers with equal abilities to pay should pay the same amount of tax. Vertical equity means that taxpayers with a greater ability to pay should pay more tax. The question of how much more tax people with higher income should pay is not an issue for the framework to resolve. Instead, the framework serves to note the importance of the principle, rather than to state how equity is achieved. How equity is to be defined and achieved for a tax system is a matter of political, social and economic debate. The presence of both horizontal and vertical equity in a tax system is thought to make the system fair. However, the term *fair* has different meanings to different people. For example, some would view an income tax system as "fair," if there were few exclusions and deductions. On the other hand, others might view an income tax as fair if there was only one rate of tax. Because taxpayers usually pay a range of different types of taxes, equity is likely best measured by considering the range of taxes people pay, rather than only looking at a single tax.

2. Certainty—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.
If taxpayers have difficulty measuring the tax base or determining the applicable tax rate or the tax consequences of a transaction, then certainty doesn't exist. Certainty might also be viewed as the level of confidence a person has that the tax is being calculated correctly. For example, if a taxpayer cannot determine whether expenditure should be capitalized or expensed or whether a particular transaction is subject to sales tax, then certainty does not exist for that tax.

1 Excerpt from "The AICPA's 10 Guiding Principles," by Annette Nellen, in *The Tax Adviser*, February 2002.

2 From AICPA Tax Policy Concept Statement No. 1 – *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, released in March 2001; available at http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf.

3 Adam Smith, *The Wealth of Nations*, 1776. See *The Wealth of Nations*, edited by Edwin Cannan, New York, The Modern Library, 1994, pages 887 to 890.

3. 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.
Convenience in paying a tax helps ensure compliance. The appropriate payment mechanism depends on the amount of the liability and the how easy or difficult it is to collect. Discussion of this principle in designing a particular rule or tax system would focus on whether it is best to collect the tax from the manufacturer, wholesales, retailer or customer, as well as the frequency of collection.

4. Economy of Collection—The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

This principle considers the number of revenue officers needed to administer the tax. Compliance costs for taxpayers should also be considered. This principle is closely related to the following principle of simplicity.

5. 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 in a tax system reduces the amount of errors and increases respect for the system and therefore improves compliance. A simple tax system better enables taxpayers to understand the tax consequences of their actual and planned transactions.

6. 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.
The principle of neutrality stands for the proposition that taxpayers should not be unduly encouraged or discouraged from engaging in certain activities due to the tax law. The primary purpose of the tax system is to raise revenue, not to change behavior. Of course, a completely neutral tax system isn't really possible. For example, an income tax could be said to discourage earning income. However, within the system, the neutrality principle would come into play in determining how to measure income or ability to pay.

7. Economic Growth and Efficiency—The tax system should not impede or reduce the productive capacity of the economy.
A tax system should be aligned with the economic goals of the jurisdiction imposing the tax. For example, the system should consider the jurisdiction's economic goals for economic growth, capital formation and international competitiveness. The system should not favor one industry or type of investment at the expense of others. For example, a jurisdiction would probably not want to design an income tax that imposes a 90% rate on the top 25 percent of income earners because such a system would harm the jurisdiction's economic growth. The principle of economic growth and efficiency might seem to be in conflict with the principle of neutrality. This is not necessarily the case though. This principle just recognizes that rules to calculate the tax base and rate have economic effects. For example, if the income tax system calls for a 30-year depreciable life for semiconductor manufacturing equipment, the jurisdiction must recognize that such a rule will have an effect (here, an adverse one) on the cost of semiconductors and the location of semiconductor manufacturing companies.

8. Transparency and Visibility—Taxpayers should know that a tax exists and how and when it is imposed upon them and others.
Transparency and visibility in a tax system enables taxpayers to know the true cost of transactions. It enables taxpayers to know when a tax is being assessed or paid and to whom.

9. Minimum Tax Gap—A tax should be structured to minimize non-compliance.
The tax gap is the amount of tax owed less the amount collected. To minimize the tax gap, procedural rules are needed to attain compliance. Generally, there is a need to strike a balance between (a) the desired level of compliance, and (b) the costs of enforcement and the level of intrusiveness of the tax system.[4]

10. Appropriate Government Revenues—The tax system should enable the government to determine how much tax revenue will likely be collected and when.
A tax system should have some level of predictability and reliability to enable governments to know how much revenue will be collected and when. Generally, a government realizes better stability with a mix of taxes. For example, in an economic downturn, unemployment would lead to reduced income tax collections. If the jurisdiction also had other taxes, such as a property tax and/or sales tax that were less affected by decreased employment or not affected as quickly, government revenues in total would be less adversely affected than if the government relied solely on an income tax.

Example—Application of Sales and Use Taxes to E-Commerce *Basics of the Issue*
Much of the discussions about taxation of e-commerce have focused on sales and use taxes. The debate ranges from exempting all e-commerce transactions from sales and use taxes to having Congress, in effect, reverse the *Quill* decision[5] to allow states to collect sales and use taxes from remote vendors. The following analysis uses the guiding principles of good tax policy to help to identify the significant policy issues involved in resolving how to apply sales and use taxes to e-commerce.

Application of the Guiding Principles
Equity and Fairness: A perspective here is that vendors selling goods and services online should be treated similarly to "Main Street" vendors selling the same goods and services and vice versa. While the sales and use tax is actually imposed on the buyer, rather than the seller, the compliance burden and price competition presented by the tax makes this a significant tax to vendors. Certainly, the compliance costs of the sales tax is greater for vendors with customers and taxable presence (nexus) in many states because of the varying sales tax rules among states and even some cities. The equity principle states that similarly situated taxpayers should be taxed similarly. With respect to sales tax, this principle could be interpreted as meaning that all vendors should have to collect sales tax (assuming the customer resides in a jurisdiction that imposes a sales tax). But, is a multistate vendor similarly situated to a "Main Street" vendor with a single location? For example, assume vendors are required to collect sales tax from all customers, even in states where the vendor has no physical presence.

A Main Street retailer with a store in San Jose would have much lower compliance costs than an online vendor also located only in San Jose, but who sells to customers in all states. The online vendor would need to determine where all of its customers live and charge the applicable sales tax (in contrast, under today's sales tax law, the Main Street vendor is allowed to just charge the San Jose rate to all customers that come into the store, on the presumption of most laws that the consumption occurs at the site of the sale). Thus, arguments of "leveling the playing field" for Main Street and Internet vendors must consider the added compliance burden placed upon vendors required to collect tax based on the location of their customers. While the prices charged by the multistate and Main Street retailers would be the same if both are required to collect sales tax, the playing field is not level if the online vendor has greater compliance 4 General Accounting Office (GAO), *Reducing the Tax Gap – Results of a GAO-Sponsored Symposium*, June 1995, GAO/GGD-95-157, page 13. 5 *Quill Corporation v. North Dakota*, 504

U.S. 298 (1992). 9 costs. Arguably, equity and fairness between Main Street and online vendors require some balancing of the compliance costs, as well as the sales tax charged. The equity and fairness principle might be achieved by, for example, 1) requiring the Main Street retailer to charge sales tax based on where its customers live (although this technique would increase complexity), 2) allowing the online vendor to charge sales tax for the vendor's jurisdiction to all customers regardless of where they live (origin approach), 3) providing compensation to the online vendor for the extra compliance costs, or 4) providing a mechanism, such as a third party collector funded by the government, to handle the online vendor's compliance activities. These possible remedies each present additional issues for discussion.

Certainty: Today, with over 6,000 jurisdictions able to assess sales tax and a lack of uniformity in the rules of these jurisdictions, as well as frequent changes to the rules, uncertainty exists for multistate vendors. Improvement is needed, such as by streamlining the rules among jurisdictions or replacing the individual state and local sales tax with a federal level tax to be distributed back to the states. Again, consideration of this particular guiding principle helps to identify areas where further analysis and discussion are warranted to design a system for effectively applying a consumption tax to e-commerce transactions.

Convenience of Payment: This principle is mostly met with today's sales tax rules, which tend to require periodic filing and payment at a time subsequent to the sale.

Economy in Collection: The costs to taxpayers of complying with sales taxes are quite significant for multistate vendors due to the large number of taxing jurisdictions and lack of uniformity in the rules.

Simplicity: For multistate vendors, sales taxes fail to satisfy the simplicity principle. The multiple definitions, rules, registration procedures, exemptions, rates, filing and audit procedures result in a great deal of complexity. Some of the improvements to simplify the sales tax system that have been discussed include uniformity of rules and procedures, better use of technology to compute and collect the tax, use of a third party to compute and remit the tax, or perhaps a federal level tax to replace the state sales tax.

Neutrality: The sales tax law is not neutral with respect to e-commerce for either vendors or customers. Sales tax has played a part in location and form of operation decisions for some vendors. For example, the founder of Amazon.com has stated that he purposely did not locate the company in California because he expected to have many customers there and did not want to have to charge sales tax.[6] Also, as noted in testimony of Peter Lowy for the E-Fairness Coalition, before a congressional committee on Internet taxation,[7] some brick-and-mortar vendors established separate subsidiaries for their online sales in order to reduce the number of states where the online entity would have a physical presence, and thus, a sales tax collection obligation. Thus, the sales tax has played a role in taxpayer location and form of operation decisions and thus, is not neutral. Also, the current situation where remote (non-present) vendors are not required to collect sales and use taxes can cause this tax to play a part in a customer's decision as to how and where to purchase goods and services. For example, a customer may decide to purchase a computer online to avoid sales tax rather than purchase the computer from a Main Street vendor. Also, in a few states, such as California, software transferred online is not subject to sales tax, while its tangible counterpart (that is, software sold on tangible medium) is subject to sales tax. Thus, the sales tax law is not neutral in that it can play a role in a customer's decision as to how and where to purchase certain products.

Further discussion of the neutrality principle might lead to the following suggestions as to how to make the system more neutral: require sales tax to be charged by remote vendors, enforce use tax rules (customers making taxable purchases from remote vendors are required to remit use tax on their own, 6 David Streitfeld, "Booking the Future; Does Amazon.com Show That Publishing Clicks on the Internet?" *The Washington Post*, July 10, 1998, page A1. Also see Chip Bayers, "The Inner Bezos," *Wired*, March 1999, page 115, 174. 7 Hearing on Internet taxation (107th Congress), March 14, 2001, at http://www.senate.gov/~commerce/hearings/0314low.pdf. 10 although state enforcement and educational efforts are weak), exempt all digitized items from sales tax along with their tangible counterpart, or tax all products regardless of how they are transferred.

Economic Growth and Efficiency: Proponents of not taxing online sales may use the principle of economic growth and efficiency by arguing that taxation will impede growth of the Internet and would be detrimental to the taxing jurisdiction's economy. However, many people believe that the Internet is growing without any indication that it is due to the current tax rules. The Department of Commerce reported that e-commerce sales increased 33.5% in first quarter 2001 over the first quarter of 2000.[8] In early 1998, prior to the enactment of the Internet Tax Freedom Act (ITFA), it was reported that the number of Internet hosts was growing at a rate of 40% to 50% annually.[9] While some studies have found that taxation of online shopping will reduce online shopping, the issue isn't really so simple as to argue that taxes should be avoided. Today, online purchases are subject to sales and use tax in all states that impose a sales tax. However, the ability of states to collect use tax on remote online sales is quite low.

Transparency and Visibility: Sales and use taxes are visible because they are shown on the customer's invoice. Even invoices prepared at Internet sites will show any sales tax charged. However, many consumers may not know that a sales tax exists on particular transactions. For example, many consumers who are not charged sales tax on online sales may believe the sale is exempt when in reality, the consumer likely needs to self-access use tax. Also, customers likely don't know all that the sales tax applies to – for example, will it apply to "free" items obtained from online vendors? Does it apply to shipping charges? Simplification and some uniformity in the sales tax systems among the states should help to better satisfy this principle.

Minimum Tax Gap: The use tax generates a tax gap because so few consumers (and even some businesses) know what a use tax is or that it exists to complement the sales tax. While some states have made efforts to inform residents about the use tax, such as by adding a line on the state personal income tax form for it compliance is very low and many dollars of taxes go uncollected. This issue becomes more widespread under the e-commerce model because it enables vendors to make multistate sales despite having few physical locations (and thus, having fewer sales tax collection obligations). Possible improvement to be discussed include having state tax agencies educate consumers about the use tax and then simplify compliance for consumers, simplify sales tax systems such that Congress might exercise its authority under the Commerce Clause and allow states to collect use tax from remote vendors, or replace the sales tax with another type of consumption tax. The Internet not only makes it easier to purchase items from a vendor in another state, but also in another country. While Congress could require a remote vendor to collect a state's sales and use taxes, it will be far more difficult, if not impossible, to get a vendor in a foreign country to collect a state's sales tax. Thus, if the tax is to be collected, states will need to get consumers to voluntarily comply or to exempt foreign sales, which then violates the neutrality principle. Discussion of the minimum tax gap principle might also lead to consideration of alternative consumption taxes to the sales tax. For example, a consumption tax could be based on the formula:

> Income less Savings. Of course, this would also involve extra recordkeeping and it would broaden the tax base over what it is today (it would tax all consumption rather than just tangible personal property).

Appropriate Government Revenues: Less than 1 percent of retail sales today are online sales; thus, the amount of lost use tax is still small. The potential growth of e-commerce poses the greatest use tax loss for state and local governments. This growth will adversely affect governments' predictability and reliability in determining expected tax revenues. Also, states that do not tax products transferred electronically, such as California, will experience a decline in tax base as more and more items are transferred digitally.

---

8 Department of Commerce, press release of May 16, 2001, http://www.census.gov/mrts/www/current.html.
9 James Glave, "Dramatic Internet Growth Continues," Wired News, February 16, 1998, http://www.wired.com/news/topstories/0,1287,10323,00.html

SAVE-THE-DATE

Do You Know Where Your Tax Dollars Are?
Forum on State & Local Taxes

Thursday, September 26, 2002
8:00 a.m. to 4:30 p.m.
Location TBA (Silicon Valley)
Sponsored by Joint Venture and the California Futures Network
DRAFT AGENDA – 3-5-02
Topics
Understanding CA Jurisdictions – All 3000+ of them!

Relevance to tax & fiscal policy California Tax Fundamentals – What Do We Collect, How Much and Why? This panel will explain how much tax is collected, by whom, and trends over the past several years. The various types of taxes and fees imposed by California and its many jurisdictions will be compared in order to provide an important framework for understanding California's fiscal issues and possible reforms. Principles of good tax policy will also be covered along with how those principles can be used to improve reform efforts. How California Tax Law and Policy is Created and Shaped Role and impact of (a) legislature, (b) initiative process, (c) tax agencies, and (d) courts.

How Fiscal Structure Affects Quality of Life Issues Moderated discussion with attendees to address:

i. How does California's tax and fiscal system cause issues in Areas A, B, C & D below?
ii. How an appropriate current proposal/concern illustrates the link between the structure and the quality of life issue.
iii. What is a possible framework for analyzing proposals writ this issue (for example, perhaps it is a set of questions)?

For the following Quality of Life considerations (attendees will be able to participate in 2 of the 4 groups):

A. Economic Development
B. Land Use and Housing
C. Education
D. Traffic and Transportation

Looking Forward/Next Steps
Registration and further information available after April 15, 2002 at:
http://www.jointventure.org/

C:\Post To Internet\GregPochey\commission talking notes PWC.doc
Testimony to the California Commission on Tax Policy in the New Economy
Matt Stolte, Partner, PricewaterhouseCoopers LLP
March 20, 2002

I am the West Region Leader of the PricewaterhouseCoopers' State Tax Consulting practice. In that capacity, I lead a group of professionals located throughout California who consult with individuals and companies ranging from small start-ups to large multinational corporations, both based within California and otherwise, regarding the various state level and local level taxes that these business face within the State. My comments today will be focused primarily on the California income/franchise tax system.

There seems to be a consistent perception among our clients (large corporations, small businesses, individuals and other business entities) that California tax laws are simply too complex and compliance is too burdensome. This seems to be validated by the results of recent surveys by CFO magazine in 1996 and 2000. In these surveys, California did not fare well in the areas of fairness and predictability (ranking in the bottom 5 states). Also the state was ranked 44th among the 50 states with respect to being friendly to small business in the annual report of the Small Business Survival Committee. High taxes was one of the factors sited in this report. In a scorecard produced by the Committee on State Taxation (COST), it was concluded that California was one of the least fair states in handling tax appeals. This scorecard ranked the states according to the efficacy of their appeals systems and according to each states adherence to certain procedural elements.

To some degree, I don't believe this reputation is entirely deserved. For instance, California has made good strides in attracting and maintaining technology and manufacturing concerns through tax credits which incentivize the conduct of these important activities within the State. The talent pool in California is very rich and as a group, we believe the tax attorneys, auditors, senior management and top leadership of California's main Tax Administrative Agencies (FTB & SBE) are among the very best in the nation. Auditors are generally well trained and customer oriented. The administrative remedies available to taxpayers help ensure a fair resolution of tax disputes without incurring costly litigation. The FTB Settlement Bureau has been effective in resolving Governor Davis' Committee on California Tax Policies Page 2 difficult cases and avoiding costly litigation. Lastly, the FTB Taxpayer's Advocate Program has been another very positive addition to the state's Tax Administration structure.

However, there ARE areas where the perception of the business community would certainly seem to be justified. We have outlined some of these areas, along with suggestions for change and/or improvements below:

1. Federal Conformity

Unlike most states, California does not truly conform to the IRC. Instead, the Revenue and Taxation Code is a patchwork of specifically adopted IRC statutes that are interwoven with unique and complex California provisions; the nuances of which are unclear for smaller businesses, many out-of-state businesses, foreign-based businesses and dynamic businesses within California that have growing and complex operations. Some specific examples of how California's conformity process creates problems are as follows:

- Timing of Conformity – Just trying to figure out which federal law is applicable for California purposes can be extremely difficult. We are already dealing with conformity to an IRC that is 4 years old…and then tax professionals have to dig through individual code sections to determine if there have been any "selective" conformity to provisions of federal tax acts in the intervening years…Finding California's tax treatment of an item of income or deduction can be extremely frustrating, time consuming and expensive.
- Application of Treasury Regs. and IRS Rulings, etc. – This can be problematic when the federal law has been changed, but California has not conformed to the latest version of the federal law…there is always the lingering question of whether the Ruling, Notice, etc. will be respected by the FTB. Another difficulty arises when the federal guidance relies on code sections or areas of law that California does not Governor Davis' Committee on California Tax Policies Page 3 follow – this also makes it difficult to gain certainty as to the application of the guidance for state purposes.

California should take a critical look at the overall conformity process and determine whether to proceed down a path of full federal conformity or automatic federal conformity with "limited" exceptions.

- Specific examples….

  i. California does not conform to federal depreciation (MACRS and ACRS) for corporations. The CA ADR depreciation is so outdated that many applications vendors (including several of the majors) do not offer the ADR method with their fixed asset modules. As such, many taxpayers simply CANNOT comply with the statutory requirements. Many taxpayers simply default to the federal or book method and "let the auditors spend as much time as they want auditing depreciation" because it is, after all, only a timing difference.

  ii. Recent areas of nonconformity or late conformity with federal law which have received negative publicity include taxation of certain retirement or deferred income, Roth IRAs, and certain REIT and Regulated Investment company provisions; and

  iii. Lack of full conformity to NOL provisions and general reduction of NOLs by 40%, to name but a few.

There are a variety of alternatives for California to consider in the area of conformity, most of which would be preferred to the existing scheme. Closer conformity would ease the administrative burden, reduce complexity and provide greater certainty to taxpayers. Governor Davis' Committee on California Tax Policies Page 4

2. Combined Reporting/Apportionment

There are many negative perceptions and some misconceptions in the business community concerning the nature of combined reporting which lend, fairly or unfairly, to California's reputation as being a tax unfriendly state in which to do business. Some of this perception is related to uncertainty caused by the delay in issuing regulations; some is simply due to the fact that most states do not require combined reporting; and some is due to the fact that combined reporting is based upon the "unitary concept," which is often a difficult and somewhat subjective determination in itself.

Examples:

1. The Regulations under CRTC Section 25106.5, dealing with Intercompany Transactions, is a good example of how extraordinarily complex combined reporting can be under California's system. In its attempt to coordinate with the Treasury Regulation 1.1502-13 (consolidated return regs.), the FTB has overlayed multiple layers of complexity on an already difficult set of federal rules. Taxpayers must first master the exceptionally complex federal rules, then piggyback the equally complex California rules to arrive at a tax result. This almost always adds significant costs to the taxpayer, creates uncertainty in tax results and potential traps for the unwary for those who do not have the resources to understand and comply with the law. One particular "trap for the unwary" that is worthy of specific note is the following:

If a subsidiary makes a distribution to its parent which is in excess of the parents' basis in the stock of the subsidiary, the resulting "realized gain" is deferred (not recognized) until a triggering event occurs. Under federal law, a non-taxable liquidation of the subsidiary into its parent would NOT be a triggering event. Under the California regulations, such a liquidation – even Governor Davis' Committee on California Tax Policies Page 5 when both corporations are part of the same unitary/combined group – will trigger the deferred income. This is counter-intuitive (no real gain has been realized by the group and the group hasn't really changed) and, we believe, bad policy.

2. Because combined reporting is dramatically different than federal consolidated reporting, incorporating "some" elements of the consolidated tax return scheme into California, without others, can create some surprising results. For example, corporatetaxpayers often find themselves facing unexpected California tax liabilities (or large capital losses) after they sell subsidiaries, due to differences in basis rules for subsidiaries. For federal income tax purposes, adjustments are made to the stock basis of consolidated subsidiaries to prevent double taxation of subsidiary income when the subsidiary is sold. California does not conform to this aspect of the consolidated return regime. Increased capital losses which are sometimes recognized when an unprofitable subsidiary is sold will often go unused due to California's conformity to federal capital loss limitation provisions.

3. Finally, companies that acquire new subsidiaries can also face somewhat unexpected tax consequences when dividend distributions are made following the acquisition. Such companies are often required to pay California tax on inter company distributions received from recently-acquired subsidiaries under unique California provisions which

have no counterpart in the federal consolidated return regulations. The above combined reporting issues stem primarily, but not entirely, from inconsistencies between federal and California law. While not all of the complexities are avoidable, a system that provides for "elective combination" and/or a federal consolidated tax return election (as does AZ), would be alternatives worthy of serious exploration. Governor Davis' Committee on California Tax Policies Page 6

Similar issues arise in the Water's-edge area. This body of law is very complex in its own right and should be simplified to be more readily understood and applied:

As an example, foreign subsidiaries with certain types of passive income and other types of income determined under the IRC are subject to inclusion in the water's-edge group in years that they are profitable. No relief via inclusion is allowed when these companies lose money. Further, the FTB has taken administrative positions which alter the amount of such income determined under the IRC. The complexity involved in this system creates a significant burden on both the taxpayer and the FTB. Apportionment provisions are considered by most taxpayers to be somewhat outdated and not reflective of how businesses operate and generate income in today's environment. Greater use could be made of the CRTC Section 25137 provisions to remedy this problem, but it is a process not used to a great extent.

3. Administration

Good Tax Administration is Transparent – Public records requests often generate pages of documents which are not disclosed because of the "deliberative process privilege." If the tax agency prepares a document pertaining to a taxpayer or an issue impacting a taxpayer – we believe the taxpayer should be able to read that document regardless of its content. Often, challenging such an administrative determination to withhold relevant documents is cost prohibitive.

More timely guidance is desired. Big issues are breaking regularly and taxpayers are left in limbo more often than not.

Governor Davis' Committee on California Tax Policies Page 7 There is a perception that California, in effect, gives with one hand and takes with another. This is particularly true with the Manufacturer's Investment Tax Credit ("MIC"), NOLs and credit utilization within combined reporting groups.

Enacted in 1994, the MIC was intended to promote manufacturing in the State by providing a credit of 6% of the cost of machinery and equipment, upon which California sales/use tax had been paid, as well as 6% of the cost of capitalized labor related to such. However, Franchise Tax Board administrative regulations and pronouncements issued as many as six years after the statute was enacted seem to narrow the scope of these provisions. For example:

- qualified manufacturing activity conducted on predominantly non-manufacturing premises were disqualified;
- a more narrow federal definition of qualified property was adopted; and

- it was announced that only the portion of the labor costs paid to independent contractors which represent the contractors' cost of the labor qualified.

These administrative positions lessen the effectiveness of the MIC in attracting business expansion in the State by creating substantial uncertainty as to the tax benefits ultimately to be received.

Similar administrative positions concerning the use of credits in a combined report limit the overall effectiveness of credits in attracting expansion as well. For legal and other reasons it is common for businesses large and small to organize subsidiaries to conduct research or for other endeavors. While the general effect of California's combined reporting approach is to treat these subsidiaries essentially as divisions of a single entity for tax purposes, the Franchise Tax Board has taken the position that credits may not be utilized on a combined basis. Allowing credits to Governor Davis' Committee on California Tax Policies Page 8 be utilized on a combined basis would go a long way towards dispelling negative taxpayer perception and improving the effectiveness of California credits in attracting business expansion.

The array of administrative remedies available to taxpayers in resolving tax disputes are not perceived as an advantage to doing business in California to the extent they could be. The overwhelming perception is that audits take too long, some assessments are arbitrary or unfair. It is not uncommon for the audit and protest process to reach final resolution 10 years or more after the returns in question were filed. During this time, regulations and administrative positions maybe issued, changed, or withdrawn, and client and auditor turnover may occur causing the returns themselves and the subsequent audit proceedings to assume a provisional and uncertain quality. The proceedings can also absorb a significant amount of our client's internal personal and financial resources.

It is also not uncommon for clients to provide the same information to state auditors on repeated occasions. This may be due to auditor turnover or due to the information requests of different audit agencies. For example, the FTB will often request information to substantiate tax credits which has already been provided to the SBE in connection with sales/use tax audits. The FTB is applauded for its efforts to improve coordination with the SBE in this area so far, but additional improvement can be made.

Thank you for the opportunity to address the Commission this afternoon.