California Commission on Tax Policy in the New Economy

Bakersfield
July 29, 2002

Proceedings

JULY 29, 2002; BAKERSFIELD

Streamlined Sales Tax Project (SSTP)
    Daniel Thompson - Certified Public Accountant, State and Local Tax Consulting

California Legislature Perspective
    Kimberly Bott - Chief Consultant, California Assembly Committee on Revenue and Taxation

Tax Reform and the Streamlined Sales Tax Project (SSTP)
    Lee Goodman - Counsel, Wiley, Rein & Fielding

Governor's Veto of SSTP and Internet Sales Tax Legislation
    Connie Squires - Program Budget Manager, California Department of Finance

Conflict of Interest Code Requirements for Commissioners
    Kathryn Doi - Chief Counsel, Counsel to the Secretary, Technology, Trade and Commerce Agency

Strategy for Report Writing
    Jesse Szeto - Assistant Secretary, Technology, Trade and Commerce Agency

CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY

Rayburn S. Dezember Leadership Development Center, Room 401
California State University, Bakersfield

July 29, 2002
FINAL AGENDA

11:00 AM	Meeting called to order, Chairman Rosendahl
11:05 AM	Welcoming Remarks Harvey Hall, Mayor, City of Bakersfield Steve Perez, Kern County Board of Supervisors Dr. Tomas Arciniega, President, CSU Bakersfield
11:15 AM	Discussion / approval of minutes from 5/16 meeting
11:20 AM	Daniel Thompson, CPA Sales and Use Tax
12:00 PM	Kimberly Bott, Assembly Revenue and Tax Committee Ex-Officio Member Representative Legislature Perspective
12:30 PM	Lunch Break
1:00 PM	Lee Goodman, Esq. of Counsel, Wiley, Rein and Fielding Former Chief of Staff for the Chairman, Congressional Advisory Commission on Electronic Commerce
1:45 PM	Bill Weintraub, Commissioner Tax Dispute Resolution in California
2:15 PM	Connie Squires, Department of Finance Ex-Officio Member Representative Governor's veto of Streamlined Sales Tax Project legislation
2:45 PM	Kathryn Doi, Chief Counsel, Technology Trade and Commerce Agency Conflict of Interest Code
3:15 PM	Commissioners' Work

Streamlined Sales Tax Project (Connie Squires assist)
- Discussion
- Public Comment

Vote

Conflict of Interest Code (Kathryn Doi assist)
Discussion
Public Comment
Vote

Strategy for Report Writing (Jesse Szeto assist)

Next Meeting

4:15 PM Additional Public Comment

4:25 PM Concluding Remarks, Chairman Rosendahl

4:30 PM Adjournment

Note: Agendas for public bodies located within the California Technology, Trade and Commerce Agency, including the California Commission on Tax Policy in the New Economy are available at http://commerce.ca.gov. For additional information regarding this notice, please contact Marshall Graves, California Technology, Trade and Commerce Agency, 1102 Q Street, Suite 6000, Sacramento, CA, 95814, (916) 445-7654, mgraves@commerce.ca.gov

CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY
COMMISSIONERS TELECONFERENCE MEETING

September 5, 2002

Call-in Phone Number: 1-888-xxx-yyyy
Passcode: uvwxyz

AGENDA

10:00 AM	Commissioners call in and register
10:10 AM	Roll Call (include Ex-Officio Members Representatives and staff)
10:15 AM	Call to Order (quorum of 5 Commissioners required)
10:20 AM	Welcoming Remarks
10:25 AM	Discussion of Issues for Interim Report
11:45 AM	Lunch break
1:00 PM	Commissioners call in and register
1:10 PM	Roll Call (include Ex-Officio Members Representatives and staff)
1:15 PM	Call to Order (quorum of 5 Commissioners required)
1:20 PM	Continue Discussions of Interim Report (if required)
2:00 PM	Discussions of Scope of Work
3:15 PM	Public Commentary
3:25 PM	Concluding Remarks
3:30 PM	Adjourn

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MEETING MINUTES
California Commission on Tax Policy in the New Economy
Rayburn S. Dezember Leadership Development Center
California State University, Bakersfield
July 29, 2002
11:00 A.M.

COMMISSIONERS PRESENT

- William J. Rosendahl, Chairman
- Sean O. Burton
- Lawrence Carr
- Scott Peters
- Glen Rossman
- Marilyn C. Brewer

COMMISSIONERS ABSENT

- William Dombrowski
- Lenny Goldberg
- William Weintraub

EX-OFFICIO MEMBERS REPRESENTATIVES PRESENT

- Connie Squires for Tim Gage (Director, Department of Finance)
- Kimberly Bott for the Honorable Ed Chavez (Chair, Assembly Revenue & Tax Committee)
- Marcy Jo Mandel for the Honorable Kathleen Connell (State Controller) Departed at 12:10 PM.
- Brian Putler for Gerald Goldberg (Executive Officer, Franchise Tax Board)
- James Legler and Carol Frost for Michael Bernick (Director, Employment Development Department)

Call to Order

WELCOMING REMARKS

Chairman Rosendahl welcomed everyone to the fourth Commission meeting, including cable viewers who will receive a tape delayed broadcast of the proceedings.

The Mayor of Bakersfield, Harvey Hall also welcomed the Commissioners and audience members and reiterated how the California business tax structure and economic climate makes it difficult for cities like Bakersfield to attract new industries to their localities and regions. He enjoined the Commissioners to consider how their recommendations will affect local governments, which are seriously impacted by changes in California tax regulations.

INTRODUCTION OF COMMISSIONERS, ET AL

Chairman Rosendahl invited the Commissioners and all members of the audience (including those representing the Ex-Officio Members of the Commission) to introduce themselves and they did so.

REVIEW AND APPROVAL OF MEETING MINUTES FROM MAY 16, 2002

Mr. Peters moved that the Commission approve the minutes of the May 16, 2002 meeting. Mr. Burton seconded the motion. The motion was approved by unanimous vote.

EXPERT PRESENTATIONS

Streamlined Sales Tax Project (SSTP)

Daniel L. Thompson
CPA, CMI – State and Local Tax Consulting

Mr. Thompson began by giving an overview of the importance of sales and use taxes to providing revenue streams for state and local taxing authorities. Some points that he emphasized were:

- Sales and use taxes yield more than $165 billion in annual revenues
- Many states are expanding their tax bases beyond sales of tangible property to include services
- Tax bases and rates vary widely amongst the states
- Each state and locality has its own filing requirements, literally in total hundreds of thousands of forms
- There is a very high cost to companies of non-compliance with the myriad tax requirements

He illustrated his discussion by distribution several small items to the Commissioners and audience and explained how different states define and tax those items. He also emphasized how burdensome it is for companies attempting to comply with state-by-state and locality-by-locality vagaries in the tax structure for each of the items he presented.

Mr. Thompson then discussed the different types of sales and excise taxes imposed by various states, localities and taxing authorities and gave examples of each:

- Privilege tax
- Consumer levy tax
- Transaction tax
- Gross receipts tax
- Illinois occupation tax
- Other occupation tax

This dialogue was followed by a brief description of use taxes and how they complement the sales and excise tax structure.

Mr. Thompson provided an overview of the U.S. Supreme Court decision in Quill vs. North Dakota in which it declared a mail order company must have a physical presence with a state (nexus) in order for the company to be subject to sales tax. In that decision the Court reiterated that the authority and responsibility to regulate commerce clearly rests with Congress.

The second half of Mr. Thompson's presentation dealt with the specifics of the Streamlined Sales Tax Project. He highlighted the primary objectives of the initiative:

- Uniformity of definitions, sourcing rules, audit procedures, treatment of bad debt and rounding rules
- Local rate simplification
- Centralized administration within states
- Simplified registration and exemption administration
- State funding of the system
- Privacy protection
- State and local taxes remitted at the state level
- No or minimal sales tax returns for out-of-state sellers who voluntarily collect sales tax

SSTP is divided into four work groups each of which has separate subgroups:

- Tax Base and Exemption Administration
- Tax Rates, Registration, Returns and Remittances
- Technology, Audit, Privacy and Paying for the System
- Sourcing and Other Simplifications

Mr. Thompson closed his presentation by briefly discussing what he felt were some of the advantages and disadvantages to California if it chose to join the SSTP. The principle benefits would accrue to California businesses, which could potentially save millions of dollars by reducing the administrative burden of compliance with the tax laws, as they currently exist. Secondary benefits would be an increase in sales and use tax revenues and an equalization between online and bricks-and-mortar vendors.

The most serious drawback, however, is that the implementing states will control the provisions of the initial agreement, which will be forwarded to the participating states Legislatures for adoption. Even if California were to join and achieve a voice in the final outcome, its influence would be limited by being only accorded a single vote equal to those of the other participating states.

Mr. Thompson responded to questions and comments from the Commissioners:

Commissioner Brewer

Question: Since California, Texas, and New York have not joined what is the advantage to California?

Answer: Tax departments will get smaller reducing staffing costs and Congress may accept the SSTP provisions as a national program, thus precluding California's interest in the early stage of development.

Comment: Ms. Brewer opined that she did not see any advantage to California joining SSTP.

Commissioner Peters

Question: Does California's economy depend upon sales and use tax simplification?

Answer: No

Commissioner Burton

Comment: Please elaborate on how California would experience loss of control if it joined SSTP.

Response: SSTP will try to squeeze local issues into a uniform state box.

Commissioner Rossman

Question: Do we have to adopt all of the SSTP provisions if we join, in other words do we have to "pay-to-play"?

Answer: Not sure. California is strongly encouraged to become a voting member and not an observer if it chooses to join, but it will only get one vote on an equal basis with the other participating states.

Commissioner Peters

Comment: SSTP may present an opportunity for simplification if we can agree where the sales taxes are paid and we may be able to close down some of the tax bureaucracy, but localities may not be willing to give up control.

Question: Are we facing a national sales tax anyway; if we stay out will it be forced on us?

Comment: (by Commissioner Brewer): Stay out and we will be OK.

Answer: The national model will probably happen.

Chairman Rosendahl

Question: Can we join SSTP later if we have an interest?

Answer: Does not think so. Only the states that joined will have a voice. California can't rely on SSTP to keep California informed.

Question: What advice can you give us?

Answer: The SSTP model is not developed enough. We might get put into a box with no way out if we join.

Commissioner Rossman

Comment: There is too much uncertainty. We wouldn't know what we are joining up for.

CALIFORNIA LEGISLATURE PERSPECTIVE

Kimberly Bott, JD, CPA, Chief Consultant for the Assembly Committee on Revenue and Taxation

Ms. Bott presented a letter from the Assembly Committee on Revenue and Taxation outlining what she believes is the Legislature perspective on the Commission's mandate. Rather than tell the Commission what it should do she encouraged them to consider how the Commission's work could be helpful. She framed the context of her remarks into two parts:

Part I

- Provide recommendations based on facts and data not suppositions
- Define measurements and metrics to track the efficacy of the recommendations should they result in legislation.
- Do no harm to one group over another.

Part II

- As the economy changes consider how the Commission's work fits with the rest of the taxation structure.
- How will State policy and the Commission's recommendations affect local jurisdictions?
- The Commission should be aware that the federal government could pre-empt some of the work of the Commission as a result of the SSTP initiative. What recommendations could the Commission provide that could possibly lessen the adverse impact of some of those anticipated provisions?

Ms. Bott responded to questions and comments from the Commissioners:

Commissioner Peters
Question: What recommendations do you suggest?

Chairman Rosendahl
Comment: Appealing to the Revenue and Tax Committee for help and support

Commissioner Brewer
Question: Is SSTP on the Legislature's "radar scope"?
Answer: No

Commissioner Rossman
Question: How can the government do anything but expand if we never take anything away from somebody (do no harm to others)?
Comment: Our current revenue base is too dependent on the economic cycle.

Answer: Only 3 or 4 tax bills (expenditures) since 1995 have had sunset provisions. Legislation rarely provides for how to measure the effects of a bill and how to change it if it is a bad bill.

Question: Why can't expenditures go down when the economy goes down?
Answer: the opposite occurs in good times. When the economy goes up the legislature tends to add programs to base levels rather one time appropriations and then the additions have no provisions for review in the event of economic downturns later.

Question: Is the State constitutionally required to balance the budget?
Answer: Discussion followed among the Commissioners. The consensus was probably yes, but with no degree of certainty.

Commissioner Carr
Question: Will the Assembly fund the work of the Commission?
Answer: Not at present, but the Commission could make that recommendation in its interim report

Chairman Rosendahl
Comment: The Commission will ask for staff and resources for next year. This year will concentrate on an education effort, but next year the work needs to get done and that will require resources. The Legislation creating the Commission includes a serious mandate, which cannot be accomplished without funding or other means of external support.

COMMISSION BUSINESS

Chairman Rosendahl confirmed the next public meeting of the Commission will be held in San Diego on September 18. He also asserted the interim report is due December 1, 2002 and the final report (unless modified by subsequent legislation) is due in December 2003.

TAX REFORM AND THE STREAMLINED SALES TAX PROJECT

Lee Goodman, Esq., of Counsel Wiley, Rein & Fielding

Mr. Goodman served as Chief of Staff to the Chairman (Governor James Gilmore of Virginia) of the Congressional Advisory Commission on Electronic Commerce (ACEC). The Commission published its report in April 2000. The Commission could not reach a consensus but a majority of 11 (of 19) Commissioners rendered the substantive recommendations. The substance of these recommendations was contentious. The Commission's most controversial policy proposal called for dramatic overhaul and simplification of sales and use taxes at the national level. Some Commissioners viewed this as a "pathway" to sales and use tax collections on all Internet sales. Other Commissioners advocated it as a necessary pro-business and pro-consumer reform; an

end in and of itself. The Commission also proposed that the exchange of information and entertainment on the Internet should not be taxed.

The National Governor's Association (NGA) and the National Conference of State Legislatures (NCSL) were very dissatisfied with the report and they collaborated to form a multistage program to draft a uniform sales tax law. This program evolved into the Simplified Sales Tax Project (SSTP).

The SSTP collaborators are anticipating a vote on the final details this Fall (2002). Even if California were to now join the project, its opportunity for influence may be small. The work of the SSTP committees is struggling with the final details. Four areas of contention are evident, which may be subverting some of the original drivers for which the SSTP was created:

- It is considering preservation of the approximately 7500 taxing jurisdictions, which initially was a primary focus for consolidation (streamlining).
- It may allow different definitions for categories of taxable goods – reviving the argument of candy vs. food.
- It may establish audit authority over participating states, thereby subjecting California to external auditing (other than federal) organizations.
- It wants to classify sales by using 9 digit zip codes for better discrimination, which may subject citizens to increased surveillance and perhaps pass the responsibility of tax collection on sales of tangible goods onto buyers (consumers) and not suppliers.

Mr. Goodman discussed several alternatives to the SSTP that have been proposed and are the subject of national debate.

- Origin-based sales tax
- Interstate sales tax collections remitted only to the vendor's home state for subsequent distribution
- Clarified nexus legislation from Congress
- A tax-free interstate compact in lieu of SSTP
- Transactional tax reform that merges telephone, wireless and cable tax reform with traditional sales taxes.

Mr. Goodman closed his remarks by advising the Commission that few details have emerged from the various SSTP committees. Also, state legislatures are wary of surrendering sovereignty of tax policy to an interstate organization. This is more than likely the major obstacle facing SSTP adoption by individual states. Ultimately Congress may step in and resolve all of these issues on a national level.

Mr. Goodman responded to questions and comments from the Commissioners:

Commissioner Rossman
Question: What are the real reasons other states have joined the SSTP?
Answer: Major supporters of taxing digital entertainment are large importers of digital entertainment such as North Dakota, South Dakota, Utah and Montana. States such as these would significantly benefit by gaining guaranteed access to taxation placed on Internet sales even though these sales may represent only 1% of the retail market in the originating states.

Comment by Mr. Goodman: Joining the SSTP may expose all information businesses to additional taxation. How would the different modes of conveying identical digital information be formulated into a comprehensive tax structure? California still has a lot to say about how the rest of the country goes.

Chairman Rosendahl
Question: What advice can you offer the Commission?
Answer: Mr. Goodman believes California will have a vote later. He phrased it as still getting "many more bites at the apple." He suggested sitting on the sidelines until SSTP publishes its report and California evaluates the details. New York and California remaining outside the SSTP sends a powerful message to Congress and the other states.

Commissioner Burton
Question: Was there any action by Virginia in response to the ACEC?
Answer: Legislation is on hold during the current recession and may be generated next year if the economy improves.

TAX DISPUTE RESOLUTION IN CALIFORNIA

Commissioner Bill Weintraub was absent and did not give his scheduled presentation (see Agenda).

COMMISSION BUSINESS

Chairman Rosendahl briefly mentioned the two memos provided by Commissioner Rossman discussing the unfunded nature of the Commission's work and the solidifying how to arrive at a scope of work. He indicated Commissioner Weintraub has offered to provide primary leadership in defining the scope of work and drafting the interim and final reports. Chairman Rosendahl deferred voting on the SSTP issue and conflict of interest issue until more Commissioners were present (anticipated for the September 18 meeting in San Diego).

GOVERNOR'S VETO OF SSTP AND INTERNET SALES TAX LEGISLATION, SEPTEMBER 23, 2000

Connie Squires, Program Budget Manager, Department of Finance

Ms. Squires provided three documents for the Commissioners' review:

- The text of SB 1949 which was the proposal for California to join the SSTP
- The text of the Governor's veto of SB 1949
- The text of the Governor's veto of AB 2412 (a companion bill to SB 1949 that would impose taxation on Internet sales)

The rationale for the veto of SB 1949 was that California already participates in forums discussing sales and use tax simplification and uniformity such as the Multistate Tax Commission, the National Governor's Association, and the Advisory Commission on Electronic Commerce. Consequently, the bill did not appear necessary.

The rationale for the veto of AB 2412 was that the Internet was too young and imposing taxes on its transactions could jeopardize the emerging dot-com industry. Also AB 2412 does not provide a stable taxation environment and attempts to impose taxes upon companies conducting electronic business to which the California courts have determined they are not subject to. The Governor indicates in this veto message that he is signing SB 1933, which creates the California Commission on Tax Policy in the New Economy to examine sales tax issues in relation to technology and consumer behavior and make recommendations.

Ms. Squires emphasized three points in addition to the remarks in the Governor's veto messages:

- Sales tax projections are very difficult to forecast and the effect of tax changes proposed by the Commission would be virtually unknown.
- Reporting individual sales transactions by taxable categories (as defined) would be an enormous burden on California businesses
- California does not provide reimbursement to any business for expenses incurred in collecting sales taxes on behalf of the state.

Ms. Squires responded to questions and comments from the Commissioners:

Chairman Rosendahl
Question: What interpretations of the Commission's charge and what resources do you expect the Commission to be provided?
Answer: The Commission must develop a scope of work that is feasible and within the guidelines delineated within the enacting legislation.
Answer: The Technology, Trade and Commerce Agency has undergone severe cutbacks in its operating budget and can provide bare minimum staffing support. However, once the scope of work is defined, a request for additional funding to accomplish the scope of work can be addressed to the legislature. A suitable recommendation could be to extend the Commission's work for another year, which may present a better opportunity for funding.

CONFLICT OF INTEREST CODE REQUIREMENTS

Kathryn Doi, Chief Counsel, Counsel to the Secretary Technology, Trade and Commerce Agency

Ms. Doi presented a memorandum to the Commissioners recommending the Commission requests an exemption from the Conflict of Interest Code governed by the Fair Political Practices Commission. Her memorandum contained two attachments: a proposed (draft) letter from her, on behalf of the Commission, to the Executive Director of the Fair Political Practices Commission, requesting such an exemption and the letter to her from the General Counsel of the Fair Political Practices Commission discussing the conflict of interest code and its applicability to the Commissioners.

In Ms. Doi's opinion the Commission may not be legally bound to adopt a conflict of interest code, but it would be in the best interest of the Commission and good public policy for individual Commissioners to voluntarily disclose pertinent holdings that may present the appearance of conflict of interest to the general public. Ms. Doi offered to draft a letter on the Commission's behalf to request an exemption should the commission vote to do so.

Ms. Doi responded to questions and comments from the Commissioners:

Commissioner Peters
Comment: As a recent appointee to the California Coastal Commission he already has to disclose his financial interests (Statement of Economic Interest) under its conflict of interest code and doing so for the California Commission on Tax Policy in the New Economy would impose no additional burden.

Commissioner Rossman
Comment: He expressed concern not about his personal economic interests but that of his company, since his company could be significantly affected by legislation enacted by the Legislature in response to the Commission's recommendations.

COMMISSION BUSINESS

Chairman Rosendahl entertained the Commissioners to vote on whether to request a conflict of interest code exemption from the Fair Political Practices Commission. Public comment was solicited, and there being none, Commissioner Brewer moved to request the exemption. Commissioner Burton seconded the motion. The motion was approved by unanimous vote. Ms. Doi accepted the task of drafting the request letter for the Commission's approval.

STRATEGY FOR REPORT WRITING

Jesse Szeto, Assistant Secretary

Technology, Trade and Commerce Agency

Mr. Szeto has solicited interest from three organizations that could potentially assist the Commission with the drafting of the interim and final reports:

- The California Research Bureau (CRB)
- The Public Policy Institute of California (PPIC)
- University of California, Davis, Institute of Government Affairs, Center for State and Local Taxation

All had indicated a willingness to assist the Commission in the drafting of its interim report, subject to some conditions and constraints.

Mr. Szeto responded to questions and comments from the Commissioners:

Chairman Rosendahl
Question to Ms. Kimberly Bott: What do you think are the pros and cons of using these organizations?
Answer: They are very valuable resources and could significantly contribute to the Commission's work if used wisely. She did not see any disadvantages. She was particularly supportive of soliciting support from Professor Terri Sexton and suggested the Franchise Tax Board may also be a valuable resource.

Chairman Rosendahl
Comment: Commissioner Weintraub has offered his leadership in writing the interim report.
Question: Could we combine the efforts of the three groups?
He believed Professor Terri Sexton, from the UC Davis Institute of Government Affairs was very much aligned with the Commission's thinking on taxation and shared its vision of how to accomplish its mission.

Comment by Commissioner Peters: He expressed concern that the organizations may not be willing to take positive direction form the Commission and would want to pursue their own agendas.
Answer: Mr. Szeto believed there could possibly be friction among the groups if they all participated.

Commissioner Rossman
Comment: The Commission needs to look at the long-term growth of the economy and get a solid economic forecast before it begins its work.

Commissioner Carr
Does an economic forecast already exist?
Answer by Commissioner Rossman: Yes.

Commissioner Brewer
Comment: Based on her experience with PPIC she rates them very highly for professionalism and competence

Commissioner Burton
Comment: He is only knowledgeable about PPIC. He was concerned that the interim report was due very soon and the Commission has yet to define a scope of work.

Commissioner Carr
Comment: the definition of what constitutes an interim report is debatable based on a previous presentation before the Commission from the Joint Venture Silicon Valley Network. He would like the Technology Trade and Commerce Agency to define the requirement for the interim report and suggested sending a letter to the Legislature and Governor requesting that the scope of work be considered as constituting the interim report.

Response by Ms. Connie Squires: The enacting legislation is silent regarding what constitutes an interim report. It is pretty much up to the Commission to define for itself what the interim report should be.

Chairman Rosendahl
Comment: he wondered if Terri Sexton would be able to work with Commissioner Weintraub in the drafting of the interim report. He asked for Ms. Kimberly Bott's assessment of the California Research Bureau.

Response by Ms. Bott: CRB is very good at what it does but it needs very clear direction on what it is asked to do to support the Commission and it could not take the lead in the effort. It can only provide support and analysis.

Commissioner Burton
Comment: He suggested Terri Sexton take the lead with Commissioner Weintraub in the preparation of the interim report and call in CRB and PPIC for targeted research as necessary.
Question: Who will ask Terri Sexton to help?
Answer: Jesse Szeto will do that if the Commission decides to adopt this approach.

Commissioner Brewer
Comment: She requested clarification on the sunset provisions in accordance with SB 394 if the interim report is not submitted on time.
Response by Ms. Kathryn Doi: Ms. Doi accepted this task and further advised the Commission that public notice was still required for any deliberations by the Commission related to this issue.

COMMISSION BUSINESS

Chairman Rosendahl invited further discussions among the commissioners regarding the scope of work. Commissioner Burton suggested the Commission clearly document what is expected from Commissioner Weintraub should he take the lead in preparing the interim report. Commissioner Peters strongly advocated the scope of work should contain the issues raised by Commissioner Rossman: sales and use tax, income tax and those presented by the Joint Venture Silicon Valley Network. Commissioner Brewer reminded the Commissioners that their charter included evaluation of taxation of Internet transactions and, therefore, that must be part of the scope of work.

Chairman Rosendahl discussed a conference call among the Commissioners prior to the September meeting (September 18 in San Diego) to deliberate about the scope of work. In preparation for this conference call a draft of the scope of work was requested to be made available to the Commissioners and to the public by posting on the Commission's website. He suggested the scope of work include a reference to possibly requesting a one-year extension for the Commission's work.

Commissioner Rossman would like to see an analysis of California's tax burden compared to other states and have that presented at the next meeting. Mr. Lee Goodman offered to provide the Commissioners that information, which he has gathered from the American Tax Foundation. He promised to mail the materials to the commissioners when he returns to Washington D.C.

Chairman Rosendahl directed the attention of the Commissioners to additional documents provided for their review: two memos from Commissioner Rossman, a briefing paper from Annette Nellen, a discussion of SSTP and GATT from Charles McLure and Walter Hellerstein, a letter in support of SSTP from Stephen Olivier of Chevron Oil, a letter in support of SSTP from Wayne Zakrewski of J.C. Penney, and a package of supplemental reading materials. The Commissioners acknowledged his direction.

Chairman Rosendahl solicited additional commentary from the Commissioners, Representatives of Ex-Officio Members, and members of the public. None was received.

ADJOURNMENT

Commissioner Peters moved to adjourn, which was seconded by Commissioner Brewer. The motion was approved by unanimous vote and Chairman Rosendahl adjourned the meeting.

CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY

Rayburn S. Dezember Leadership Development Center

California State University, Bakersfield

July 29, 2002

Proceedings

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CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY

Rayburn S. Dezember Leadership Development Center, Room 401
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July 29, 2002

FINAL AGENDA

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Vote

Conflict of Interest Code (Kathryn Doi assist)
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MEETING MINUTES
California Commission on Tax Policy in the New Economy
Santa Monica City Council Chambers
Santa Monica, California
May 16, 2002
10:00 A.M.

Commissioners Present

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

Members Absent

- Glen Rossman

Ex-Officio Members Present

- Connie Squires (Program Budget Manager), for Tim Gage (Director, Department of Finance)
- Marcy Jo Mandel (Deputy State Controller, Taxation) for the Honorable Kathleen Connell (State Controller)
- Kimberly Bott, for the Honorable Ed Chavez (Chair, Assembly Revenue & Tax Committee)
- John Davies (Division Chief, Executive Programs), for Gerald Goldberg (Executive Officer, Franchise Tax Board)
- Robert Affleck (Deputy Director, Tax Branch), for Michael Bernick (Director, EDD)
- Travis Foss, for Loretta Lynch (Public Utilities Commission)
- The Honorable John Chiang, Chair of the State Board of Equalization

Call to Order

Welcoming Remarks

Chairman Rosendahl welcomed everyone to the third Commission meeting, including cable viewers in the Los Angeles basin, who could tune to a live broadcast courtesy of Adelphia Communications.

Introduction of Members

Review and Approval of Meeting Minutes from March 20, 2002

Mr. Goldberg moved that the Commission approve the Minutes of the March 20, 2002 meeting. Ms. Brewer seconded the motion. The motion was approved by unanimous vote.

Expert Presentations

Streamlined Sales Tax Project

Charles D. Collins, Jr., North Carolina Department of Revenue
Co-Chair Streamlined sales Tax Project

Diane L. Hardt, Wisconsin Department of Revenue
Co-Chair Streamlined Sales Tax Project

Steven P. B. Kranz, Tax Counsel, Council On State Taxation (COST)

Mr. Collins and Ms. Hardt, as Co-Chairs of the Streamlined Sales Tax Project (SSTP), and Mr. Kranz, an advisor to the SSTP, presented a progress report on the initiative to simplify sales and use taxes among the 36 cooperating states. They are: Alabama, Arkansas, District of Columbia, Florida, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, south Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, west Virginia, Wisconsin and Wyoming. The steering committee consists of the members from the states of Michigan, Missouri, New Jersey, North Carolina, South Dakota, Texas, Utah and Wisconsin. California is not a participating or observing member of this project.

The objectives of the SSTP are fivefold:

- Simplify procedures and practices
- Reduce the current compliance burden
- Move toward a level playing field
- Reduce administrative costs for government entities
- Enhance voluntary compliance from remote vendors

Recommendations were developed for three primary categories:

- Base and Rate
  - Uniform definitions
  - Simplified exemption processing

- Rate simplification
- Local governments reporting rate and boundary changes to states

- Administration and Sourcing
  - Single registration for all states
  - Uniform treatment of bank holidays
  - Uniform treatment of bad debts
  - Uniform sourcing for all products and services

- Technology
  - Electronic filing
  - Electronic funds transfers
  - Tax collection and remittance models
    - Certified Service Provider (CSP)
    - Retailer using a Certified Automated System (CAS)
    - Proprietary System as a Certified Automated System (CAS)
    - Traditional collection system

Ms. Hardt then discussed the status of the legislative initiatives. To date, 27 states and the District of Columbia have enacted the "Uniform or Simplified Sales and Use Tax Administration Act." The Act is pending in 5 additional states. No legislative actions have yet been undertaken in the remaining 3 states that are participating in the project.

Additional project goals are to develop standardized audit procedures, tax forms and exemption certificates.

The presenters then responded to questions and comments from the Commissioners:

Commissioner Goldberg
Question: Can states adopt only certain provisions of the Act?
Answer: No. Uniformity with all of the provisions must be maintained. If terms and provisions are altered by a state's Legislature the other participating states will not recognize that state as a participating member.

Commissioner Burton
Question: Is there flexibility for state and local jurisdictions to set rates?
Answer: Yes. The only requirement of the Act is provide at least a 60-day notice prior to the first day of the quarter for when the rate or rate change will become effective.

Commissioner Peters
Question: Is your ability to affect the Quill Decision dependent on the large states joining SSTP?
Answer: There will need to be both simplification AND the participation of the large states in order for Congress to consider overturning Quill.

Commissioner Peters
Question: Why is California not participating in the project?
Answer: Unknown.

Commissioner Dombrowski
Comment: California should join the project or at least become a non-voting observer.

Chairman Rosendahl
Comment: The Commission should vote on whether to recommend California joining the SSTP at the next Commission meeting in July.

Commissioner Goldberg
Comment: The business representatives at the last hearing unanimously wanted California to join the Project.

Commissioner Carr
Comment: Someone from the Governor's Office should present at the July hearing to explain the veto.

Chairman Chiang
Comment: Further engagement in the policy issues associated with joining the SSTP is necessary.

Commissioner Goldberg
Question: What is the estimated cost to a state to implement the SSTP?
Answer: Minimal.

California Board of Equalization Member's Perspective

Dean Andal, Member, California Board of Equalization

Mr. Andal addressed three aspects related to taxation of Internet sales: the scope of Internet sales, a level playing field, and courses of action for the state to consider.

Regarding the scope of Internet sales, Mr. Andal stated that 50% of all California Internet sales involve the purchase of airline tickets or common stocks, which are not subject to California sales tax. Of the remaining 50%, he indicated 80% of the sales are business-to-business transactions, which are also precluded from California sales tax. He surmised that the remaining 10% of California Internet purchases were primarily books and clothing and were of such small dollar value compared to the other transactions (approximately 2% of total dollar sales), that it would not be worth the effort to incorporate those sales into the California tax codes.

Mr. Andal disputed the argument about unlevel playing fields among traditional brick and mortar retailers and Internet marketers. He opined that shipping costs of items typically purchased on the Internet almost always exceeded the sales tax on the item if it

were purchased in a typical California brick and mortar establishment. He concluded that Internet sales are more subject to an unlevel playing field than the traditional retailers. He believes Internet sales are primarily driven by customer convenience and not by an effort to circumvent California sales tax.

Mr. Andal recommended the following courses of action (or inaction) for the Commission to consider:

- Initiate legislative action to further codify the Quill decision to determine or more clearly define the concept of physical presence.
- In California, personal income taxes and property taxes provide a far greater percentage of state revenue than sales taxes compared to the states that are partnered in the SSTP. Consequently, the argument in favor of California joining the SSTP does not merit consideration.
- Telecommunication companies and related infrastructure networks (such as fiber optic systems) are taxed at much higher rates in California compared to most other states. The Commission should consider reducing that burden, which would do more to promote investor capital with subsequent economic benefit to the state than taxing Internet sales.

A general discussion among Commissioners followed. It was surmised that the cost of compliance with Internet sales tax would be significant for small businesses and that perhaps the Commission should think more along the lines of streamlining existing sales and use tax regulations and not so much on developing an additional revenue stream from Internet sales. If the effort to tax Internet sales goes forward the question was raised as to whether the state could provide the tax code software a no cost to businesses. No additional discussion on that idea took place.

Another question was raised regarding which industries are most affected by Internet sales and what subsequent loss of revenue to the state results. There was a consensus that digital media enterprises were most affected (sales of music CDs and DVD videos) and represented the bulk of "true losses" to the state. No data were presented. The extent of those losses was speculative.

The Commission then asked staff to provide a copy of the bill (SB 1949) that would have authorized the state to join the SSTP, and also a copy of the Governor's veto message, for the Commission to review at the next meeting.

Real Property and Personal Property Taxes

Rick Auerbach, Los Angeles County Assessor

Mr. Auerbach indicated that state revenues from property taxes are less than what they could be because there is very little incentive for counties to fully staff tax assessor offices. The reason is that only a very small percentage of the real property taxes collected by the counties actually accrue to the counties. For instance, Los Angeles

County's share of the real property taxes it collects is 23%. The rest is distributed to the State and City of Los Angeles. And, 45% of that 23% goes to schools, by Legislative mandate. Consequently, the County of Los Angeles does not have much incentive to increase its staffing levels in its Tax Assessor's Office, which would facilitate more reassessments. This adversely impacts (from a tax assessor's viewpoint) the assessed property values on the tax rolls, by depressing the true value of the affected properties. Assessed values consistently lag behind the estimated real property values resulting in potentially significant losses of revenue for the state, but much less so for the County. Other counties throughout California may not exactly mirror Los Angeles County's predicament, but they face similar circumstances and likewise have little incentive to increase Tax Assessor's Offices staffs.

Mr. Auerbach raised concerns about how difficult and time consuming (costly) it is to administer supplemental assessments when property is sold or reassessed. This time could be better spent doing normal reassessments.

Three other concerns were briefly brought to the Commission's attention: Personal property taxes are subject to annual determinations based on actual value, not cost, which is very, very difficult to evaluate. The homeowner's exemption and renter's credit has not been raised in 20 years and is still about $75 per year. This small revenue stream does not justify the administrative costs necessary to collect it. Pleasurecraft (watercraft) should be taxed by DMV not by Tax Assessor's Offices. DMV already has a structure in place that would need only minor modification to handle registration of boats.

Mr. Auerbach recommended the following:

- All agencies that benefit from a tax collection system should bear a prorata share of the cost of collection.
- Allow real property assessments to have rolling lien dates based upon the date of sale or transfer of ownership. This would eliminate the requirement for supplemental assessments.
- Personal property taxes should be set on a cost only basis. Market values are far too difficult to accurately determine. Self-reporting should be used, subject to audit.
- The homeowner's exemption and renter's credit should either be eliminated or increased significantly to justify the cost of collection.
- Change of ownership for commercial property is vaguely defined and needs to be clarified. For example, when a firm is owned by a partnership and one partner sells his share which is subsequently bought by either a new partner or the other existing partners, does that qualify as a change in ownership sufficient to merit a reassessment? Mr. Auerbach cautioned, however, that a business might not invest in a real property purchase and improvement with an unknown future tax burden. This is particularly relevant to manufacturing companies that are merged (change of ownership?) or acquire other investors.

- An effort should be undertaken to look at the entire scope of real and personal property taxes for commercial property. A determination should be made as to how often real commercial property should be reassessed:
    - change of ownership? What is a change in ownership?
    - every 5 years? 10 years?
    - never (provides a predicable tax burden)?

California Budgeting Process

Jean Ross, Executive Director, California Budget Project

Ms. Ross presented a paper that highlighted the following points and recommendations regarding California tax policy:

- California has a regressive tax structure. The poorest one-fifth of its citizens pays the largest share of its income in taxes.
- The policy governing assessments of commercial property gives an unfair advantage to older businesses that pay taxes on old property values. This prevents some new businesses from being competitive in the market place.
- There is no accountability in the system. No one has been able to relate tax incentives to actual job creation.
- Proposition 13 shifted control of tax revenues away from local jurisdictions to the state with consequent state control of previously local issues.
- California's "new economy" is very much like the old economy with tourism, industry, and agriculture constituting the bulk of state revenue sources.
- Thresholds of income tax liability for families should be adjusted to reduce the tax burden on the working poor.
- California is losing far more sales tax revenue because of the movement away from a goods and consumption based economy towards a services based economy. The Commission should consider how to level the playing field between goods and services by with an equitable tax structure.
- California should participate in the SSTP.
- Establish a link of accountability between tax incentives and job creation.
- Provide more flexibility for local jurisdictions to keep more of the collected tax revenues (on behalf of the state).

Commissioner Lenny Goldberg requested Ms. Ross's paper to be included in the official minutes of this meeting.

Commissioner Carr
Question: If local government kept more of the property tax, would that be "pro-growth"?

Answer: Property doesn't pay for itself and Propositions 218 and 63 locked down local governments' ability to raise taxes, so that would be a difficult strategy to take. It is easier to chase down big sales tax revenue generators.

Commissioner Burton
Question: How would you prioritize things for the Commission?
Answer: Recommend you look at property and sales taxes and give recommendations that address accountability. Also, California taxes too few services.

State Controller's Viewpoint

Kathleen Connell, California State Controller

Ms. Connell discussed the results of her tax simplification task force study, which convened in 2000. The report, "Tax Simplification Task Force 2000", was distributed to each Commission member and was made available to all who were present. The mission of the task force was "to consider ways to refresh California's existing tax system in order to maximize California's potential and minimize taxpayer dissatisfaction". The task force's policy recommendations were separated into four major tax policy goals, which are summarized below:

- Conformity. Conformity with federal tax law should be a primary goal for income and franchise tax laws, while recognizing that not every federal tax law provision will have relevance to California's situation. The Legislature should make conformity with federal law an express policy, and should clearly identify non-revenue reasons why particular provisions should differ. The task force recommended phasing out itemized deductions, and exact conformity for depreciation, net operating losses and charitable contributions of appreciated property.

- Simplicity. The California Revenue and Tax Code is becoming increasingly complex and burdensome. Ms Connell emphasized three recommendations the task force suggested to alleviate some of that burden:

  - Repeal the Alternative Minimum Tax (AMT).
  - Allow full deductions for dividends received by corporations.
  - Unitary business tax credits should be made available to other members of the business group to preclude those tax credits from being unused.

- Fairness. Ms. Connell reiterated Ms. Ross's statement that California has a regressive tax structure. She strongly believes removing the lower 50% of income earners from the tax rolls would have negligible effect on state revenues. She also believes middle class taxpayers bear a disproportionate burden of the tax liability for California citizens. Top marginal tax rates should be reduced.

- Investment. California should exclude from income 50% of capital gain assets held over one year, which would cut taxes on long term investments in half, thereby encouraging investment activity. Business income in California is allocated to three factors: property, payroll and sales, with the sales factor being double weighted. Because property values and personnel costs are disproportionately high in California compared to other states (and other countries), corporations in California are taxed at a higher rate in comparison to their revenue (sales). This discourages investments. California should abandon the three-tiered system of income calculation in favor of a single sales factor.

Ms. Connell stated that California's current budget crisis is the result of three major factors; $12 billion in extra energy costs and interest purchased by the state, a 40% drop in personal income taxes collected compared to the last fiscal year; and a 65% decrease in capital gains revenue, also compared to the last fiscal year. To ameliorate these fluctuations in revenue she recommended a constitutional change to incorporate a trigger mechanism for tax indexing that could respond to changes in economic conditions. Tax collection could then rise and fall with the expansion and contraction of the economy without having to resort to legislative remedies.

Ms. Connell concluded her remarks by encouraging the Commission to reach out to others and to seek commentary and review of the Commission's work in the public domain. She also strongly encouraged the Commission to take bold and aggressive strokes with visionary concepts. She indicated she had an open mind about joining in the SSTP, but with a caution to be careful of protecting California's interests.

The Commissioners thanked Ms. Connell for her time before the Commission and Commissioner Rosendahl requested staff to place the "Tax Simplification Task Force 2000" report on the website. Chairman Rosendahl also requested the State Controller to provide a staff member at the next Commission meeting to brief them more thoroughly on the conformity issues raised by Ms. Connell.

Commission Business

Chairman Rosendahl enjoined Commission members to consider the next meeting date in July. After much deliberation it was left to staff to contact each Commissioner and select a date suitable to the most members. Commissioner Brewer requested either Ms. Elizabeth Hill or a representative from the Legislative Analyst Office to appear at the next Commission meeting to discuss the cost of conformity.

California Economic Forecast

Professor Edward E. Leamer, Director UCLA Anderson Forecast

Professor Leamer presented data that indicated the Anderson forecast was the most accurate of all economic forecasts in predicting the California economy in 2001. The economic picture in California was exacerbated by the massive upturn and then downturn

in “dot.com” and high tech business fortunes. He called this phenomenon the “Internet Rush”. Contrary to all economic predictors the California housing market remained strong during the downturn. This had an adverse impact on savings as consumers devoted greater percentages of their disposable income to long-term mortgage debt. Professor Leamer envisions an impending “national disaster” as nationwide individual savings dip into negative territory for the first time ever. He questioned what could be done in the way of tax policy to reverse that trend. During the downturn corporations significantly reduced their spending on capital investments and physical plant construction or expansion. One particular sector of the California economy that was hit hard was the hotel industry, which experienced rapidly decreasing occupancy rates well before the events of September 11.

Professor Leamer’s preliminary thoughts on California’s economy in 2003 envision a weak recovery with minimum profits and growth in the 2% range. He pointed out that California actually has two distinct economies, geographically centered in Los Angeles (Southland) and San Jose (Silicon Valley). Market forces and economic opportunities in each region are very different; therefore any tax policies initiated to improve California’s economic fortunes must take into account these distinctions.

Professor Leamer concluded his remarks by stating taxation of Internet sales in California would provide very little economic benefit to the state.

Public Comment

A member of the public spoke briefly about the upcoming November elections and wanted to know if the Commission would host candidate debates regarding tax policy changes. His request was acknowledged and was taken under advisement. No other members of the public wished to speak before the Commission.

Commission Discussion

There was discussion that the public input has not been very strong, but that once the scope of work is better defined, then public interest should increase. It was felt that the discovery phase of the Commission’s work has not concluded and that at this stage it would be premature to finalize a scope of work.

Adjournment

SPEAKER PRESENTATIONS

Speaker Presentation

Daniel Thompson

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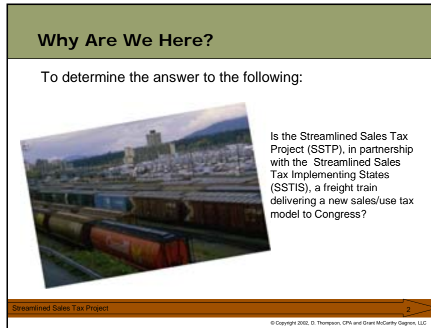
Slide 2



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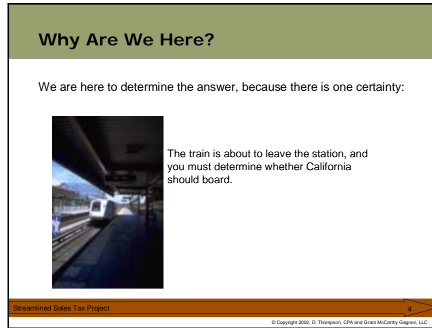
Slide 4

Why Are We Here?

We are here to determine the answer, because there is one certainty:



The train is about to leave the station, and you must determine whether California should board.

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Sales Tax 101

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Slide 6

Show Me the Money!

- Sales and use taxes yield more than $165 billion in annual revenue to state and local taxing authorities
- Previously limited to sales of tangible property, states are expanding their tax bases to reach many services

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They're Everywhere!

- 45 states and the District of Columbia impose broad-based sales and use taxes
- Localities in 34 states impose broad-based sales and use taxes
- There are over 45,000 sales and use tax rates across the country
- These rates fall within more than 7,500 state and local filing jurisdictions

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The High Cost of Compliance

- Keeping track of tax bases and rates can be difficult:
  - Each state and locality administers its own tax
  - Tax bases differ amongst these states and localities
  - Tax rates differ amongst these states and localities
  - Each state and locality has its own filing requirements
  - Returns are filed frequently– either annually, quarterly, or monthly

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The High Cost of Non-Compliance

- Significant liability can result if a company:
  - Does not report tax in a jurisdiction with which it has nexus
  - Does not report tax on purchases from out-of-state vendors
  - Does not pay tax on sales or purchases of taxable services
  - Makes sales outside the regular course of its business

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What is a Sales Tax?

- A sales tax is a tax imposed on the gross proceeds from the *transfer* of goods or services at retail
- It is a transaction tax
- It is generally imposed on the *seller*

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Types of Sales/Excise Taxes

- Sales-type taxes include:
  - Privilege tax
  - Consumer levy tax
  - Transaction tax
  - Gross receipts tax
  - Illinois occupation tax
  - Other occupation tax

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What is a Use Tax?

- A use tax is a complement to the sales tax, and is levied on transactions not covered by the sales tax
- Use tax is imposed on the privilege of owning, possessing, storing or using taxable property
- It is usually imposed on the same goods and services subject to sales tax

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When is a Use Tax Imposed?

- Use tax is imposed on:
  - Interstate sales, i.e., where the purchaser and seller are in different states. This includes sales made by remote sellers:
    - Internet
    - Mail order
  - Purchases initially made tax-free and later put to a taxable use
  - Property stored in-state for later use in other states

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Liability for Tax -- Nexus

Nexus is the minimum contact a company must have with a state before the state may require the company to pay or collect tax

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The Mighty *Quill*

The U.S. Supreme Court ruled in Quill v. North Dakota (504 U.S. 298 (1992)) that an out-of-state mail order company must have a *physical presence* with a state in order for the company to have nexus. Contact with potential customers through catalogs sent via U.S. mail/common carrier is not sufficient physical presence. *De Minimis* physical presence is also insufficient.

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Clothing: In Minnesota, boots are taxable if they come up above the knee– any lower, and they aren't taxable.

Delivery costs?
Candy?
Rounding?
Software- load and leave
Wire???

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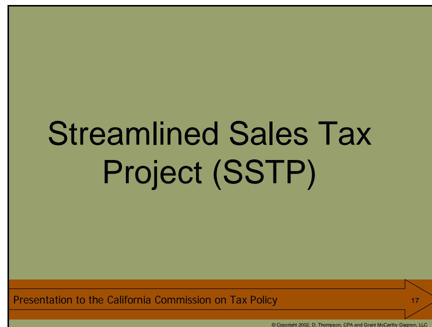

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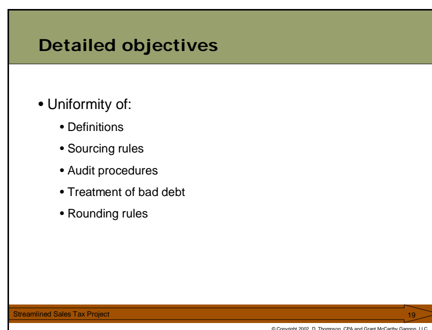

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Detailed objectives

- Local rate simplification
- Centralized administration within states
- Simplified registration and exemption administration

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Detailed objectives

- State funding of system
- Privacy protections
- State and local taxes remitted at state level only
- No or minimal sales tax returns for out-of-state sellers who voluntarily collect sales tax

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Background

- Initiated by Multistate Tax Commission and Federation of Tax Administrators in 2000
- 33 states and D.C. are voting participants in SSTP
  - All have official state authority to participate, generally due to legislation
  - Five others are non-voting, but taking part in discussions

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Background

- Participation by states has been via steering committees, consisting of revenue department representatives
- Significant and constant input from many businesses, industry groups, and associations
- Would be first significant overhaul of national sales tax system in over half a century

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Background

- The Project is divided into four workgroups:
  - Tax Base and Exemption Administration
  - Tax Rates, Registration, Returns and Remittances
  - Technology, Audit, Privacy and Paying for the System
  - Sourcing and Other Simplifications

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Legislative Components

- States would adopt Uniform Sales and Use Tax Administration Act ("the Act")
- States would modify laws to achieve uniformity

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Legislative Components

- The Act
  - Allows the state to enter into an agreement with one or more states to simplify and modernize sales and use tax administration and reduce the burden of tax compliance
- The Agreement
  - Changes could range from very minor to significant depending on current sales and use tax law
  - The Agreement would affect statutes, administration, and the audit and compliance aspects

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Governance

- Thirty-three states and the District of Columbia have enacted the Act (the "Implementing States")
- Implementing States will control the provisions of the initial Agreement
- It is anticipated that states that enact the provisions of the Agreement will continue as the governing states in the future

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Potential Benefits of SSTP

- Save businesses many millions of dollars by reducing administrative burden
- Increase sales and use tax revenues for states
- Equalize inequities between online and bricks-and-mortar vendors

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Potential Obstacles of SSTP

- Potential loss of absolute control by state and local jurisdictions
- Budget considerations
- Impracticable without participation of major states:
  - CA (Observer)
  - CT (Observer)
  - GA, ID (Observers)
  - MA*
  - NY (Observer)
  - Not Participating- CO, HI, and NM

•*Legislative mandate to participate likely to be signed in near-term

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What does this mean for California?

Presentation to the California Commission on Tax Policy 30

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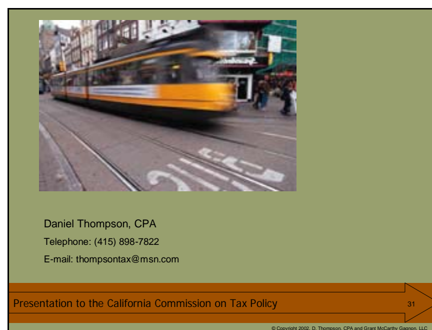

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Presentation to the California Commission on Tax Policy 31

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Speaker Presentation

Kimberly Bott

CALIFORNIA STATE ASSEMBLYMAN
ED CHAVEZ, CHAIRMAN
ASSEMBLY COMMITTEE ON REVENUE AND TAXATION

Presentation
California Commission on Tax Policy in the New Economy

July 29, 2002
Bakersfield, California

Legislative Perspective

By nature and by role, legislators are called upon to make decisions in a multitude of areas about which they have limited personal knowledge, experience, or expertise. Their charge is to make policy decisions in a political world. They must balance the interests of numerous groups that represent the constituents of the California Legislature.

Legislators must rely on information provided to them from various sources. Generally, these sources include, but are not limited to, constituents, lobbyists, staff (including the Legislative Analyst's Office), academicians, fellow members, and the press. Many of those that proffer information will frame the information in a form that suits, or more favorably presents, their respective agendas. This statement is intended not to be pejorative, but merely to recognize the reality of the conditions within which legislators operate.

Legislators must integrate and evaluate the information provided from varied and numerous sources. Oftentimes, the information, or more correctly, the conclusions drawn from the information, will contradict other conclusions that are equally well reasoned and salient. Consequently, legislators must try to separate the information presented from the agendas of those that provided the information. In addition, they must review the information provided for its impact on California revenue and resources, as well as the economy of California.

As the new economy develops, legislators will be required to make decisions that balance

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the policy of encouraging the new economy, particularly Internet businesses, with generating sufficient resources to meet the fiscal needs of California. The information provided by this Commission will be critical to strategic development of, or revisions to, the current tax structure to incorporate the activities of the new economy.

In order to make the information more valuable to the legislators as a whole, it is important to apprehend that the primary goal of many legislators in carrying out the duties of their position is “above all, do no harm”. In general, legislators negatively view any measure that results in some persons being worse off after the legislation, despite significant benefits that are afforded to others. Therefore, the information from this Commission needs to meet certain criteria. Any recommendation will be most useful if it meets a Pareto optimum -- everyone is at least as well off as before and at least one person is better off.

In addition, the favorably received recommendations are those that will be effective in both the short- and long-term. Due to term limits, many legislators will focus on the short-term results of legislation. Those that advise policymakers will also take long-term considerations into account.

Also, legislators deal with a considerable amount of dysfunctionality in state-local fiscal relations. Legislative actions that advance California's interest in certain situations might well impact the amount of revenue that is received by local jurisdictions. Understandably, a tension develops between the state legislators and the local governments, wherein local officials are more likely to applaud state actions as long as their abilities to provide for their own constituencies are not impaired. The tax policy in the new economy should attempt to mitigate this dysfunctionality, or at the very least, not exacerbate it.

The expansion of the Internet into the current business economy has been likened to the introduction of railroads and the resulting impacts on business. The methods employed by businesses to market and sell products, as well as changes in consumer behavior, suggest that much of the business activity that yields profits to the Internet operations will fall outside of the general tax framework currently in place in California. Clearly, a tension exists between the changing economy and forms of business transactions and the existing tax structure.

Briefly, California's tax revenues arise primarily from three specific sources: Property tax, personal income and corporate franchise tax, and sales and use tax. The property tax revenues accrue for the benefit of local government, as does a part of the sales and use tax. However, the majority of the sales and use tax, as well as all of the franchise and income tax, accrue to the benefit of, and for the use by, the General Fund of the State of California. [Note: California has been accused of an increasing reliance on personal income tax revenues as a source of funding. Tax policy in the new economy should address the prudence of increased reliance by California on revenue produced through the personal income tax.]

As the new economy develops, the question arises whether the very foundation of the tax system must change to maintain resources needed for California to carry out its business. Without transforming into a discussion of the relative value of State expenditures, there is a simple recognition of the need to review the overall structure and estimate the impact on revenue to California. Under current law, the taxes contributing the greatest amounts to the General Fund of California apply to transactions reflecting activity within California. As the economy becomes less reliant on physical presence in any given geographical area, the existing tax structure decreasingly will be able to provide the same level of revenues currently realized. In addition, the changing form of business transactions creates the concern that the system of taxation will be unable to create a fair tax environment for similar (and competitive) businesses until all such business is conducted via the Internet, which is unlikely to occur in the foreseeable future.

The Legislature will look to this Commission to provide ideas, suggestions, and recommendations that are politically, socially, and economically viable. As discussed above, legislators will rely on information presented to them in order to make the policy decisions that will drive California through the new economy. The collaborative effort of the members of this Commission to process and refine the information presented creates an expectation of a report or product that assists the legislators in their efforts to appropriately create an environment that fosters economic growth as well as equitable taxation of the profits earned by businesses from Californians.

Speaker Presentation

Lee Goodman

The New Economy's Challenge for True Tax Reform And The "Streamlined Sales Tax Project"

A Presentation To The

California Commission on Tax Policy in the New Economy

By
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Bakersfield, California

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The Sales Tax Meets the Internet

Ever since the Supreme Court's decision in *Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), state and local governments have been in a quandary over how they might eliminate the costly burdens and complexities inherent in the collection of sales and use taxes across 7,500 different state and local taxing jurisdictions. By 1992, when the Supreme Court cast its burden analysis in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), as matter solely of interstate commerce clause concerns, no significant progress had been made by state and local governments to radically simplify the collection of sales and use taxes despite years of discussion and attempts.

Then came the Internet and the boom it launched in dot-com electronic commerce. State and local governments panicked at the sight of a powerful new facilitator of interstate sales and commerce in a tax system governed by the *Quill* nexus paradigm. The boom in dot-coms reignited efforts by state and local governments to extend their sales taxes across state boundaries and harness them to burgeoning electronic commerce.

At the same time, the advent of the Internet and electronic commerce gave rise to novel tax policy questions for which there was no clear precedent, such as:

- Should state and local governments be permitted to impose "access taxes" on Internet access obtained for a fee from Internet service providers, like a telephone tax?
- Should consumers pay sales taxes to access digital content and entertainment, including web pages accessed for a bundled fee?
- Should services provided on-line, like software applications uploaded and published reports, be subject to sales taxes?
- Does a business's purely digital presence in a state, for example the hosting of a business's website on a server located in the state, subject that business to tax jurisdiction in the state?
- What are the privacy implications of taxing otherwise discreet electronic transfers of data, software and content?
- If state and local governments were to attempt to eliminate the excessive burdens and costs associated with tax collection on interstate sales over the Internet, how would they go about it?

As millions of American consumers logged online in the late 1990s, these and similar tax issues emerged as difficult, even intransigent, public policy questions at the state, local and federal levels. What for decades had been a lingering nuisance to state and local government revenue structures since *Bellas Hess* and *Quill*, had virtually overnight been transformed into a major national conflict between state and local governments on the one hand and a new breed of national commerce on the other. The New Economy of the 21st century was challenging a tax system built in the 19th and 20th centuries.

Congress, exercising its powers under the interstate commerce clause, assumed its proper role as arbiter in the new national debate over whether and how to reform state and local tax structures. In 1998, Congress enacted the Internet Tax Freedom Act which halted, for three years, the imposition of state and local efforts to impose "access taxes" on Internet service fees charged by Internet service providers. Eleven states had enacted these taxes as well as several local governments, and the Congress was alarmed at how these disparate taxes might inhibit full development of and widespread access to the Internet. The Internet Tax Freedom Act also prohibited states and local governments from imposing "multiple and discriminatory" taxes on electronic commerce, a phrase that was more prophylactic and conjectural in its meaning, but that nonetheless was critical to a pro-Internet national tax policy.

Congress planned to take the next three years (1998 to 2001) to study the implications of Internet taxation. That task was not easy in light of the unprecedented legal and technological issues, the magnitude of the tax and social policies implicated, as well as intensity among competing commercial and philosophical interests. The central challenge was how to harmonize important but competing national objectives in one national tax policy that would:

- Preserve the free and unburdened flow of interstate commerce;
- Promote economic growth and opportunity, entrepreneurial investment and technological advancement in a free market;
- Expand liberty and freedom of individual people as citizens, taxpayers and consumers who have been empowered by the personal computer and Internet; and
- Allow state and local governments effectively to provide their legitimate regulatory and service responsibilities to their citizens, including their ability to raise tax revenues sufficient to provide those services in a potentially unprecedented interstate economy.

To assist it in addressing these challenges, in 1999, Congress appointed the Advisory Commission on Electronic Commerce (ACEC) to study the issues and report back to Congress in early 2000. While the substance of the Commission's work proved contentious and failed to garner consensus, a clear 11-member majority of the 19-member Commission rendered a comprehensive set of tax proposals aimed at encouraging the growth of electronic commerce in a New Economy. Those proposals were forwarded to Congress in a Report in April 2000. To date, Congress has acted on several of the ACEC Report's proposals and others are incorporated in pending legislation.

Sales Tax Simplification Proposed in the
Report of the Advisory Commission on Electronic Commerce

The overriding theme of the ACEC Report was for Congress to support tax policy designed to promote electronic commerce and protect the American people and businesses from additional or excessive tax burdens when they engage in electronic commerce.

The ACEC's most controversial tax proposal was a call for state and local governments to submit their labyrinthine sales and use tax schemes to the National Conference of Commissioners of Uniform State Laws (NCCUSL) for a fundamental overhaul. The overhaul was intended to dramatically simplify sales tax laws across the country and streamline tax collection burdens for businesses.

Specifically, The ACEC recommended that state and local sales tax structures be submitted to NCCUSL to "simplify state and local sales and use taxation policies so as to create and maintain parity of collection costs (net of vendor discounts) between remote sellers and comparable single-jurisdiction vendors that do not offer remote sales, including providing the following:

(a) uniform tax base definitions;
(b) uniform vendor discounts;
(c) uniform and simple sourcing rules;
(d) one sales and use tax rate per state and uniform limitations on state rate changes;
(e) uniform audit procedures;
(f) uniform tax returns/forms;
(g) uniform electronic filing and remittance methods;
(h) uniform exemption administration rules (including a database of all exempt entities to determine exemption status);
(i) a methodology for approving software that sellers may rely on to determine state sales tax rates;
(j) a methodology for maintaining revenue neutrality in overall sales and use tax collections within each state (such as reducing the state-wide sales tax rate) to account for any increased revenues collected (on a voluntary basis or otherwise) from remote sales."

For some commissioners, sales tax simplification provided an implicit "pathway" for state and local governments eventually to require sales taxes to be collected on all Internet and interstate transactions. These commissioners provided further in the Report for a follow-up advisory commission that would, among other things, assess NCCUSL's success, or lack thereof, in accomplishing these goals, and whether "requiring all remote sellers to collect and remit sales and use taxes to those states that adopt the uniform sales and use tax act would impose any unreasonable burden on interstate commerce or would otherwise adversely impact economic growth and activities through remote electronic

channels." In other words, these commissioners favored incremental steps toward a potential interstate sales tax system with several check points along the way to ensure state and local governments could do what they had promised – in the words of Utah Governor Mike Leavitt, establish a new "burdenless" sales tax system.

For others, including the ACEC Chairman and Virginia Governor Jim Gilmore, sales tax simplification was solely an end in and of itself and the extension of sales taxes across state boundaries was deemed counterproductive. These commissioners had little confidence that a "burdenless" sales tax system was achievable – practically or politically – and saw the extension of sales taxes as merely an expansion of taxes paid by American consumers and tax burdens on American businesses. These commissioners successfully included in the Report a proposal for Congress to codify clear and modern "nexus" standards to perpetuate the Supreme Court's nexus construct and thereby block interstate sales tax collection. Other commissioners viewed the call for perpetuation of the "nexus" paradigm as sufficient leverage to make state and local governments get serious about sales tax simplification.

Other commissioners who represented the interests of state and local governments to raise adequate revenues in a fairer tax system, joined by state and local government lobby associations and national retail chains, were dissatisfied with anything short of an explicit recommendation for Congress to expand sales taxes to all electronic and catalogue transactions nationwide. They opposed certain planks in the Report's model of uniformity, such as revenue neutrality and one-rate per state. Some also were not confident NCCUSL would render a law the states and localities could accept. They dissented from the majority Report.

Unhappy with the ACEC Report, in early 2000, the National Governors' Association (NGA), the National Conference of State Legislatures (NCSL) and other organizations sponsored a multi-state program to draft a uniform sales tax law. The work of the Streamlined Sales Tax Project (SSTP) continues in 2002, and represents the most serious attempt by state and local governments ever to reform a sales tax system constructed in the 19th and 20th centuries.

Meanwhile, the NGA and NCSL, supported by several national retail corporations, have been lobbying Congress to endorse the SSTP proposal and authorize, pursuant to Congress's interstate commerce clause power, an interstate sales tax compact to make American consumers pay -- and American businesses collect -- sales taxes on all interstate transactions. They also have been lobbying state legislatures and executives to endorse and participate in the SSTP in a demonstration of national commitment to their effort.

Does SSTP Meet The Challenge of the 21st Century?

For over two years the NGA and NCSL, working through a loose organization of state and local tax administrators assembled as the SSTP, and sort of board of directors of state tax administrators and legislators assembled as the "Implementing States," have been drafting a new uniform sales tax law. Within months from now, before the Internet Tax Freedom Act moratorium on access taxes expires (it sunsets on November 1, 2003), these state and local government lobbies will ask Congress to endorse the SSTP uniform sales tax law and thereby authorize, pursuant to Congress's interstate commerce clause powers, all state and local governments to require out-of-state merchants to collect and remit sales taxes on their sales to customers in their respective states. As momentous as this sea change in national tax policy is, the SSTP has received very little public attention or scrutiny. Many businesses and consumers could wake up to a very different reality a year from now if Congress chooses to accept the SSTP policy and legal framework.

The stated purpose in crafting a uniform sales tax law for adoption by each state that imposes a sales tax (currently 45 states and the District of Columbia) is to eliminate the burden of collection across 7,500 different state and local tax jurisdictions and facilitate the payment of sales taxes on interstate Internet and catalogue transactions.

At the core of the debate over sales tax reform in the new borderless, electronic economy is the fundamental need to promote open interstate commerce with as few state burdens as possible. Accordingly, SSTP should be looking at ways to adapt old state tax systems to the new electronic economy of the 21st century rather than forcing the new electronic economy to adapt to burdensome and complex 19th and 20th century tax systems.

It is in this regard, however, that one may question whether the SSTP is meeting the challenges of the borderless 21st century economy. Substantial friction from collection and regulatory burdens remain in the various proposals being adopted piecemeal by the SSTP and Implementing States. There are hidden tax increases on some commercial sectors and products in some states. And nobody has explained how it is that third-party tax collectors are to integrate their tax collection software into the mainframes of hundreds of thousands of businesses across the United States in a seamless interstate sales tax collection system. The SSTP also avoids some of the more dramatic reforms called for by the retail industry – such as one-rate per state or a perpetual guarantee of interstate uniformity – because of what the SSTP calls "political, administrative and revenue issues" that are too difficult to resolve nationally. Some have called SSTP's response to these difficulties patchwork, minimalist, or "low bar" reform.

Nonetheless, the significance of the SSTP and what it represents for tax policy in the United States cannot be understated. It represents an attempt at perhaps one of the most sweeping sea changes in national tax policy in decades. And lurking in its esoteric details are several momentous policy and practical implications for businesses, taxpayers and consumers, as well as the entire economy of the United States for decades to come. Therefore, it deserves close and constructive scrutiny.

Issues & Concerns In SSTP Tax Policy

To date, the SSTP process has not produced a complete uniform sales tax law for review and critique. Discreet sales tax policies have trickled out in the form of "issue papers" and "recommendations" that are drafted in working groups. Reports are that SSTP promises to complete its work and present a uniform law as early as Fall of 2002. That timeframe may prove too ambitious, but at least it demonstrates the SSTP is far into its work.

Analysis of a piecemeal uniform law is difficult, but at least the general direction of SSTP can be discerned in some areas, and some of these areas raise concerns or issues that should be addressed by the SSTP before a final uniform law is presented to state legislatures and Congress. Several of these issues and concerns are outlined below. While some of these issues are less significant than others, considered together they indicate the SSTP has a long way to go to meet the promise of *true reform, true simplification, and burdenless sales tax collections* in the New Economy.

In particular, the SSTP still must resolve the following issues:

- SSTP perpetuates significant complexities and burdens for businesses and consumers engaged in electronic and catalogue interstate commerce;
- SSTP does not provide real or perpetual uniformity across the states or over time;
- SSTP's promise of a technology fix has not been demonstrated to work efficiently for all businesses in America;
- SSTP does not know how much interstate sales tax collection will cost businesses, even with a technology fix;
- SSTP has rejected the ACEC Report's call for revenue neutrality and proposes obvious and hidden expansions in the amount of taxes American taxpayers pay;
- SSTP has several direct and harmful tax consequences for certain segments of society, such as senior citizens, farmers and families with children;
- SSTP does not adequately protect consumer privacy and in several ways exposes consumers to new threats of privacy breaches;
- SSTP proposes to open on-line content, data, entertainment and information to sales taxes and threatens to expand sales taxes to services in the process.

Conclusion: A Call For True Reform

Although the SSTP projects that it will produce a uniform sales and use tax law as soon as the Fall of 2002, and no later than Winter 2003, nothing less than a truly dramatic reform can adequately address the challenge presented by the Internet and the electronic commerce it facilitates. Whether the SSTP version meets this test remains to be seen. Congress will analyze it carefully and may even be called upon to substitute its own policy judgments for those of the tax administrators who participated in the SSTP drafting process. Congress promises to present a major test for the SSTP details as well as its overriding objective.

Equally difficult will be 50 state legislatures and Governors. Although several have endorsed, in general terms, the SSTP process through participation, few have been apprised of the actual details. Other multi-state tax compacts have proved to be thorns in the side of legislative finance committees in the past. SSTP might be viewed the same way. Since uniformity is the goal of reform, states will be called upon to surrender their sovereignty over state tax policy to an interstate compact for a payoff of tapping an additional 1% of retail commerce. That presents a major political hurdle to SSTP adoption across many states.

Then, of course, American consumers, taxpayers and businesses will get to weigh in. While large national retail chains advocate interstate sales tax collections to “level the playing field” between brick-and-mortar and Internet merchants, they will be met by their own consumers and taxpayers who will ask not to pay higher taxes in the name of tax fairness.

There also is the possibility that alternatives to the SSTP will emerge in the public debate. Several alternatives already have been proposed, such as,

- Origin-based sales taxes;
- Interstate sales tax collections remitted only to the vendor’s home state, which in turn distributes the taxes collected to sister states (similar to the interstate motor-fuels tax system);
- Perpetuation of the “nexus” paradigm with updated and clarified nexus standards codified in the U.S. Code (similar to multi-state business activity taxes);
- A “tax free” interstate compact which would compete for businesses and consumer purchases against the SSTP interstate compact;
- A sweeping “transactional tax” reform that addresses the myriad of tax policy challenges presented by the advent of electronic commerce and the Internet, and that merges telephone, wireless and cable tax reform with traditional sales taxes.

At a minimum, the SSTP will be held to a high standard in its bid to adapt state and local tax structures to the electronic nature of the 21st century economy, and patch working a 20th century tax system and asking the electronic economy to fit into it probably will not suffice. The challenge is great and the opportunity for real, lasting reform is demanding.

Speaker Presentation

Connie Squires

BILL NUMBER: SB 1949 ENROLLED

BILL TEXT

PASSED THE SENATE   AUGUST 30, 2000
PASSED THE ASSEMBLY   AUGUST 28, 2000
AMENDED IN ASSEMBLY   AUGUST 25, 2000
AMENDED IN ASSEMBLY   JULY 5, 2000
AMENDED IN SENATE   MAY 26, 2000
AMENDED IN SENATE   MAY 15, 2000
AMENDED IN SENATE   APRIL 24, 2000

INTRODUCED BY   Senators Costa and Chesbro
(Coauthors: Assembly Members Alquist, Honda, Migden, and Romero)

FEBRUARY 24, 2000

An act relating to sales and use taxes.

LEGISLATIVE COUNSEL'S DIGEST

SB 1949, Costa. Sales and use taxes: uniformity.

The Sales and Use Tax Law imposes a tax on the gross receipts from the sale in this state of, or the storage, use, or other consumption in this state of, tangible personal property. Under the Bradley-Burns Uniform Local Sales and Use Tax Law, counties and cities are authorized to impose local sales and use taxes in conformity with state sales and use taxes.

This bill would make findings and declarations regarding the benefits of a simplified, uniform sales and use tax system. The bill would direct the Governor or his or her representative to enter into discussions with other states regarding the development of a multistate, voluntary, streamlined system for sales and use tax collection and administration.

This bill would provide for specified return information to be confidential. This bill would direct the Governor or his or her representative to report to specified legislative members on the status of multistate discussions and, if a proposed system has been agreed upon by participating states, to recommend whether this state should participate in the system.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. This act shall be known and may be cited as the "**Streamlined Sales Tax System for the 21st Century Act.**"

SEC. 2. The Legislature finds and declares all of the following:

(a) State and local tax systems should treat transactions in a competitively neutral manner.

(b) A simplified sales and use tax system that treats all transactions in a competitively neutral manner will strengthen and preserve the sales and use tax as a vital state and local revenue source and preserve state fiscal sovereignty.

(c) Remote sellers should not receive preferential tax treatment at the expense of local "main street" merchants, nor should these vendors be burdened with special, discriminatory, or multiple taxes.

(d) The state should simplify sales and use taxes to reduce the administrative burden of collection.

(e) While states have the sovereign right to set their own tax policies, states working together have the opportunity to develop a more simple, uniform, and fair system of state sales and use taxation without federal government mandates or interference.

SEC. 3. The Governor or his or her representative shall enter into discussions with other states regarding development of a multistate, voluntary, streamlined system for sales and use tax collection and administration. These discussions shall focus on a system that would have the capability to determine whether the transaction is taxable or tax exempt, the appropriate tax rate applied to the transaction, and the total tax due on the transaction, and provide a method for collecting and remitting sales and use taxes to the state. That system may provide compensation for the costs of collecting and remitting sales and use taxes. Discussions between the Governor or his or her representative and other states may include, but are not limited to:

(a) The development of a "Joint Request for Information" from potential public and private parties governing the specifications for the system.

(b) The mechanism for compensating parties for the development and operation of the system.

(c) Establishment of minimum statutory simplification measures necessary for state participation in the system.

(d) Measures to preserve confidentiality of taxpayer information and privacy rights of consumers.

(e) Following these discussions, the Governor or his or her representative may proceed to issue a Joint Request for Information.

SEC. 4. Return information submitted to any party or parties acting for and on behalf of the state shall be treated as confidential taxpayer information. Disclosure of confidential taxpayer information necessary under Sections 3 and 4 of this act shall be pursuant to a written agreement between the Governor or his or her representative and the party or parties. The party or parties shall be bound by the same requirements of confidentiality, and applicable penalties, as under Part 1 (commencing with Section 6001) of Division 2 of the Revenue and Taxation Code.

SEC. 5. The Governor or his or her representative shall provide quarterly reports to the Speaker of the Assembly, Minority Leader of the Assembly, Senate presiding officer, and

Senate Minority Leader, and to the Chairpersons and members of the Assembly and Senate Committees on Revenue and Taxation on the progress of multistate discussions.

SEC. 6. By March 1, 2001, the Governor or his or her representative shall report to the Speaker of the Assembly, Minority Leader of the Assembly, Senate presiding officer, and Senate Minority Leader, and to the Chairpersons and members of the Assembly and Senate Committees on Revenue and Taxation on the status of multistate discussions and, if a proposed system has been agreed upon by participating states, shall also recommend whether this state should participate in that system.

SEC. 7. This act shall remain in effect only until January 1,2002, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2002, deletes or extends that date.

Governor's Veto Message

September 23, 2000

To Members of the California State Senate:

I am returning Senate Bill 1949 without my signature.

This bill would direct the Governor or his representative to participate in discussions with other states on sales and use tax simplification and uniformity. The Governor or his representative would be required to present the Legislature with quarterly progress reports.

I am vetoing this bill because California officials already participate in forums where issues of sales and use tax simplification and uniformity are discussed. Examples of these forums include the Multistate Tax Commission, The National Governor's Association, and the Advisory Commission on Electronic Commerce. Therefore, this bill does not appear necessary.

Sincerely,

GRAY DAVIS

GOVERNOR'S VETO MESSAGE

September 23, 2000

To the Members of the Assembly:

I am returning Assembly Bill 2412 without my signature.

This bill would impose sales tax collection obligations on retailers who process orders electronically, by fax, telephone, the Internet, or other electronic ordering process, if the retailer is engaged in business in this state.

In order for the Internet to reach its full potential as a marketing medium and job creator it must be given time to mature. At present, it is less than 10 years old. Imposing sales taxes on Internet transactions at this point in its young life would send the wrong signal about California's international role as the incubator of the dot-com community.

Moreover, the Internet must be subject to a stable and non-discriminatory legal environment, particularly in the area of taxation. Unfortunately, AB 2412 does not provide such a stable environment: it singles out companies that are conducting transactions electronically and attempts to impose tax collection obligations on them to which, according to California courts, they are not subject. Furthermore, AB 2412 re-enacts provisions that the Legislature has recently repealed due to court decisions.

In the next 3 to 5 years, however, I believe we should review this matter. Therefore I am signing SB 1933, which creates the California Commission on Tax Policy in the New Economy. The Commission will examine sales tax issues in relation to technology and consumer behavior and make recommendations.

Sincerely,

GRAY DAVIS

Speaker Presentation

Kathryn Doi

C<u>ALIFORNIA TECHNOLOGY, TRADE AND COMMERCE AGENCY</u>

Memorandum

To: Members,
Commission on Tax Policy in the New Economy

From: Kathryn Doi,
Chief Counsel/Counsel to the Secretary

Subject: FPPC Advice Letter Regarding the Need for the Commission to Adopt a Conflict of Interest Code

Date: July __, 2002

On January 25, 2002, the Technology, Trade and Commerce Agency ("TTCA") submitted a letter to the Fair Political Practices Commission ("FPPC") on behalf of the Commission on Tax Policy in the New Economy (the "Commission") requesting formal advice as to whether the Commission is required to adopt a conflict of interest code requiring Commission members to file statements of economic interests ("Form 700s"). A copy of the January 25 letter is attached.

On June 25, 2002, the TTCA received a response to its request for advice. In the letter, the FPPC concluded that the Commission is a public agency, and is therefore required to either adopt a conflict of interest code or submit an exemption request. A copy of the June 25 letter is also attached.

A conflict of interest code is a document that specifically enumerates each position within a public agency which involves the making, or participation in the making, of decisions which may foreseeably have a material effect on a financial interest. For each such enumerated position, the code requires disclosure of specific types of investments, business positions, interests in real property, and sources of income. (Government Code section 87302.)

In the FPPC's letter, the FPPC's observes that the Commission may not have persons to designate in its conflict of interest code as required to file Form 700s because it does not have any employees and Commission members are serving in a short-term advisory capacity. In such a situation, it would appear to serve no purpose for the Commission to go through the process of adopting a code and an exemption is available pursuant to regulation. (2 California Code of Regulations section 18571(c)).

The TTCA recommends that the Commission include this item on the agenda for its July meeting and vote at that time whether to begin the process of adopting a conflict of interest code or to request an exemption.

Attachments (2)

KD draft – 7/5/02

July __, 2002

Executive Director
Fair Political Practices Commission
428 J Street, Suite 620
Sacramento, CA 95814

Re: California Commission on Tax Policy in the New Economy Request for Exemption

Dear Sir or Madam:

The California Technology, Trade and Commerce Agency ("TTCA") is serving as Executive Secretary for the California Commission on Tax Policy in the New Economy ("Commission"). On January 25, 2002, the TTCA sent a letter to the FPPC, requesting formal advice with whether the Commission must adopt a conflict of interest code. On June 25, 2002, the FPPC responded that the Commission is a "state agency" required to adopt a conflict of interest code. The FPPC response further directed the Commission to either request an exemption or begin the process to develop a conflict of interest code.

The TTCA now writes on the Commission's behalf to request an exemption to the Government Code section 87300 requirement that the Commission adopt and promulgate a conflict of interest code. The request is made pursuant to Title 2, section 18751 of the California Code of Regulations ("Regulation 18751") on the grounds that if the Commission does not have "designated employees" who would be subject to the provisions of a Commission conflict of interest code.

Accompanying this request are the following documents and information, as required by Regulation 18751(f):

(1) A list of every position in the agency, including each officer, employee, member and consultant with the agency;
(2) A copy of the job description for each position listed in (1), above;
(3) A copy of the statutory authority under which the agency was created with specific citations to the provisions setting forth the duties and responsibilities of the agency (Exhibit A);
(4) Identification of the person or body to whom the agency reports;
(5) A copy of the last annual or regular report submitted by the agency to the person or body to whom the agency reports; and

(6) A detailed justification of the request for exemption including an explanation of why none of the positions listed in (1) above, are designated employees.

1. A list of every position in the agency

The Commission consists of the following positions (as set forth in Revenue and Taxation Code section 38063):

- Nine (9) voting members;
- Nine (9) ex officio, nonvoting members.

The Commission does not have any employees or consultants.

2. Job descriptions for each position

The Commission shall submit an interim report to the Governor and the Legislature not later than 12 months from the date of the Commission's first public meeting and a final report with recommendations not later than 24 months from the date of the Commission's first public meeting. (Revenue and Taxation Code section 38066.)

In preparing the final report and developing its recommendations, the Commission shall do all of the following (Revenue and Taxation Code section 38065):

- Identify all the key stakeholders in the new economy and invite them into the commission's process.
- Develop a comprehensive agenda of goals and a roadmap of all critical issues that ought to be addressed in achieving a workable, flexible, and balanced long-term solution.
- Undertake the process of conducting public hearings and in the correct phases address each of these critical issues and seek to arrive at a comprehensive conclusion with respect to the smartest public policy taxation of the Internet.
- Examine and describe all aspects of the current and future California economy, with special attention to the influence of new technologies, including, but not limited to, the use of the Internet in electronic commerce.
- Assess the impact of those predictions about the economy on the sources and size of projected public revenues, with special attention to the needs of local government.
- Study and make recommendations regarding specific elements of the California system of state and local taxes, including, but not limited to, sales and use tax, telecommunications tax, income taxes, and property taxes.

Please see Revenue and Taxation Code section 38065 for additional detail regarding the specific elements of the California system of state and local taxes that the final report is required to address.

3. STATUTORY AUTHORITY

A copy of the statutory authority under which the agency was created, Senate Bill No. 1933, which added Revenue and Taxation Code, Part 18.3, Sections 38061-38067, is attached as Exhibit A.

The provisions setting forth the duties and responsibilities of the agency are Revenue and Taxation Code Sections 38065 and 38066.

4. IDENTIFICATION OF THE PERSON OR BODY TO WHOM THE AGENCY REPORTS

The Commission reports to the Governor and the Legislature. (*See* Revenue and Taxation Code section 38066.)

5. MOST RECENT REPORT

Regulation 18751(f) requests that a copy of the last annual or regular report submitted by the agency to the person or body to whom the agency reports be attached to an exemption request. At this time, the Commission has not yet submitted a report to the Governor or the Legislature. By statute, the Commission's first report to the Governor and the Legislature is to be submitted not later than 12 months from the date of its first public meeting. (*See* Revenue and Taxation Code section 38066.) The Commission held its first public meeting on January 29, 2002.

6. JUSTIFICATION OF THE REQUEST FOR EXEMPTION

The question presented here is whether the Commission members are "designated employees" who should be covered by a code. Government Code section 82019 and Regulation 18700(a)(1) both provide that for purposes of defining "designated employee", a "member" includes, but is not limited to, salaried or unsalaried members of boards or commissions with decision-making authority. Government Code section 82019 further states that "'Designated employee' does not include … any unsalaried member of any board or commission which serves a solely advisory function …."

Regulation 18700(a)(1) provides that a board or commission possesses decision-making authority whenever:

(A) It may make a final governmental decision;

(B) It may compel a governmental decision; or it may prevent a governmental decision either by reason of an exclusive power to initiate the decision or by reason of a veto that may not be overridden; or

(C) It makes substantive recommendations that are, and over an extended period of time have been, regularly approved without significant amendment or modification by another public official or governmental agency.

The members of the Commission on Tax Policy in the New Economy are unsalaried. The Commission will make recommendations to the Governor and the Legislature, but the Governor and Legislature are not bound by these recommendations, and the recommendations would be subject to the legislative process before being implemented. The Commission does not have the power to make final governmental decisions nor the ability to compel of prevent governmental decisions. The Commission does not have a budget, nor does it have the authority to hire employees or enter into contracts. For these reasons, the Commission members are not "designated employees" within the meaning of Government Code section 82019 and Regulation 18700(a)(1)(A) and (B). (*See Milne* Advice Letter (1994) No. A-94-260.)

The Commission was established by statute (Senate Bill 1933), effective January 1, 2001. The Governor's appointments to the Commission were made on September 19, 2001 (see press release attached as Exhibit B), and the legislative appointments were made in the following months. The Commission held its first meeting on January 29, 2002. Since the Commission has only recently come into existence, it has not had an opportunity to establish a history regarding the disposition of its recommendations. For these reasons, the Commission does not currently possess decision-making authority within the meaning of Regulation 18700(a)(1)(C).[1] (*See Gergen* Advice Letter (1997) No. A-96-328.)

For the foregoing reasons, we submit that the Commission does not have "designated employees" within the meaning of the Political Reform Act and is appropriately exempted from promulgating a conflict of interest code under Regulation 18751.

If the TTCA can provide you with additional background information or can otherwise be of assistance to you in making your determination in this matter, please call me at (916) 324-3836.

Very truly yours,

Kathryn Doi
Chief Counsel/Counsel to the Secretary

Enclosure

cc: William J. Rosendahl,
Chair, Commission on Tax Policy in the New Economy
Jesse Szeto,
Assistant Secretary, Division of Science, Technology & Innovation

[1] We note as well that the Commission is currently scheduled to sunset as of January 1, 2004. (Revenue and Taxation Code section 38067.) However, if the Commission's lifespan is extended, it may be necessary in a few years to reevaluate whether it has achieved decision-making authority within the meaning of Regulation 18700(a)(1)(C).

FAIR POLITICAL PRACTICES COMMISSION
P.O. Box 807 • 428 1 Street • Sacramento, CA 95812-0807

(916) 322-5660 • Fax (916) 322-0886

June 25, 2002

Kathryn Doi California Technology, Trade
and Commerce Agency Chief
Counsel/Counsel to the Secretary 1102 Q
Street, Suite 6000 Sacramento, CA
95814-651 l

Re: Your Request for Advice
Our File No. A-02-025

Dear Ms. Doi.

This letter is in response to your request for advice on behalf of the California Commission on Tax Policy regarding the provisions of the Political Reform Act (the "Act").1

QUESTIONS

l Must the California Commission on Tax Policy in the New Economy adopt 1 conflict of interest code?

2 Must commission members file statements of economic interests?

CONCLUSIONS

1. The tax commission is required to adopt a conflict of interest code or submit an exemption request.

2 The code should specify the appropriate disclosure categories for designated employees.

Government Code sections 81000 - 91014. Commission regulations appear at Title 2, section 18109-18997, of the California Code of Regulations.

FACTS

The California Technology, Trade and Commerce Agency ("TTCA") is serving as Executive Secretary for the California Commission on Tax Policy in the New Economy ("Tax Commission"). The Tax Commission was established by Senate Bill No. 1933 for the purpose of examining the impact of Internet and other forms of electronic technology on various types of taxes.

The Tax Commission is comprised of nine voting members, appointed by the Governor, the Senate Rules Committee, and the Speaker of the Assembly, as well as a number of ex officio nonvoting members (Rev. and Tax. Code § 38063) *The* Commission may also form additional technical assistance work groups. (Id § 38064.*)* The functions of the Commission are set forth in Revenue & Taxation Code § 38065 and can be summarized as follows:

- Identify all the key stakeholders in the new economy and invite them into the Commission's process.
- Develop a comprehensive agenda of goals and a roadmap of all critical issues that should be addressed in achieving a workable, flexible, and balanced long-term solution.
- Conduct public hearings with the goal of arriving at a comprehensive conclusion with respect to the smartest public policy taxation of the Internet.
- Examine and describe all aspects of the current and future California economy, with special attention to the influence of new technologies, including the use of the Internet in electronic commerce.
- Assess the impact of those predictions about the economy on the sources and size of projected public revenues, with special attention to the needs of local government.
- Study and make recommendations regarding specific elements of the California system of state and local taxes. The statute identifies a number of specific issues relating to sales and use taxes, telecommunications taxes, income taxes, and property taxes

The Commission is required to submit an interim report to the Governor and the Legislature not later than 12 months from the date of the Commission's first public meeting, and a final report with recommendations not later than 24 months from the date of the Commission's first public meeting. *(Rev. and* Tax. Code § 38066*.)* The Commission's first public meeting was held on Tuesday, January 29, 2002. The statute will be repealed as of January 1, 2004, unless the date is shortened or extended before that time. (Rev. & Tax. *Code § 38067.)*

You state the Commission does not have the authority to make, compel or prevent a final governmental decision, and the Commission has not made substantive recommendations that over an extended period of time have been regularly approved without significant amendment or modification by another public official or governmental agency. Any recommendations made by the Commission to the Governor and the Legislature would be subject to the legislative process before they were adopted. The Tax Commission has no employees - only the commission members themselves.

ANALYSIS

I. Conflict of Interest Code:

Section 87300 requires every agency to adopt a conflict of interest code pursuant to the provisions of the Act The Fair Political Practices Commission is the code reviewing body for state agencies. (§ 82011, subd.(a).) Specifically, section 87300 of the Act states that "[e]very agency shall adopt and promulgate a Conflict of Interest Code" applicable to its "designated employee[s]." For the purposes of section 87300, "agency" is interpreted to mean any state agency or local government agency. *(Maas* Advice Letter, No A-98-261.) A "state agency" is defined in the Act as "every state office, department, division, bureau, board and commission, and the Legislature." (§ 82049.)' You ask whether the tax commission is an agency required to file a conflict of interest code.

Where a state entity, such as the Tax Commission, is not definitively included or excluded from coverage under the Act, the Commission applies the analytical framework set forth in its opinion in *In re Siegel* (1977) 3 FPPC Ops 62, to assist in making that determination (See *Maas* Advice Letter, No. A-98-261.) However, the framework set forth in *Siegel is* not a litmus test, and ultimately the issue must be decided on a case by case basis. *(In re Vonk* (1981) 6 FPPC Ops. I.)

Under *Siegel,* to determine the nature of a given entity, four criteria are examined

1. Whether the impetus for formation of the corporation originated with a governmental agency

2. Whether it is substantially funded by, or its primary source of funds is, a governmental agency.

3. Whether one of the principal purposes for which it is formed is to provide services or undertake obligations which public agencies are legally authorized to perform and which, in fact, they traditionally have performed; and

Regulation 18219 defines "state agency" only for purposes of the Act's lobbying registration mid disclosure provisions, mid is not applicable for determining whether an

4. Whether the corporation is treated as a public entity by other statutory provisions.

The Impetus for Formation of the Registry

From a review of your letter and SB 1933 itself, it is clear that the state Legislature is providing the impetus for formation of the Tax Commission to act in coordination with the Governor for the purpose of examining the impact of Internet and other forms of electronic technology on various types of taxes. This commission is based in part on a recommendation of the Legislative Analyst report recommending a comprehensive review of the sales and use tax and other e-commerce activity. Therefore, the Tax Commission meets this first criterion.

The Primary Source of Funding for the Registry

You indicate there is no funding appropriated by the Legislature for the Tax Commission's activities. Rather, any expenses are absorbed by the TTCA. On balance, then, it appears this element tips in favor of a finding that the entity is a state agency

The Principal Purpose of the Organization

As set forth in your letter and SB 1933 itself, the purpose of the Tax Commission is to develop solutions to address problems associated with issues surrounding e-commerce and taxation. Among these tasks is to study and make recommendations regarding specific elements of the state's system of taxation and the impact of policies on public revenues. The Tax Commission is to report to the Governor and the Legislature on its findings and make recommendations regarding the entire system of tax policies and collection mechanisms in light of e-commerce. In this way, although lacking final authority, the Tax Commission is performing the primary governmental purpose of assessing policy on behalf of the legislative and executive branches and making policy advice accordingly. As such, the Tax Commission will be performing a traditional governmental function.

Treatment of the Registry as a Public Agency

The Tax Commission is established and operated under a scheme of state statutes and under the Revenue and Taxation Code. The Tax Commission is composed of nine voting members, five of whom are appointed by the Governor and two each appointed by the Senate Rules Committee and Speaker of the Assembly. Ex officio nonvoting members (or a designee) include the executive officer of the Franchise Tax Board, the chair of the State Board of Equalization, the director of Employment Development, the chair of the Public Utilities Commission, the Director of Finance, the Controller, and others You have concluded that the meetings of the Tax Commission are subject to the Bagley-Keene Open Meetings Act. (Government Code § 11120, et seq.) Your belief is consistent with the public participation provisions of the legislation. (Rev. & Taxation Code § 38065, subd (c)).) Based upon all of these factors, this fourth criterion is met.

In sum, the Tax Commission meets all of the criteria under the Siegel test. It has all of the hallmarks of a state entity created to accomplish legislatively mandated goals for a public purpose in the prevention of pollution and conservation resources. Therefore, it is a "state agency" within the meaning of the Act and is required to adopt a conflict of interest code enumerating designated employees unless an exemption applies, as discussed below.

Regulation 18751 governs the procedures and standards for requesting an exemption from the requirement to adopt a conflict of interest code. In light of the circumstances you described, we draw your attention to subdivision (f) of that regulation, if you determine you wish to request an exemption to the Commission's executive director. Otherwise, we encourage you to contact the Technical Assistance Division of this agency to assist you in the formulation and adoption of a conflict of interest code.

II. **Disclosure:**

As indicated above, for purposes of the Act, the Tax Commission is a state agency. The next question is whether the commission members are designated employees who should be covered in a code Regulation 18700, subdivision (a)(1) provides that for purposes of Government Code section 82019' (defining "designated employee") and § 82048 (defining "public official"), a "member" includes, but is not limited to, salaried or unsalaried members of boards or commissions with decision making authority A board or commission possesses decision making authority whenever:

(A) It may make a final governmental decision;
(B) It may compel a governmental decision; or it may prevent a governmental decision either by reason of an exclusive power to initiate the decision or by reason of a veto which may not be overridden; or
(C) It makes substantive recommendations that are, and over an extended period of time have been, regularly approved without significant amendment or modification by another public official or governmental agency." (Regulation 18701(a)(1).)

If an agency meets any of the tests of regulation 18701(a)(I),(A), (B) or (C), it possesses decision making authority; its board members are deemed public officials and designated employees subject to the conflict of interest provisions of the Act.

In the Milne Advice Letter, No. A-94-260, Commission staff advised that a Governor's task force on information policy and technology procurement did not meet any of the criteria above because the governor was not bound by recommendations of the

[3] A copy of section 82019 is enclosed.

Body. Rather, the body served a "solely advisory function." Similarly, staff advised that the members of the Inspection and Maintenance Review Committee of the Bureau of Automotive Repair did not possess governmental decision making authority and its officials were not public officials. (*Gergen* Advice Letter, No. A-96-328.) According to the facts provided, the committee did not have the power to make final governmental decisions nor the ability to compel governmental decisions. Since it had only recently come into existence, it did not have an opportunity to establish a history regarding the disposition of its recommendations.

According to your facts, the purpose of the Tax Commission is to examine the impact of Internet and other forms of electronic technology on various types of taxes. You indicate the commission is destined to issue a final report with recommendations within two years of its first meeting, after which the commission will cease to exist. You indicate that the Tax Commission does not have the authority to make, compel or prevent a final governmental decision. This would mean, as well, that the Tax Commission does not have the authority to enter into contracts on behalf of the commission or state. (*Biddle* Advice Letter, A-93-390.) If the foregoing is true, then the board is advisory and they would not have filing obligations pursuant to regulation 18700 We further note that a state agency with no designated employees qualifies for a conflict of interest code exemption pursuant to regulation 18571, subdivision (c).

If you have any other questions, please contact me at (916) 322-5660.

Sincerely,

Luisa Menchaca

General Counsel

By: C. Scott Tocher
Counsel, Legal Division

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§ 82017. County.

"County" includes a city and county.

§82018. Cumulative Amount.

(a) Except as provided in subdivisions (b), (c), and (d), "cumulative amount" means the amount of contributions received or expenditures made in the calendar year.

(b) For a filer required to file a campaign statement or independent expenditure report in one year in connection with an election to be held in another year, the period over which the cumulative amount is calculated shall end on the closing date of the first semiannual statement fled after the election.

(c) For a filer required to file a campaign statement in connection with the qualification of a measure which extends into two calendar years, the period over which the cumulative amount is calculated shall end on December 31 of the second calendar year.

(d) For a person filing a campaign statement with a period modified by the provisions of this section, the next period over which the cumulative amount is calculated shall begin on the day after the closing date of the statement.

§ 82019. Designated Employee.

"Designated employee" means any officer, employee, member, or consultant of my agency whose position with the agency;

(a) Is exempt from the state civil service system by virtue of subdivision (a), (c), (d), (e), (f, (g), or (m) of Section 4 of Article VII of the Constitution, unless the positron is elective or solely secretarial, clerical, or manual;

(b) Is elective, other than an elective state office;

(c) Is designated in a Conflict of Interest Code because the position entails the making or participation in the making of decisions which may foreseeably have a material effect on any financial interest;

(d) Is involved as a state employee at other than a clerical or ministerial level in the functions of negotiating or signing my contract awarded through competitive bidding, in making decisions in conjunction with the competitive bidding process, or in negotiating, signing, or making decisions on contracts executed pursuant to Section 10122 of tire Public Contract Code.

"Designated employee" does not include an elected state officer, any unsalaried member of any board or commission which serves a solely advisory function, any public official specified in Section 87200, and also does not include any unsalaried member of a nonregulatory committee, section, commission, or other such entity of the State Bar of California.

§ 82020. Elected Officer.

"Elected officer" means any person who holds an elective office or has been elected to an elective office but has not yet taken office. A person who is appointed to fill a vacant elective office is an elected officer.

§ 82021. Elected State Officer.

"Elected state officer" means any person who holds an elective state office or has been elected to an elective state office but has not yet taken office. A person who is appointed to fill a vacant elective state office is an elected state officer.

§ 82022. Election.

"Election" means any primary, general, special or recall election held in this state. The primary and general or special electrons are separate elections for purposes of this title.

§ 82023. Elective Office.

"Elective office" means my state, regional, county, municipal, district or judicial office which is filled at an election. "Elective office" also includes membership on a comity central committee of a qualified political party, and members elected to the Bond of Administration of the Public Employees' Retirement System.

§ 82024. Elective State Office.

"Elective state office" means the office of Governor, Lieutenant Governor, Attorney General, Insurance Commissioner, Controller, Secretary of State, Treasurer, Superintendent of Public Instruction, Member of the Legislature, member elected to the Board of Administration of the Public Employees'

Speaker Biographies

DANIEL L. THOMPSON, CPA, CMI – STATE AND LOCAL TAX CONSULTING

Specializing in multistate sales and use taxes, Dan's expertise covers all areas of multistate sales and use taxation including transaction consulting. Dan has performed sales and use tax consulting projects for many international and national companies in the financial, high tech, construction, manufacturing, motion picture, food servicing, and leasing industries, and for medical and non-profit facilities. His practice also covers the constantly changing sales and use issues that are emerging from sales and marketing on the Internet.

Dan earned his B.S. in accounting from the California State University at Long Beach. Dan has over 10 years of experience with California State Board of Equalization and more than 15 years' experience in public accounting. Dan was a Partner of a Big Five accounting firm's State and Local Tax practice and a business taxes administrator with the California State Board of Equalization.

As a frequent public speaker, Dan has lectured on taxation for many highly regarded tax educators including Tax Executives Institute (TEI), Georgetown University Law Center, California Society for CPAs, Lorman Education Services, National Business Institute, Institute for Professionals in Taxation (IPT), and various business groups. He has authored articles for the Multistate Corporation Tax Guide – *Midyear Supplement* and the *Journal of California Taxation.* Dan is currently a Professor at Golden Gate University, San Francisco, instructing the class in State and Local Taxation for the LLM Program.

Dan is a recognized member of the American Institute of CPAs, a member of the California Society of CPAs, a certified member of the Institute for Professionals in Taxation (IPT), a member of the American Electronics Association state and local tax subcommittee (AEA) and a Professor for State and Local Taxes with the Golden Gate University LLM Program. He was also chairman of the California Society of CPAs Sales and Use Tax Symposium.

Dan can be reached at his office at (415) 518-7829, via facsimile at (415) 898-7822, and via email at thompsontax@msn.com.

KIMBERLY MITCHELL BOTT

Kimberly Mitchell Bott, JD, CPA, is the Chief Consultant for the Assembly Committee on Revenue and Taxation.

Although new to the Capitol last year, she has practiced tax law for almost 25 years in various representative capacities, including:

Tax practitioner in private law practice at a large Sacramento law firm,
Senior tax counsel for the Franchise Tax Board and for the State Board of Equalization,

District counsel attorney for Internal Revenue Service, Sacramento District,
Tax manager in the Los Angeles office of an international (former Big 8) public accounting firm.

Ms. Bott has been an adjunct professor in the masters in law, taxation program, at McGeorge School of Law and has spoken before many groups and tax associations in California.

LEE GOODMAN, OF COUNSEL, RILEY REIN AND FIELDING

- Of Counsel in the firm's Election Law, Government Affairs, Internet & E-Commerce, Education and Litigation Practices.
- Litigation experience before state, federal and appellate courts, in a broad range of policy-oriented civil matters, including First Amendment rights of political parties and political participation, education issues and academic freedom, defamation, employment, product liability, commercial disputes and creditors' rights.
- Advises corporate and political clients on compliance with federal and state election laws, ethics and lobbying regulations, and represents their interests in court and before the Federal Election Commission.
- Advises clients on state and federal government affairs strategies and policy solutions, particularly with reference to Internet, e-commerce and education issues.
- Counsels clients on education matters including K-12 standards and testing, charter schools, education technology, higher education governance, academic freedom, student rights, non-discrimination policies and commercialization of academic inventions.
- Former Deputy Counselor to the Governor & Deputy Director of Policy, Office of the Governor of the Commonwealth of Virginia (1998-2002).
- Former Chief of Staff to the Chairman, Congressional Advisory Commission on Electronic Commerce (1999-2000).
- Former Counsel to the Attorney General of Virginia (1997).
- Former Special Assistant Attorney General & Associate General Counsel, University of Virginia, Office of General Counsel (1995-1996).
- Director, Virginia Foundation for the Humanities & Public Policy at the University of Virginia; Director, Hampton Roads Sports Facility Authority.
- Member, the District of Columbia and Virginia Bars. Admitted to practice before the U.S. Supreme Court, U.S. Court of Appeals for the Fourth Circuit, U.S. District Courts for the Eastern and Western Districts of Virginia and the District of Columbia, and the Supreme Court of Virginia. Member, American Bar Association and The Federalist Society.

B.A., with highest distinction, University of Virginia; J.D., University of Virginia School of Law; Articles Editor, *Journal of Law & Politics*.

CONNIE SQUIRES

Connie is the Program Budget Manager for the Department of Finance for the Financial, Economic, and Demographic Research Units as well as the Local Government, Franchise Tax Board, Board of Equalization, and Business, Transportation and Housing Agency program areas. She has over 25 years of experience working for the Department, with almost 21 years of experience working directly with California tax policy issues and revenues. She has primary responsibility for developing the revenue estimates for the Governor's Budget process and has been an active participant in the development, drafting, analysis, and negotiations of tax proposals considered as part of the State's budgetary process.

KATHRYN DOI

Chief Counsel, and Counsel to the Secretary of the California Technology, Trade & Commerce Agency

Kathryn Doi is the Chief Counsel and Counsel to the Secretary of the California Technology, Trade and Commerce Agency. Since assuming the post in May 2000, she has served as legal adviser to Agency Secretary Lon S. Hatamiya, and as chief counsel to more than 300 people at the Agency.

Prior to joining the TTCA, Ms. Doi was staff counsel for the state's Commission on Judicial Performance, where she investigated and evaluated complaints of ethical misconduct against California state judges. She began her legal career in 1986, as an associate in the public finance and litigation departments of Orrick, Herrington & Sutcliffe in San Francisco.

Ms. Doi's professional background also includes a year spent as a judicial clerk for the Honorable Jane A. Restani of the United State Court of International Trade. She was also selected by former Congressman Norman Y. Mineta in 1980 to serve as a Congressional intern in the U.S. House of Representatives.

Ms. Doi graduated in the top 10 percent of her class at King Hall School of Law at the University of California, Davis, in 1985. While there, she was awarded the Order of the Coif and American Jurisprudence Award in Contracts, and served a term as President of the Asian Law Students Association. Currently, Ms. Doi is president-elect of the Alumni Board at the UC Davis School of Law. She earned a Bachelor of Arts degree in Economics from Stanford University in 1981.

Ms. Doi's public service includes work with the Asian Women's Shelter, a battered women's shelter in San Francisco, where she was a member of the Board of Directors and co-chaired the Annual Fund Raising Event. She currently serves on the Board of Directors of My Sister's House, a battered women's shelter in Sacramento. Ms. Doi and her daughter Tara reside in Sacramento, California.

Materials for the Commissioners' Consideration

Memos to the Commissioners

Glen Rossman

DATE: July 26, 2002

TO: Members, The Commission on Taxation in the New Economy

FROM: Glen L. Rossman

RE: Proposed Scope of Commission Activities

Given the broad scope of the Commission's charge in SB 1933, there is a need to focus our efforts and adopt a series of criteria with which we will evaluate the performance of the California tax system in the "new economy".

Set forth below is my proposal for two distinct phases of Commission inquiry. The first surrounds the advisability and methodology of taxation of electronic commerce and Internet access and use. The second phase concerns the development of a critical framework for evaluating all tax programs and systems brought before the Commission.

I. E-Commerce, Internet Access and Use and the California Sales Tax

A. The Sales Tax.

We have received testimony that California has increased its reliance on personal income taxes and sales taxes in recent years. We have received conflicting testimony on the issue of whether the transition to the new economy will have an influence on either of these two revenue sources, but particularly on the sales tax. Further, I am personally concerned that our discussion of e-commerce and the sales tax has occurred in a vacuum. In other words, the discussion has occurred under the assumption that there are no "side effects" to economic expansion and job growth associated with the sales tax decision. Utilizing the limited resources we have at our disposal, the Commission should undertake a more organized study of the California sales tax, focusing on several issues:

1) What is the current sales tax base? How amenable are the different categories of property comprising the sales tax base to being sold through e-commerce without the collection of tax at some point?

2) What has been the performance of sales tax revenues as e-commerce expands? Is there any evidence that the growth of electronic commerce has adversely effected the growth of situs-based sales and sales tax revenue in California?

3) In light of the implosion of the dot-com economy, is there any evidence that e-commerce will form a significant portion of retail purchases in the near future?

4) To the degree there has been "growth" in e-commerce, what have been the primary areas of growth and are those areas of growth relevant to the sales tax (e.g., stock trades and airline tickets)?

5) In those growth areas of e-commerce that may have an impact on the sales tax base, what is the most appropriate way to respond? Should California broaden the tax base, exempt from sales tax goods that can be digitized or some other response? What effects do these proposals have on tax burden across income classes, on revenue growth and on economic growth in California?

6) Are the prospects of future problems with the sales tax in the new economy so profound that California should begin to examine a replacement revenue source for the sales tax?

7) How would expansion of transaction taxes affect the growth of e-commerce in California?

B. Business Activity Taxes on Internet Access and Use.

As Internet use has become more pervasive in California, some (primarily local governments) are advocating expanded business activity taxes (primarily business license taxes and utility user taxes) on such Internet access and use. Is such taxation advisable, or does it merely serve to increase the price of Internet access (and therefore reduce access to the poor)? Also, since underlying cable service and telephone service are already subject to utility user taxes (in most jurisdictions) would separately taxing Internet access as a value-added service result in double taxation?

II. Criteria for Evaluating California Taxes in New Economy

As the Commission moves forward in its discussions, it needs to develop a meaningful framework for analyzing the tax structure envisioned for the "new economy", as well as the components thereof. Set forth below are my ideas of how such a framework should be constructed.

A. What is the "New Economy"?

While it is true that the digital age has effected the nature of certain goods produced by the California economy, and the manner in which some of those products are sold, we do not have a clear picture of whether the "new economy" will differ significantly from the "old economy" when it comes to the manner in which California taxes are levied and collected.

This threshold question needs to be answered before any large scale reconstruction of the California tax system is proposed. In short, we need to ascertain whether the transition to the "New Economy" will require wholesale changes to the existing system, or whether reforms *within* the existing system to make it promote economic growth and revenue stability will be sufficient to carry California forward.

B. What should be the optimal tax burden on Californians?

One of the early problems the Commission has identified is whether to start from the "revenue end" or the "services end" when discussing a tax system. In other words, does one start by agreeing on a socially optimal tax burden on its citizens, seeing how much revenue that tax system raises for the various levels of government, and prioritizing government programs based on the availability of revenue, or does one decide on the socially optimal scope of government, determining how much it costs to finance such a government, they designing a tax system to raise that revenue in the most socially and economically optimal way?

I have started with the focus on tax burden for two reasons: 1) unless there is a discussion of fiscal constraints, the demand for government services is essentially infinite, making the discussion of "How big should government be?" an exercise in futility; and 2) as recent events at the state level have shown, there is more than adequate government revenue available when the economy is healthy. There is a need to emphasize, therefore, the design of a tax system with tax burdens on Californians that does not discourage sustained economic growth and reinvestment in the California economy.

In pursuit of that "optimal" tax burden, the Commission should examine the current total tax burden of California (all state and local taxes)versus the similar burden on taxpayers of the other states. This review, however, should take place with enough detail to distinguish tax burden amongst income classes of the population. Far too much information is disguised by relying on "per capita" tax burden or even by relying on taxes "per $100 of personal income".

Also, the Commission should look at "affordability". Affordability is examined by considering tax burden in the context of the cost of living and of disposable income. In other words, is a lower tax burden offset by higher costs of living (and/or lower wages)? Given that California has such a high cost of living, an affordability measure could give the Commission a much different picture of whether a future California tax system should have a greater or lesser burden.

Next, the Commission should examine the impact of demographic shifts forecasted in California's future to see if projected changes in the age structure, educational background and other factors will have an impact on personal income (and therefore the Personal Income Tax) and on the distribution of tax burden as well.

Finally, there needs to be a tie between the health of the economy and the size of government, at least as a general policy matter. If the current budget crisis is able to

teach us any valuable lessons for the future, it is that some cap on increases in government spending (perhaps fixed as a percentage of the growth in gross state product) should be considered for California. The Commission should seek some method of achieving “sustainability”—a tax system which results in a tax burden that encourages sustainable economic growth in California, which should in turn lead to sustainable revenue growth for government.

C. Administrability.

Besides tax burden, whether and at what cost a tax program or tax system can be administered by the government and by taxpayers should be considered by the Commission. For example, the Commission has heard testimony about the need to impose a sales and use tax collection burden on interstate sales, but there is no existing system that would solve all of the administrative problems associated with such a new program.

If indeed the “new economy” will require new types of tax programs, can taxpayer privacy be protected at the same time tax information is verified by the taxing agency? What is the public cost of compliance and auditing? All of these factors need to be explored by the Commission.

D. Does the tax program and tax system encourage formation of capital (human or plant)?

The Commission should also evaluate each proposed program or system to determine whether it encourages capital formation. This could be encouragement of investment in human capital (e.g. education and training), or the encouragement of investment in productive assets, such as new plant and equipment. Many aspects of the California tax system today (such as apportioning corporate income on the basis of payroll and property) discourage investment in California plant and jobs. As we look to the future, these types of problems need to be addressed.

E. Does the tax encourage or impede California’s competitiveness in the world economy?

Another factor which should enter the Commission's framework of analysis is “competitiveness”. Like it or not, the dawn of globalization and the spread of capitalism worldwide has made global competition a reality within the business community. It has even become a reality within individual corporate entities, where plants producing similar goods in different parts of the world compete for corporate resources.

States and nations, as well as businesses, are not immune from competition. If California is to have a “new economy”, it must reform its tax system so that it makes California competitive against the states and nations with whom it competes for investment so that the “new economy” finds it way here.

F. What is the relationship between taxpayer and the entity imposing the tax?

This factor is less tangible than the others previously discussed, but it is in every way as important. Accountability and responsiveness are important factors to consider because a tax that is not deemed to be "fair" encourages evasion and ill political will. While there are many ways to measure whether a tax is "fair", one measure often overlooked is the relationship between the tax "payers" and the jurisdiction imposing the tax or spending the revenue raised. For example, local governments have increasingly sought to impose or raise "transient occupancy taxes" (hotel/motel taxes) or entertainment taxes because they are imposed on people who do not usually live within the taxing jurisdiction. This is known as the "Welcome, Stranger" effect. As more and more requirements for voter approval of new taxes are passed, governments have naturally brought forth proposals that they believe the voters will pass. These proposals are for taxes that will be paid by nonvoters.

This situation is not limited to "out-of-town" individuals. Corporations, because they do not vote, are also likely targets for tax increases. High-wealth individuals are also popular targets, because it is politically popular to use upper-bracket income tax increases to fund middle-bracket and lower bracket tax relief. California now has the highest income threshold for paying personal income tax of any state in the nation, and also has witnessed a massive shift of personal income tax burden to upper-bracket taxpayers. When any group of taxpayers feels that the relationship between what they pay into the system, and what they get out of the system becomes completely disconnected, negative consequences result. The Commission should examine this relationship as a part of its review of all reform proposals.

G. What is California's "tax policy" and what should California's tax policy be in the "New Economy"?

Finally, at the Commission's meeting in Silicon Valley, I asked the question, "What is California's tax policy?". No one had an answer. Tax policy options run the gamut from optimizing revenue collection to pursuing social and economic change. The Commission should not be satisfied with "drawing a circle" around whatever tax programs are present, and trying to discern a policy existing within. Instead, the Commission should decide up front what policy the tax system should promote, and align tax programs consistent with that policy.

III. <u>Conclusion</u>

I look forward to discussing this proposal when we meet in Bakersfield.

GLR/dmc

DATE: July 26, 2002

TO: Members of the California Commission on Taxation in the New Economy

FROM: Glen L. Rossman

RE: Lack of Commission Funding and Achievement of Commission Objectives

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Senate Bill 1933 (Ch. 619, Stats. of 2000) placed a very broad mandate on this Commission. Among numerous other duties, the legislature acknowledged "a need to reevaluate *our entire system of tax policies and collection mechanisms* in light of this new economy." (subdivision (g)(Emphasis added)). This suggests an expectation that we are to examine all California state level tax programs both on a policy and on an administrative level. This in and of itself would be a daunting task, but our mandate is broader yet. We are also to develop: ". . .a long-term strategy for revising state *and local* tax structure for California. . ." (subdivision (j)(Emphasis added)). This means we are not only supposed to undertake a comprehensive review of the state tax system, but the local tax system and the state-local fiscal relationship as well.

Any one of these topics would be difficult to fully examine and prepare recommendations on in the time limit required in the bill. This is particularly true since we are also under a mandate to ". . .create an open, public, fair and balanced participatory process. . ." in the preparation of our recommendations. When these topics are taken together, however, it may be that the Legislature has assigned us a task that no Commission can complete.

I am extremely concerned that the Legislature has provided no funding for us to achieve these lofty goals. To accomplish the mandate in the manner required, we need to have the capacity to assemble the best experts in the field of taxation, finance and public administration. We need to be able to commission economic analyses and computer modeling to ascertain the impact of proposed tax changes on economic activity in new economy industries. We may even need to do data collection from sources other than from state or local government agencies. In short, the Legislature's lack of commitment on funding the Commission's activities is inconsistent with their expectations of a quality product.

Since it has been made expressly clear to us that funding is not in the cards, we have only a few options. We can narrow our focus from the Legislature's broad mandate to something more manageable. We could also merely take input from the public and summarize the input without recommendations. Finally, we could try to get state government agencies to provide support services to the Commission that are more in

depth than merely answering questions at Commission meetings. There are difficulties with all of these options.

On thing is clear. The integrity of this Commission and its report will be judged on the basis of the report's quality. For that reason, I urge my fellow Commission members to carefully consider what we can do that will have a quality product. It is far better to lower the public's expectations of what this Commission can produce at the outset than to wait and produce a product that fails to meet anyone's expectations.

I look forward to discussing this matter at a future Commission meeting.

GLR/dmc

Joint Venture Network Briefing Paper

Annette Nellen

Background on the California Commission on Tax Policy in the New Economy

In September 2000, SB 1933 was signed into law (Chapter 619) by Governor Davis. This legislation called for formation of a Commission on Tax Policy in the New Economy to "examine the impact of Internet and other forms of electronic technology on various types of taxes." SB 1933 notes that much of the discussion on Internet taxation has focused only on sales tax and that the federal advisory commission created by the Internet Tax Freedom Act failed to achieve the required two-thirds majority vote to make significant recommendations to Congress. The prefatory language to SB 1933 also points out that California's existing tax structure is based on an industrial economy rather than one based on a technology economy focused on information and services.

The Commission consists of nine voting members – three representing business, three representing local government and three at-large members representing the public. Ex officio nonvoting members include leaders of California's tax agencies (Franchise Tax Board, Board of Equalization, Employment Development Department and Public Utilities Commission), Director of Finance, Controller, public member of the California Economic Strategy Panel, and the chairs of the Senate and Assembly Revenue and Taxation committees. The Commission may establish technical assistance groups and is to hold public hearings. The Commission is to make recommendations and issue a preliminary report within 12 months of its first meeting and a final report within 24 months.

To attempt to remedy a delay in appointment of the Commissioners, in September 2001 an incentive was added to SB 394 (Chapter 343) enacted in 2001 to extend the California Internet Tax Freedom Act. SB 394 calls for the Act to be extended two years to January 1, 2004. However, if the interim report called for by SB 1933 is not submitted to the Governor and the Legislature by December 2, 2002, the Act is only extended to January 1, 2003. The Commission held its first hearing in Sacramento on January 29, 2002.

For additional information about the Commission (including its meeting agendas and minutes), click on the Technology & Innovation link at http://www.CAneweconomy.ca.gov.

Charge of the Commission

The Commission has a fairly extensive charge. As stated in SB 1933, the Commission "shall do all of the following:

(a) Identify all the key stakeholders in the new economy and invite them into the commission's process.

(b) Develop a comprehensive agenda of goals and a roadmap of all critical issues that ought to be addressed in achieving a workable, flexible, and balanced long-term solution.

(c) Undertake the process of conducting public hearings and in the correct phases address each of these critical issues and seek to arrive at a comprehensive conclusion with respect to the smartest public policy taxation of the Internet.

(d) Examine and describe all aspects of the current and future California economy, with special attention to the influence of new technologies, including, but not limited to, the use of the Internet in electronic commerce.

(e) Assess the impact of those predictions about the economy on the sources and size of projected public revenues, with special attention to the needs of local government.

(f) Study and make recommendations regarding specific elements of the California system of state and local taxes, including, but not limited to, the following:

(1) With respect to the sales and use tax, the commission shall do all of the following:

(A) Examine the impact that economic transitions have had on the sales and use tax.

(B) Determine whether uneven treatment with respect to the method of sales, the type of commodity, and the location of the buyer and the seller may occur and the extent to which they may have led to tax-generated distortions in economic decision making and disadvantages for certain businesses and economic sectors.

(C) Examine the extent to which the allocation and distribution of sales and use taxes impact local decision making on land use and whether alternative methods may be more appropriate.

(2) With respect to telecommunications taxes, the commission shall examine the status of the current telecommunications tax system, including state telecommunications surcharges, utility user charges, and franchise fees, in light of changes in the competitive and technological features of the industry. This examination should focus on the complexity, consistency, and efficiency of the system.

(3) With respect to income taxes, the commission shall do both of the following:

(A) Examine recent trends in the collection of bank and corporation taxes and the impact that a transitioning economy has had on those trends.

(B) Examine the relationship between the bank and corporation tax and the personal income tax and whether trends in the new economy will have an impact on that relationship.

(4) With respect to property taxes, the commission shall do both of the following:

(A) Investigate the revenue repercussions for local government in assessment of real property, assuming changes in the trends of real property versus personal property utilization.

(B) Examine the effects of electronic commerce activity on land-based enterprises in the new economy and evaluate the impact on local economic development approaches and consider what new tools could be used."

Advice for The Commission

The task before the Commission is significant and a bit overwhelming. It is very important to the continued fiscal strength of the state, however, to examine California's tax structure in terms of its ability to continue to be effective in light of changes in the economy that have occurred since the tax structure was designed. Joint Venture's Tax Policy Group has spent years examining various issues with California's fiscal structure.

We know how daunting the task before the Commission is not only in terms of just explaining California's tax and fiscal structure and any disconnects between that structure and the new economy, but also in terms of making recommendations that can be implemented in light of the constitutional foundation of key parts of the structure and the significant number of taxing jurisdictions within the state. Yet, discussion and recommendations are required.

To help shape the discussions, we offer the following suggestions:

1. Recognize the "new economy" as a changing economy.
2. Call for the State to identify and state its strategic plan and vision. Without a clearer idea of what the State of California aims to achieve in terms of an economic structure, it is not possible to better articulate what infrastructure is needed to support that structure, what types of taxes are needed to best support and develop it, and what levels of government should provide the necessary infrastructure (including how the tax revenues should be distributed among the various levels of government).

The New Economy

The "new economy" is probably better described as a changing economy. It is an economy where services and intangible assets are becoming more significant than tangible goods, and the marketplace is increasingly global and disintermediated for more types of transactions. Also characteristic of the new economy is that knowledge and innovation are growing in importance relative to traditional production factors such as land and capital, and productivity tends to be increasing. A company's workers, investments, and business operations are likely to be geographically dispersed, yet electronically connected such that everything operates almost as if it were in a single physical location. Information and services can often be transferred quickly via telecommunications, and longstanding notions of intellectual property rights, production cycle times, and supply chain configurations are being revisited. Borders and physical locations are less important in the new economy (yet are key factors in today's tax structures).

The basic needs of the new economy for government provided services are mostly the same as for the old economy – roads, legal system, economic development, housing, education, welfare, etc. New economy services include an infrastructure for highly capable telecommunications systems. They further call for attention to ensuring that consumers, increasingly removed physically from retailers, are not harmed in ways that cannot readily be resolved using market-based means or traditional regulatory mechanisms. Other services may be required in different amounts than in the old economy.

Need for a State Strategic Plan and Vision

Many of the current and continuing issues that can be identified in California's tax and fiscal structure stem from our lack of an articulated strategic plan and vision. For example, if part of the strategic plan is to expand the number of high-paying jobs in the

state, the fiscal structure needs to exist at all levels of government to work to help meet that goal.

Creation of a "comprehensive agenda of goals and a roadmap" and finding the "smartest public policy" is difficult without identifying the purpose for such agenda and policy.

Additional Suggestions

1. Seek Assistance: The Commission has a tremendous task before it. We encourage the Commission to put out a call for papers to obtain more of the information it needs to complete its report.
2. Utilize Existing Work: Much work has been done already in identifying and suggesting improvements to California's tax and fiscal structure, as well as for issues resulting from the emergence of e-commerce. Many of these reports are available on the Internet, including reports of the Legislative Analyst's Office and testimony submitted to the federal Advisory Commission on Electronic Commerce.
3. Promote Input via the Commission Web Site: We encourage the Commission to require that people testifying before the Commission also submit written testimony. The Commission's web site should have all of this written work posted so that people can comment on the papers.
4. Seek Legislative Modification to the Commission's Agenda: Request that the legislature change the requirement for a preliminary report to a request for identifying what the Commission plans to address and ask for an extension of time without an effect on the expiration date of the California Internet tax moratorium.

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Joint Venture's Tax Policy Group and Internet Taxation
The Joint Venture Tax Policy Group will continue its activities to promote understanding and discussion on these important issues, with an emphasis on state and local taxation considerations.

For more information on the work of the Tax Policy Group and Internet taxation, please visit:

http://www.jointventure.org/initiatives/tax/tax_pubs.html

Streamlined Sales Tax Project and GATT

Charles McLure

and

Walter Hellerstein

Does Sales-only Apportionment of Corporate Income Violate International Trade Rules?

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I. INTRODUCTION

Over the past quarter century there has been a pronounced change in the formulas states use to apportion the income of multistate corporations. In 1978, the year the U.S. Supreme Court sustained the constitutionality of Iowa's single-factor apportionment formula based on sales (at destination) of tangible personal property,[2] almost all the states that imposed corporate income taxes placed equal weight on property, payroll, and sales. Now almost three-fourth of the states that have corporate income taxes place at least half the weight on sales, and eight base apportionment solely on sales.[3] It seems reasonable to believe that this trend will continue and that other states will adopt sales-only apportionment formulas in an effort to improve their competitive positions.[4] This note, which is intended to stimulate further analysis and debate, rather than provide a definitive conclusion, suggests that sales-only apportionment may violate international trade rules that prohibit export subsidies.[5] Given this purpose, we concentrate on the simplest case, involving the apportionment of income from the manufacture and sale of tangible

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[2]*Moorman Mfg. v. Bair*, 437 U.S. 267 (1978). This note concerns only the apportionment of income from the manufacture and sale of tangible personal property. Although some states assign sales from services on a market state or destination basis, most states assign sales from services on the basis of where the income-producing activity relating to those sales is performed. *See* Uniform Division of Income for Tax Purposes Act [UDITPA] § 17(a). Accordingly, single-factor apportionment of such sales often does not raise the issues addressed in this note, which concerns the exclusive use of a destination-based sales factor to assign income. Moreover, the original 1947 General Agreement on Tariffs and Trade (GATT 1947), discussed further below, applied only to goods. When the United States adopted the Uruguay Round Agreements, thereby extending the scope of international trade rules embodied in GATT 1947 to services under the General Agreement on Trade in Services (GATS), it explicitly reserved from the scope of the GATS national treatment requirement:

Sub-federal tax measures which afford less favorable treatment to services or service suppliers of another Member based on the method of allocating or apportioning the income, profit, gain, losses, deductions, credits, assets or tax base of such service suppliers or the proceeds of a services transaction.

These reservations were submitted to the GATT on June 29, 1994 as a "Schedule of Specific Commitments for the U.S" in connection with its adoption of the Uruguay Round Agreements. The reservation quoted above was designated as "paragraph 3."

[3]See Mazerov (2001). Connecticut, Massachusetts, and Missouri are included in this count, since sales-only apportionment is available to manufacturers in the first two states and is an option in the third.

[4] Indeed, the California Assembly's Revenue and Taxation Committee has approved a measure that would change the state's current three-factor formula with double weight on sales to a single-factor formula based exclusively on sales, Pratt (2002a), and both incumbent Governor George Pataki of New York and one of his Democratic rivals (Andrew Cuomo) have supported New York's adoption of a single-factor sales formula. Plattner (2002). The California measure is currently on hold due to its revenue implications. Pratt (2002b).

[5]This is, of course, not all that is wrong with sales-only apportionment; see Hellerstein & Hellerstein (1998), at pp. 8-233 to 8-234; Hellerstein (1995); Mazerov (2001) and McLure (forthcoming). It appears at first glance that sales-only apportionment may also constitute a tax on imports that is prohibited by international trade rules. We do not discuss that possibility in detail, although we advert to it briefly in the notes below (see *infra* ns. 21&22) as there may be reasons why it would not actually have the effect of taxing imports, such as the use of domestic affiliates of foreign corporations to make imports in states without single-factor sales formulas

personal property, where there appears to be a prima facie violation of international trade rules, inviting others to consider other more complex situations. Perhaps we should note at the outset that we are not arguing that international trade rules make sense; rather, we take them as given.

II. The International Trade Rules Prohibiting Export Subsidies

Under international trade rules adopted during the Uruguay Round of multilateral trade negotiations in 1994, the world trade community reaffirmed and reinforced the long-standing prohibition against export subsidies embodied in preexisting trade rules and related understandings.[6] Specifically, the Uruguay Round Agreement on Subsidies and Countervailing Measures (SCM Agreement) defined a "prohibited subsidy" to include "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance."[7] Prior to the adoption of the Uruguay Round Agreements, the General Agreement on Tariffs and Trade of 1947 (GATT 1947), which is now incorporated in the Uruguay Round Agreements,[8] imposed general restraints on "any subsidy … which operates directly or indirectly to increase exports …."[9]

For many years, GATT's prohibition of export subsidies has been understood to prohibit so-called "border tax adjustments" (BTAs) for direct taxes, such as income taxes and payroll taxes, while permitting BTAs for indirect taxes, such as VAT, sales taxes, and excise taxes.[10] Although the term BTA does not appear in GATT 1947, in 1970 a Working Group of the GATT described BTAs generically

> *as any fiscal measures which put into effect, in whole or in part, the destination principle* (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all

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[6] In April 1994, after years of discussion, more than 100 participating countries signed agreements reached in the Uruguay Round of multilateral trade negotiations. The Uruguay Round negotiations were conducted under the auspices of the original 1947 GATT. The results of the Uruguay Round consist of the Agreement Establishing the World Trade Organization (WTO) plus 16 multilateral and two plurilateral agreements (including GATT 1947), which are annexed to the WTO Agreement, as well as many other annexes, decisions, and understandings referenced in the principal agreements. See generally Hellerstein (1995).

[7] Agreement on Subsidies and Countervailing Measures, Article 3.1(a).

[8] See *supra* note 5 and *infra* note 8.

[9] GATT 1947, Article XVI. The General Agreement on Tariffs and Trade 1994 (GATT 1994) consists of (1) GATT 1947 "as rectified, amended or modified" by the various legal instruments that entererd into force before the date of the WTO Agreeement; (2) provisions of legal instruments entered into force under GATT 1947 before the date of the WTO Agreement, including, among other things, "decisions of the CONTRACTING PARTIES to GATT 1947"; and (3) agreements reached during the Uruguay Round. GATT 1994, Paragaphs 1(a) -1(d).

[10] Hufbauer (2002a); Hufbauer (2002b). The prohibition of BTAs for direct taxes was originally implied by silence, but was made explicit in the Illustrative List of Export Subsidies contained in the Code on Subsidies and Countervailing Measures adopted in 1979 at the Tokyo Round and repeated in Annex I to the Uruguay Round Agreement on Subsidies and Countervailing Measures.

> of the tax charged in the importing country in respect of similar domestic products) (emphasis added).[11]

Sales-only apportionment appears to violate the GATT's prohibition against providing export BTAs for direct taxes (hereafter simply "export subsidies").

III. The Economics of Formula Apportionment[12]

A. The Need for Formula Apportionment

The American states have long recognized — and the Member States of the European Union are coming to realize — that geographic separate accounting is not practicable within a highly integrated economy such as the United States. First, economic interdependence between parts of the corporate group often makes it impossible to isolate the geographic source of profits on a separate accounting basis. Second, even if corporations undertook to account separately for the income earned in each state, the task would be fearfully expensive, because their books and records would need to be maintained to reflect the details of their business operations on a state-by-state basis. Third, separate accounting is vulnerable to the manipulation of actual or imputed transfer prices within the enterprise in a manner that shifts income to low-tax states. As a result, the states, like the provinces of Canada, have long employed formula apportionment to determine the portion of the income of multistate corporations they will tax.

Some states apportion the combined income of related corporations deemed to be engaged in a unitary business, rather than limiting apportionment to the income of separate legal entities. In the late 1980s, following a period in which some states combined the worldwide activities of commonly controlled corporations, the states, under political pressure from the federal government, foreign governments, and the business community, imposed "water's edge" restrictions on combined reporting.[13] A more detailed analysis of the basic question addressed in this note would take account of combination and other variations of state practice.

B. UDITPA and the Multistate Tax Compact

During the first half of the twentieth century the states used a wide variety of divergent apportionment formulas, before converging toward the standard practice of

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[11]The GATT Working Group on border tax adjustments, in its report of December 2, 1970, attributes this description to the OECD; see http://www.worldtradelaw.net/reports/gattpanels/bordertax.pdf, visited May 2, 2002. For a much more complete discussion, see Hufbauer and Erb (1984).
[12]For a more detailed exposition of the points covered in parts A and B of this section, see Hellerstein and Hellerstein (1998), Chapter 8.
[13]With the limited exception of oil companies in Alaska, all the states now limit mandatory combination to the "water's edge." That is, with limited exceptions for certain tax haven and other corporations whose activities are conducted predominantly in the United States, only domestic corporations are included in the combined groups and only the income of such corporations is apportioned. In some states, notably California, there is a water's-edge election; taxpayers that fail to make the election are subject to worldwide combined reporting.

employing three, equally weighted factors of property, payroll, and sales in the formula used to apportion income. Throughout this period the quest was to find a formula that would accurately reflect the geographic source of income, tempered by the need to provide for a formula that fairly divided income among the states.[14] The broad consensus that emerged in favor of the equally-weighted, three-factor formula as a reasonable method for attributing income to the states, embodied both traditional "sourcing" concepts in the weight accorded to capital (property) and labor (payroll) as well as the equitable claim of the "market" state to a share of the income tax base, as reflected in sales made into the state.[15] In 1957 the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Division of Income for Tax Purposes Act (UDITPA), a model law intended to provide the basis for uniform state taxation of corporate income. UDITPA, which was incorporated in the Multistate Tax Compact, codified the then-standard equally weighted three-factor formula.[16] While 20 states are currently members of the Compact,[17] most have forsaken its underlying purpose to "[p]romote uniformity"[18] by abandoning the uniform apportionment formula and placing greater weight on the sales factor.[19]

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[14]In its comprehensive report to Congress on state taxation of interstate commerce, the Willis Committee observed that "[m]ost students of State taxation have assumed that the search for reasonable division of income rules necessarily resolves itself into a search for the 'sources' of income.'" Willis Committee Report (1964-65), p. 158. However, the Committee went on to note that a countervailing view held that the search for the "source" of income was misguided and that "the important issue is the proportion of the company's activities which take place in the each State, since 'these activities cause the state to incur the governmental costs which form the justification for its demand for a compensatory tax." *Id.* at 158-59 (citation omitted). The Committee went on to point out the conflict between these two approaches, since
[a] company with factories in two States … may conduct an unprofitable operation in one of the States by any standard which may be used for determining the source of income, but it can hardly be argued that its activities contribute to governmental costs only in the State in which its operation is profitable.
Id. at 159. On the history of the development of formula apportionment, see Hellerstein and Hellerstein (1998), Chapter 8; Weiner (1996).

[15] See Hellerstein and Hellerstein (1998), ¶ 8.06.

[16]Section 9 of UDITPA provides: "All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three." Professor William J. Pierce, the principal draftsman of UDITPA, recognized that UDITPA's three-factor formula reflected both supply and demand factors and declared that the act "represents a compromise between the positions of consumer and manufacturing states." Pierce (1957), p. 781.

[17]Hellerstein and Hellerstein (2001), p. 576.

[18] Multistate Tax Compact Article I(2).

[19]Section 16(b) of UDITPA provides that sales made to a state where the taxpayer is not taxable are attributed to the state of origin. If this "throwback" rule were universally applied to foreign exports, it is less likely that sales-only apportionment would violate the GATT, because the reduction of taxes on export income would occur only in circumstances when another jurisdiction had a legitimate claim to tax at least a portion of that income. (For reasons set forth below, however, we still believe that such a rule would probably understate the export income properly attributable to the state of origin and overstate the export income properly attributable to the destination jurisdiction.) In any event, such a rule would violate the Commerce Clause as a discrimination against foreign commerce unless also applied to "interstate" exports. *See Kraft General Foods, Inc. v. Iowa Department of Revenue*, 512 U.S. 71 (1992) But in that case, the wholesale adoption of the throwback rule would undercut the economic development objective of sales-only apportionment. It is worth pointing out, moreover, that many states (including, in particular those with

C. The Economic Effect of Sales-only Apportionment

It is easy to understand why states have reduced the weight on property and payroll in their apportionment formulas and have increased the weight on sales. Formula apportionment has the economic effect of converting a tax on corporate income into a set of taxes on the factors in the apportionment formula[20] That is, the sales-related portion of the income tax is equivalent to a destination-based sales tax,[21] the payroll-related portion is equivalent to a tax on payroll, and the property-related portion is equivalent to a tax on property. Since both payroll and property are origin-based factors and sales is a destination-based factor, the shift in weights that is occurring reduces the weight on the *origin* of interstate sales used to assign income and increases the weight on the *destination* of such sales, thereby increasing the state's competitive position in both in-state markets and out-of state markets, including foreign markets. To see this in the case of foreign exports, consider the simple case of a corporate manufacturer, all of whose payroll and property are located in a single state, that either exports all of its output or sells all of it in the state where is it produced.

Exports. Under the equally weighted three-factor formula, if the corporation exported all its output, it would pay state tax on two thirds of its profits; under the formula that double-weights sales, it would pay state tax on half of its profits. By comparison, under sales-only apportionment, it would pay no state tax, if it exported all its output.

Domestic (in-state) sales. Under any of the above formulas (equally weighted, double weighting of sales, or sales only), the corporation would pay state tax on all its income, if it exported none of its output.

Net effect. These results can be summarized as in Table 1. The net effect of placing greater weight on sales is to reduce the tax paid on income associated with exports, while leaving the tax on income associated with domestic (in-state) sales unaffected.[22]

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single-factor or heavily-weighted sales formulas (e.g., Connecticut, Iowa, and Minnesota) do not employ the "throwback" rule.

[20]See McLure (1980). The effective tax rate on each factor depends on the profitability of the corporation, relative to the factor nationwide, as well as the statutory tax rate.

[21] Again, we remind readers that our concern in this note is only with income derived from the manufacture and sale of tangible personal property.

[22] The following is the analogous table for income associated with sales of imports and income associated with sales of domestic products:

Table 1
Fraction of income that is taxable in-state, assuming all output is sold in state or is exported

	Domestic manufacturer making in-state sales	Domestic manufacturer making foreign sales ("exports")
Equally-weighted three-factor formula	100 percent	2/3
Double-weighted sales formula	100 percent	½
Sales-only apportionment	100 percent	0

IV. Why Sales-only Apportionment Violates International Trade Rules

In the case of sales-only apportionment the corporation in the foregoing example pays no tax in the state if it exports all its output, but pays tax on all its income if it exports none of its output. Thus sales-only apportionment falls squarely within the description of BTAs quoted earlier, *"fiscal measures which put into effect, in whole or in part, the destination principle* (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market ...)"[23] (emphasis added). Since corporate income taxes are direct taxes, sales-only apportionment constitutes an export subsidy of the type prohibited by the long-established understanding of GATT 1947[24] -- an understanding that should command no less respect under GATT 1994. Indeed, Article XVI(1) of the WTO Agreement provides that "[e]xcept as otherwise provided…, the WTO shall be

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Fraction of income associated with in-state sales that is taxable in state, for a domestic manufacturer and a foreign manufacturer

	Domestic manufacturer making in-state sales	Foreign manufacturer making in-state sales ("imports")
Equally-weighted three-factor formula	100 percent	1/3
Double-weighted sales formula	100 percent	½
Sales-only apportionment	100 percent	100

For purposes of the foregoing table, we again assume that the domestic manufacturer has all of its property and payroll in the taxing state. We also assume that the foreign manufacturer has nexus in the taxing state, and we ignore whatever domestic payroll and property of the foreign manufacturer may be associated with such nexus.

[23]The same thing occurs on the import side. Sales-only apportionment falls within the prohibited class of *"fiscal measures which put into effect, in whole or in part, the destination principle* (i.e. ... which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products) " (emphasis added).

[24] See *supra* Part II.

guided by the decisions, procedures, and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947."[25] Moreover, Annex I(e) of the SCM Agreement lists among the "illustrative list of export subsidies," which are generally prohibited by Article 3.1,[26] "[t]he full or partial exemption, remission, or deferral specifically related to exports, of direct taxes … paid or payable by industrial or commercial enterprises."[27] In short, sales-only apportionment violates the international trade rules because it produces a destination-based income tax, which constitutes a prohibited export subsidy.[28]

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[25] WTO Agreement, Article XVI(1).

[26] See *supra* Part II.

[27] SCM Agreement, Annex I(e).

[28] Despite the apparent subsidy for exports created by sales-only apportionment, we recognize that one may nevertheless argue that it does not constitute an *export* subsidy because such apportionment favors "interstate" as well as "foreign" exports. For example, if Corporation A and Corporation B, conduct all of their manufacturing operations in State X, which has adopted sales-only apportionment, and Corporation A sells all of its output to State Y while Corporation B sells all of its output to Country Z, one may contend that there is no violation of GATT because foreign sales are subsidized no more than domestic sales. Although this is plainly an issue that will require further exploration to determine whether the "prima facie" case set forth in this article will survive more extended scrutiny, we offer several preliminary observations at this juncture.

First, in the context of "national treatment" allegations against subnational legislation, the appropriate comparison is between treatment of in-state and foreign goods. *See Canada - Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*, GATT Doc. No. DS17/R (18 February 1992) (report of the panel); *United States - Measures Affecting Alcoholic and Malt Beverages*, GATT Doc. No. DS23/R (Feb. 7, 1992) (report of the panel). The fact that out-of-state goods are treated no better than foreign goods does not save the state legislation from condemnation under GATT. One might advance an analogous argument with regard to the treatment of interstate and foreign exports.

Second, as noted above, see *supra* Part II, the SCM Agreement defines a "prohibited subsidy" to include "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance," SCM Agreement, Article 3.1(a), and GATT 1947 imposes general restraints on "any subsidy … which operates directly or indirectly to increase exports …." GATT 1947, Article XVI(1 Whether or not sales-only apportionment constitutes a "subsidy" that is "contingent, in law or in fact … upon export performance" or one that "operates directly or indirectly to increase exports" will depend, in the end, on a definitive interpretation by the WTO of the meaning of those phrases in the context of subnational measures and, in particular, whether "foreign" in that context should be construed to embrace all out-of-state sales.

Third, even if one were to conclude that (1) the "national treatment" analogy is inapposite because it deals with indirect taxes on goods rather than subsidies for direct taxes and (2) the language of Article 3.1 of the SCM Agreement and Article XVI of GATT 1947 requires a comparison between a state's treatment of all domestic sales and all foreign sales rather than between in-state and out-of-state sales, the more that the states adopt sales-only apportionment, the stronger the case becomes for establishing a violation of international trade rules. Indeed, if

V. But Can Sales-only Apportionment Be Defended as a Reasonable Method for Determining Where Income Originates Rather than a Prohibited Export Subsidy?

To overcome the prima facie case that sales-only apportionment is a prohibited export subsidy, it would be necessary to argue persuasively that sales-only apportionment accurately reflects where income originates. After all, there is nothing wrong with an income tax that attributes income to the place where sales occur, provided that income originates where sales occur. Defenders of sales-only apportionment against the prima facie case advanced above would presumably base their position on the SCM's definition of a subsidy:

> [A] subsidy shall be deemed to exist if (a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e., where … (ii) government revenue that is *otherwise due* is foregone or not collected (e.g., fiscal incentives such as tax credits)…; and (b) a benefit is thereby conferred.[29]

In substance, the defenders of sales-only apportionment would contend that it is not a "subsidy" at all within the meaning of the SCM Agreement, because it does not constitute revenue "otherwise due" but rather is a reasonable method of exempting income from foreign economic processes.[30] This seems to be a daunting task.

In adopting formula apportionment as the methodology for attributing income, one must accept that there is no objective standard for what is the correct apportionment formula. But one can appeal to common sense, economic analysis, judicial precedent, standard practice, the legislative history of sales-only apportionment, and federal law. None of these supports sales-only apportionment.

Common sense. The notion that only sales reflect where income is earned — that labor and capital make no contribution — is far-fetched.

Economic analysis. The common sense view that labor and capital contribute to the creation of income reflects — indeed, is probably grounded in — economic analysis. Income is the return to capital and labor. Sales are essential to the realization of income, but they are not enough, by themselves.[31]

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every state adopted sales-only apportionment, the subsidy "to increase exports" or "contingent … upon export performance" would be self-evident, however one defined exports.

[29] SCM, Article 1 (emphasis supplied).

[30] See *United States - Tax Treatment for "Foreign Sales Corporations*," AB-2001-8, WT/DS108/AB/RW (14 January 2002) (Report of the Appellate Body).

[31] Indeed, some economists have argued that sales should be dropped altogether from the apportionment formula; see Harriss (1959); Studenski (1960), pp. 1131-32. We cite these authorities not because we necessarily agree with them but only to demonstrate the absurdity, from an economic standpoint, of the position that capital and labor may be ignored altogether in an income apportionment formula. Musgrave (1984) considered both "supply" and "supply-demand" based formulas. Although the former approach considers using only labor and capital as apportionment factors, the latter includes sales. Musgrave does not consider using only sales to apportion income.

Judicial precedent. The U.S. Supreme Court has opined that income "may be defined as the gain derived from capital, from labor, or from both combined."[32] While this statement is now regarded as an unduly narrow view of income, the notion that capital and labor should be ignored completely in determining the source of income flies in the face of the Court's observation that "the standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates."[33] We recognize, of course, as we observed at the outset of this note, that single-factor sales apportionment has survived scrutiny as a matter of federal constitutional law. But that was no ringing endorsement of single-factor sales apportionment as a method for apportioning income. To the contrary, the Court permitted a deviation from the "benchmark"[34] three-factor formula in *Moorman* only because to do otherwise would require "extensive judicial lawmaking"[35] and because Congress rather than the Court was the appropriate body to fashion such rules.

Standard practice: As noted earlier, until recently the equally weighted three-factor formula was the standard formula. "The three-factor formula … has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated."[36], because it was thought to reflect reasonably well where income originates, and even now only a few states have shifted to sales-only apportionment. Canada uses payroll and sales, equally weighted, to apportion corporate income.

Legislative history. The states that have made the shift have almost certainly done so only to improve their competitive position.[37] As a key economic advisor to the Governor of Georgia observed in explaining the state's adoption of a double-weighted sales factor, the legislation "offer[s] economic incentives for business expansions and locations here. . . . By promoting the activities of firms that have a physical presence---property and labor---in Georgia, [the legislation] should clearly have a stimulative effect."[38] It seems unlikely that any state has made the shift because it thought sales-only apportionment accurately reflects where income is earned.

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[32] *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (quoting *Doyle v. Mitchell Bros. Co*., 247 U.S. 179, 185 (1918) and *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399, 415 (1913)).

[33] *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1965).
[34] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 170 (1963).
[35] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 278 (1978).
[36] *Id.* at 183.
[37] The following argument is typical of this line of reasoning: "[U]nder current tax policy, a company with multi-state operations faces a higher tax bill in New York if it locates jobs and investment here. For tax purposes, New York now allocates a company's income to this state based on three factors: in-state sales (which is counted twice), in-state payroll, and in-state property. By basing corporate taxation solely on in-state sales, New York can reward, rather than punish, employers that create jobs here. . ." *The Wir*e, newsletter of the Business Council of New York State., Inc., November 24, 2000, quoted in Mazerov (2001).
[38] Georgia Department of Revenue, *Georgia Revenue Quarterly*, Vol. 17, No. 1, at 1 (1995) (quoting Dr. Henry Thomassen, economic advisor to Governor Zell Miller). Politicians and business groups in other states have expressed similar sentiments in supporting legislation to change their three-factor formulas with a double-weighted sales factor to a single-factor sales formula. *See, e.g.,* Pratt and Goldberg (2002); (California) Plattner (2002) (New York)..

Federal law. Under the Internal Revenue Code, when a taxpayer manufactures goods within the United States and sells them outside the United States or manufactures goods outside the United States and sells them within the United States, the income "shall be treated as derived partly from sources within and partly from sources without the United States."[39] The implementing regulations describe two methods that may be used for dividing the income from these transactions between foreign and domestic sources. Under the so-called "'50-50" method, one half of the income from these transactions is allocated to production activities and one half is allocated to the sales function -- essentially a two-factor apportionment formula of property and sales.[40] Under the independent factory price (IFP) method, the taxpayer may elect to allocate income between foreign and domestic sources on the basis of an independent factory price that is "fairly established" by sales to unrelated third parties.[41] These rules are significant because they provide yet another piece of evidence as to what constitutes a reasonable standard for determining the source of income derived from manufacturing in one jurisdiction and selling in another. Whatever room for debate there may be about whether the formulary "50-50" method is superior to the "arm's-length" IFP method, one thing is clear: Under no circumstances, under federal law, can a taxpayer who manufactures in one jurisdiction and sells in another assign *all* of the income to the jurisdiction of the sale, which is exactly what sales-only apportionment does.

VI. Do International Trade Rules Constrain State Tax Policy?

International trade rules derived from GATT 1947 generally have been regarded as applicable to subnational governments. GATT 1947, Article XXIV:12 provides that "[e]ach contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territories." As an eminent American authority on GATT has observed, "Article XXIV:12 obligates the United States to compel state adherence to [GATT] . . . .".[42] Indeed, over the years a number of disputes involving subnational measures have arisen under GATT, including an American challenge to the practices of Canadian provinces regarding imports of beer ("*Beer I*")[43] and a Canadian

[39] I.R.C. § 863(b).
[40] Reg. § 1.863-3(b).The property factor is determined by reference to the location of the taxpayer's "production assets" within and without the United States. Reg. § 1.863-3(c)(1). The sales factor is determined by reference to the location of sales within and without the United States based on where rights, title, and interest of the seller are transferred to the buyer. Reg. §§ 1.863-3(c)(2), 1.861-7(c).
[41] Reg. § 1.863-3(b)(2)(i). Under a third approach, the taxpayer may apportion income from § 863 sales by the method it uses in keeping its books and records if it has received advance permission from the Internal Revenue Service to do so. Reg. § 1.863-3(b)(3).
[42] Hudec (1986), p. 221. see also Schaefer (2001), p. 630. Whether the trading partners of the United States can convince it to enforce their complaints against sales-only apportionment does not affect the basic issue of whether that method contravenes the GATT.
[43] *Canada - Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*, GATT Doc. No. DS17/R (18 February 1992) (report of the panel).

challenge to various U.S. national and subnational taxes and regulations applicable to alcoholic beverages ("*Beer II*").[44]

It was precisely because the international trade rules embodied in GATT and related agreements applied to subnational taxing measures that the American states expressed considerable misgivings about the impact on their taxing authority of the agreements reached during the Uruguay Round of multilateral trade negotiations.[45] While the preexisting understanding under the language and practice of GATT was that its rules applied to subnational measures, the new rules developed during the Uruguay Round for services (the General Agreement on Trade in Services (GATS)) were explicitly made applicable to subnational measures.[46] The states, speaking through the Multistate Tax Commission (MTC)[47] and the Federation of Tax Administrators (FTA),[48] objected both to the restrictions imposed by the GATT/GATS on their traditional taxing powers and on the impact of the new dispute settlement procedures under the WTO Agreement.[49] Whatever the merits of those objections, the crucial point for present purposes is the simple fact that the states made them, for it constitutes powerful evidence, if any were needed, that states are subject to the substantive discipline of contemporary international trade rules.[50]

VII. What Now?

Our purpose has been to stimulate debate, by suggesting that sales-only apportionment is a prima facie violation of international trade rules. If that suggestion stands up to further analysis, one would expect that the European Union and perhaps other trading partners of the United States will lodge complaints in the World Trade Organization, contending that sales-only apportionment constitutes a prohibited export subsidy. If those contentions are sustained, sales only apportionment will have reached

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[44] *United States - Measures Affecting Alcoholic and Malt Beverages*, GATT Doc. No. DS23/R (Feb. 7, 1992) (report of the panel). See also *Territory of Hawaii v. Ho*, 41 Haw. 565 (1957) (GATT has same effect as treaty and therefore Hawaii law in violation of GATT is preempted under Supremacy Clause).

[45] See Aune (2002); Hellerstein (1995).

[46] See GATS Art. I:3(a) (defining "measures by Members" as meaning "measures taken by . . . central, regional or local governments and authorities").

[47] The MTC is the administrative arm of the Multistate Tax Compact. The Compact seeks to facilitate proper determinations of state and local tax liability of multistate taxpayers, promote uniformity or compatibility of state tax systems, facilitate taxpayer convenience and compliance, and avoid duplicative taxation. The MTC frequently supports the states' interests before judicial and legislative bodies. There are 20 state members and 19 state associate members of the Multistate Tax Compact.

[48] The FTA frequently represents the interests of states and state tax administrators before legislative bodies.

[49] MTC and FTA spokesmen have expressed these concerns formally and informally to the Executive Branch, to Congress, and to the tax community through oral and written submissions. Their views are summarized in MTC and FTA (1994) and FTA (1994).

[50] The United States submitted a number of reservations to the new GATS rules (as distinguished from the preexisting GATT rules), including reservations relating to the states' use of formulary apportionment. See *supra* note 1. In addition, in enacting the Uruguay Round Agreements, Congress provided a number of procedural protections from GATT/GATS-based attacks on state laws, including a provision barring any "private" right of action challenging a state law under GATT or GATS. See 19 U.S.C. § 3512. Only the United States may bring such an action for the purpose of declaring a state law invalid under the Uruguay Round Agreements.

its high-water mark. If states want to improve their competitive position, they will need to do it honestly and transparently, by reducing corporate tax rates, perhaps replacing lost revenues with revenues from taxes levied explicitly --rather than implicitly -- on payroll, property, or sales.[51]

If sales-only apportionment is proscribed, what formula would be allowable under international trade rules? This question is difficult to answer; as we noted above, the decision is, to some extent, arbitrary. It seems, however, that a formula that double-weights sales would be found acceptable; as noted above, Canada uses a two-factor formula that places half the weight on sales, as does the United States, at least in the context of goods manufactured by the seller.

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[51] Of course, those that levy sales taxes could also eliminate tax on sales to business; see McLure (2001).

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Letter from Chevron Oil

Stephen Olivier

Mr. David Brady
Program Manager
California Commission on Tax Policy in the New Economy
1102 Q Street, Suite 6000
Sacramento, CA 95814

Streamlined Sales Tax Project - - CA Participation

Dear Mr. Brady:

I am Steve Olivier, Manager of Excise Tax Advice for Chevron U.S.A. Inc. I have worked with on the Streamlined Sales Tax Project (SSTP) for the past two years representing business interests. I have testified numerous times before the SSTP, once before the National Conference of State Legislatures (NCSL), and several times before the SSTP Implementing States. I commend the SSTP, NCSL, and the Implementing States for the many proposals that attempt to simplify and standardize the sales and use tax system. I also wish to compliment this Project for including business in this important process and listening to all of our input. In the recent past, Chevron has worked cooperatively with the Federation of Tax Administrators (FTA) and many States on Motor Fuel Tax issues. The goals were similar - - uniformity, standardization of terms and definitions, and a simpler and fairer system. We found that these joint efforts of State and business produced mutually beneficial results.

The joint efforts of States and the business community on this project have resulted in tremendous progress especially in the areas of reducing the burden of tax compliance and potential improvement in tax administration. Specifically, Chevron supports the following:

- State level administration of sales and use tax collections,
- Simplified administration of exemptions,
- Uniformity in the State and local tax bases,
- Central electronic registration system for all member States,
- Simplified tax returns,

- Simplified tax remittances,
- The concept of uniform definitions, and
- Protection of consumer privacy.

Chevron believes in order to accomplish the stated goals of the SSTP, a simpler, more uniform sales and use tax system, that all forty-five states with a sales tax system must participate. California is recognized as a leader in the new economy and should be an active participant in the historic effort. We strongly urge that this Commission recommend to Governor Davis to pass enabling legislation that will allow California to participate in the Streamlined System. Please feel free to distribute this letter to your fellow Commission members.

Sincerely,

Stephen P. Olivier

Letter from J.C. Penney

Wayne Zakrzewski

July 25, 2002

Bill Rosendahl, Chairman
California Commission on Tax Policy in the New Economy
1102 Q Street, Suite 6000
Sacramento, CA 95814

Dear Chairman Rosendahl:

This letter is to express JCPenney's support for the Streamlined Sales Tax Project (SSTP) and to urge California to take a leadership role in this effort by becoming one of the Streamlined Sales Tax Implementing States.

JCPenney is a major retailer with approximately 1,100 department stores across the United States including over 110 California locations. In addition our Eckerd subsidiary operates over 2,600 drugstores in the eastern, mid Atlantic and southern states. JCPenney is also one of the world's largest remote sellers with over three billion dollars in catalog and Internet sales. We collect sales and use taxes on all of our sales whether made in stores, by catalog or over the Internet. We remit approximately $140 million in tax annually to California.

As a company with over $300 million in sales over the Internet, we believe that the evolution of electronic commerce should occur in an environment driven by good business models and not by the artificial and illusory pricing advantage the current sales tax law provides. We strongly favor leveling the sales tax playing field for all businesses. However, we know from experience that the current sales tax system is extremely burdensome and understand the reluctance to expand the duty to collect tax to remote sellers and electronic commerce until and unless there is substantial simplification of the sales tax.

The goal of SSTP is to provide simplification of the sales tax through uniform administrative procedures and uniform definitions for taxability. The system aspires to provide businesses certainty and ease of administration while allowing the states flexibility needed to maintain adequate revenues. JCPenney associates have worked with SSTP since its inception and believe that it is a program with long-term benefits for both business and government.

Many of the benefits SSTP should provide come at little or no cost to the state. For example: the most current version of the SSTP proposal provides for one stop

registration, a uniform tax return form, and uniform rules for exemption administration, and fund remittance. A more uniform system of tax compliance across the states will reduce costs for business while providing the government with timely and more accurate filings at less enforcement cost. If only these simple administrative provisions were enacted by most of the sales taxing states, JCPenney would view the project as worthwhile.

There are other provisions of the SSTP proposal, such as uniform definitions, uniform sourcing rules, limitations on caps and thresholds, and limited number of tax rates that are more controversial and could require changes in California law or tax policy to implement. The same is true for virtually every other state that is taking part in the project and these problems should not keep California from participating.

As a major center of commerce and gateway to global trade, California should be a leader in this effort to streamline and update the sales tax. At a minimum, California should participate in the Streamlined Sales Tax process to assure that its voice is heard in this important effort. Please call me if you have any questions.

Cordially,

Wayne Zakrzewski

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Does Sales-only Apportionment of Corporate Income Violate International Trade Rules?

Abstract

There has been a pronounced change in the formulas states use to apportion the income of multistate corporations from one that placed equal weight on payroll, profits, and sales to one that places at least half the weight on sales, and eight base apportionment solely on sales. This paper, which is intended to stimulate further analysis and debate, rather than provide a definitive conclusion, suggests that sales-only apportionment may violate international trade rules that prohibit export subsidies.

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