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California Commission on
Tax Policy in the New Economy

Final Report

December 2003

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Final Report

DECEMBER 2003

California Commission on Tax Policy in the New Economy

900 "N" Street, Suite 300, Sacramento, CA 95814
916-653-6742
Fax: 916-653-1764

TO: *The Honorable Arnold Schwarzenegger, Governor*
Members of the California Senate and Assembly

FROM: *William J. Rosendahl*
Chairman, California Commission on Tax Policy in the New Economy

RE: *Final Report*

DATE: *December 2003*

On behalf of the Commissioners and Ex-Officio Members of the California Commission on Tax Policy in the New Economy, I am pleased to present our Final Report.

This report documents the work of the Commission over the past two years and contains the Commissioners' final recommendations. It further develops the themes and issues contained in our Interim Report, November 25, 2002, and our Options for Revising the California Tax System, June 15, 2003.

The Proceedings of the Commission are included in the attached CD. After 17 hearings and over 140 speakers, the Commission has accumulated a wealth of information concerning tax policy in California. Videotapes of each hearing were also produced. Many of these hearings were simultaneously webcast so that California citizens could follow and participate in the Commission's work.

Should you so desire, the Commission has volunteered to continue its work with selected outreach to key Legislature Committee Chairs and their staffs, as well as with your financial advisory team, to facilitate bipartisan agreements and legislation to help restore a solid foundation for California's economic future.

We are here to serve you and all Californians in this important task. Please contact me if we can be of further assistance.

Respectfully submitted,

William J. Rosendahl, Chairman

CC: California Commission on Tax Policy in the New Economy

California Commission on Tax Policy in the New Economy

Commissioners

William J. Rosendahl, Chairman

Marilyn C. Brewer	Lenny Goldberg
Sean O. Burton	Scott Peters
Larry Carr	Glen Rossman
William Dombrowski	William Weintraub

Ex-Officio Members, 2002

Michael Bernick	Director, Employment Development Department
Honorable Jack Scott	Chair, Senate Committee on Revenue & Taxation
Honorable Ed Chavez	Chair, Assembly Committee on Revenue & Taxation
Gerald H. Goldberg	Executive Officer, California Franchise Tax Board
Donald Fowler	Public Member, California Economic Strategy Panel
Honorable John Chiang	Chair, State Board of Equalization
Tim Gage	Director, California Department of Finance
Loretta Lynch	President, California Public Utilities Commission
Honorable Kathleen Connell	California State Controller

Ex-Officio Members, 2003

Michael Bernick	Director, Employment Development Department
Honorable Gilbert Cedillo	Chair, Senate Committee on Revenue & Taxation
Honorable Ed Chavez	Chair, Assembly Committee on Revenue & Taxation
Gerald H. Goldberg	Executive Officer, California Franchise Tax Board
Sunne Wright McPeak	Public Member, California Economic Strategy Panel
Honorable Carole Migden	Chairwoman, State Board of Equalization
Steve Peace	Director, California Department of Finance
Michael Peevey	President, California Public Utilities Commission
Honorable Steve Westly	California State Controller

Acknowledgements

The nine Commissioners of the Commission on Tax Policy in the New Economy have performed a valuable public service for the State of California. Over a period of two years, they have attended 17 meetings and dedicated substantial amounts of their own time and resources to help accomplish the Commission's work. They paid their own expenses. We owe them a very sincere expression of thanks.

The Commission on Tax Policy in the New Economy was not supported by a legislative appropriation and did not have a funded staff. Staff support for the Commission was obtained from state agencies (principally the California Technology, Trade, and Commerce Agency and the California Research Bureau in the State Library) as well as from the Ex-Officio members of the Commission. Many Ex-Officio members attended the hearings throughout the state and provided valuable contributions to the process. Most of the Commission's meetings were organized by Marshall Graves of the California Technology, Trade, and Commerce Agency, with assistance from others.

The Commission's reports (the Interim Report, Options for Revising the California Tax System, and Final Report) were the result of the collaborative work of many people. The reports were written by Dr. Martha Jones of the California Research Bureau. Marshall Graves was a contributing editor and Trina Dangberg of the California Research Bureau provided technical support. Many people provided input, reviewed drafts, and gave advice at various points in the process. In addition to the individuals named on the following page, the Commission would like to thank analysts at the State Board of Equalization, the Franchise Tax Board, the Employment Development Department, the Legislative Analyst's Office, and the Office of the Controller for taking such an active role in providing technical expertise and supporting our work.

The Proceedings of the Commission, a record of many of the presentations made before the Commission, was assembled by Trina Dangberg and Marshall Graves, with the assistance of Dr. Martha Jones. Videotapes of each hearing are catalogued in the California State Library collection. The production of these tapes was arranged by Adelphia Communications and the California Senate TV office in the Capitol.

Jesse Szeto, Assistant Secretary of the Division of Science, Technology and Innovation, in the California Technology, Trade, and Commerce Agency, was instrumental in arranging funding from that agency to support the Commission's work for the last six months of 2003. This funding was used to pay for logistical support for the Commission's meetings from the California State University, Sacramento, CSUS/CCE Conference & Training Services and for the costs of publishing the Final Report.

Tina Jung, Public Information Officer for the California Technology, Trade, and Commerce Agency, performed the duties of webmaster. The Commission's Final Report can be accessed from the California State Library. http://www.library.ca.gov.

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Charlene Simmons, Ph.D.

Tax Policy Group of Joint Venture: Silicon Valley Network and the College of Business, San Jose State University
Professor Annette Nellen, CPA, Esq.

Center for State and Local Taxation at University of California, Davis and the Economics Department at California State University, Sacramento
Professor Terri Sexton, Ph.D.

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Scott Farris, Eric Wiesenthal

Office of the Governor
Amy Hair

American Society of Mechanical Engineers
Marshall Graves, P.E.

Public Policy Institute of California
Fred Silva, Senior Policy Advisor

Howard Jarvis Taxpayers' Association
Jonathan Coupal, Joel Fox

California Center for Regional Leadership
Nick Bollman

California State University, Sacramento, CSUS/CCE Conference & Training Services
Andrea Killeen

The staff of the Senate Committee on Revenue and Taxation
(Chair, Senator Gilbert Cedillo; Chief Consultant, Martin Helmke)

The staff of the Assembly Committee on Revenue and Taxation
(Chair, Assembly Member Ed Chavez; Chief Consultant, Kimberly Bott)

And the staff of the Senate Select Committee on Economic Development
(Chair, Senator John Vasconcellos; Senior Consultant, Doug Brown)

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OVERVIEW

On September 23, 2000, the California Commission on Tax Policy in the New Economy was established by SB 1933 (author: Senator Vasconcellos).* The Commission was directed to identify key stakeholders in the new high-tech economy, conduct public hearings, develop a comprehensive agenda of goals and critical issues in order to achieve long-term tax policy solutions, examine all aspects of the current and future California economy with special attention to the influence of new technologies, and assess the impact of the evolving California economy on public revenues with special attention to the needs of local governments. The Commission was also directed to study and make recommendations regarding specific elements of California's state and local tax system, including, but not limited to, sales and use taxes, telecommunications taxes, income taxes, and property taxes. The history of the Commission and a list of presentations and speakers are included in Appendix B.

The enacting legislation, as amended by SB 934 (author: Senator Sher), required the Commission to submit an Interim Report not later than December 1, 2002, and a Final Report not later than December 31, 2003. The Commission conducted public hearings in 2002 in Sacramento, Sunnyvale, Santa Monica, Bakersfield, San Diego, and Redondo Beach. In accordance with its statutory obligations, the *Interim Report* was issued on November 25, 2002. This report is included in Appendix E.

The downturn of the California economy and its impact on tax revenues led Governor Davis, at a February 3, 2003 appearance before the Commission, to suggest that the Commission consider releasing a second, non-mandated interim report. In addition to the short-term need to develop a budget for the upcoming fiscal year, state policymakers were grappling with the long-term issue of structural reform of the state's fiscal structure. The Commission agreed that a report issued in June 2003 could be helpful to policymakers as an outline of tax policy options being considered by the Commission. The Commission also helped define the parameters of what constitutes "good" tax policy, based on a set of guiding principles.

In response to the Governor Davis' request and the growing sense of urgency about the need for structural reform, the Commission undertook an aggressive agenda. In lieu of meeting every two months, as was the practice in 2002, the Commissioners met six times in Spring 2003. Realizing that success would lie with a non-partisan approach, an outreach to Legislators and elected Constitutional Officers of both parties was initiated. The Commission aspired to be an honest broker for all viewpoints along the political spectrum and offered a safe haven for those viewpoints to be discussed critically, without partisan rancor.

As a sound foundation on which to consider changes in tax policy, the Commission consulted a blue-ribbon panel of experts from previous commissions on April 14, 2003 and has based the Commission's work on reports from groups such as the California

* The text of the SB1933 (Vasconcellos) is in Appendix F.

Economic Strategy Panel, the Speaker's Commission on State and Local Government Financing, the Speaker's Commission on Regionalism, the Constitution Revision Commission, the Governance Consensus Project, the State Municipal Advisory Reform Team, and the Commission on Building for the 21st Century.

The Commission conducted five hearings throughout the remainder of 2003. Each policy option considered by the Commission was the focus of a debate between advocates and opponents of the change. The four debates were held in Beverly Hills, San Francisco, Los Angeles, and San Diego. At the final meeting in Newport Beach, Commissioners voted on which tax policy proposals to recommend to the Governor and the Legislature. For each of the options considered, the bipartisan Commission reached a decision to recommend either implementation of the proposal or further study.

In addition to debating policy options, the Commission devoted a considerable amount of time to an extensive evaluation of selected California taxes. This exercise, led by Professor Annette Nellen,* was designed to help the Commissioners better understand the complexities and problems of California's tax system. The evaluation was based on a set of standard tax principles, as outlined by the American Institute of Certified Public Accountants (AICPA). With the tax policy group at Joint Venture: Silicon Valley, Professor Nellen prepared a scoring of selected California taxes. The Commissioners did not vote to formally endorse this particular evaluation, but considered this process necessary for anyone interested in examining tax policy.† Joint Venture: Silicon Valley's *Scoring of Selected California Taxes* is included in Appendices H and I of this report.

Participation in the Commission's process by California citizens was strongly encouraged. Forums where citizens provided their ideas and comments about the tax and revenue policies that most affect their daily lives significantly helped the Commissioners gain a broader perspective. On behalf of the Commissioners, an invitation was extended to all Californians to work as equal partners with the Commission in developing tax and revenue programs that guarantee a high quality of life for all Californians.

---

* Professor Nellen teaches at the College of Business, San Jose State University and is also the Chair of the Tax Policy Group, Joint Venture: Silicon Valley Network. She appeared three times before the Commission (3/20/02, 4/21/03, 7/18/03) and submitted Joint Venture's *Scoring of Selected California Taxes* in November 2003 to the Commission.

† For more information, http://www.jointventure.org/initiatives/tax/tax.html

SUMMARY OF THE RECOMMENDATIONS

In May 2003, after almost a year and a half of testimony, the Commissioners decided on a set of tax policy and budget process reform proposals to consider for recommendation to the Governor and Legislature. In June 2003, these reform proposals were published in the Commission's *Options for Revising the California Tax System*. From July to October 2003 debates were held on most of the proposals. **Commissioners voted on which options for reform to recommend on November 17, 2003. Ex-Officio Members of the Commission did not vote.**

The Commissioners heard extensive testimony concerning the need for tax simplification, conformity and fairness at the March 2002 meeting in Sunnyvale. In May 2002, State Controller Kathleen Connell presented the findings of the Tax Simplification Task Force 2000. The Commissioners felt tax complexity is an extremely important area in need of reform in California, and recommended the Task Force recommendations for further study and consideration. **On November 17, 2003, a majority of the Commissioners voted to include the main ideas from Controller Connell's report in their own *Final Report*.** The Executive Summary from the report of the Tax Simplification Task Force 2000, "Conformity, Simplicity, Fairness, Investment," is included in Appendix G.*

Two sets of proposals were withdrawn from consideration. The first was whether California should join the Streamlined Sales Tax Project (SSTP) as a voting member. Commissioners heard a lot of testimony on this proposal, but did not vote on it in November 2003 because on October 8, 2003, legislation authorizing California's participation as a voting member was approved by Governor Davis. Although this legislation made it unnecessary for the Commission to vote, the Commissioners all agreed that further study is necessary to determine whether California should change its sales and use tax laws to conform to the Streamlined Sales and Use Tax Agreement.

Telecommunications taxes were the second set of proposals withdrawn from the Commission's consideration. The telecommunications industry is changing rapidly and this topic is extremely complex. The Commissioners decided they did not have enough information to make a solid recommendation or the resources to conduct additional research.

The Commissioners did consider the wide range of reforms listed below when they voted in November 2003. For each option, the possible vote choices were: yes, no, abstain, or further study. The "further study" choice was for proposals the Commissioners believed had merit but would need more research before the Commissioners would be ready to make a recommendation. A detailed voting record is in Appendix C. In the following sections of the Final Report, the Commission's recommendations are discussed in detail.

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* The report is available on-line at: http://www.sco.ca.gov/eo/genint/taxforce2000/cataxrpt2000.pdf

RECOMMENDED TAX POLICY REFORMS

Sales Tax

Recommendation (unanimous): Efforts should be made by the Board of Equalization to improve collection of the use tax that is currently California law.

Recommendation: Broaden the sales tax base to include selected services, while lowering the state rate to retain revenue neutrality.

> **Comment**: The Commissioners emphasized the importance of revenue neutrality in this proposal. This is not part of a 2-step process to increase the state rate at a later date.

Recommendation for further study (unanimous): Eliminate selected sales and use tax exemptions or exclusions.

Property Tax

Recommendation: Property/Sales Tax Swap: Change the mix of local general-purpose revenue by decreasing the amount of sales tax revenue and replacing it with property tax revenue. The objective of this proposal is to decrease local reliance on the sales tax and increase reliance on the property tax.

Recommendation for further study: Periodically reassess non-residential property to market value without changing existing rates and in the context of improving the business climate in California.

Local Taxes

Recommendation: Provide a constitutional minimum allocation of property taxes to local government.

Recommendation: Reduce the vote threshold now required for approval of local special tax measures from two-thirds to 55 percent.

Other Tax Policy Options

Recommendation (unanimous): State Tax Court: California should establish a state administrative body to operate like the U.S. tax court. This body would resolve all tax disputes, including personal income tax, corporate income tax, sales and use tax, property taxes, payroll taxes, and excise taxes as outlined in Professor Simmons' September 23, 2003 letter to the Commission.

Recommendation for further study: Flat-Rate Tax Proposal - Eliminate all current taxes in California except for "sin taxes," such as cigarette and alcohol taxes,

and establish two new taxes, a six-percent flat-rate personal income tax and a six-percent flat-rate business value-added-tax.

Comment: Commissioners found the simplicity of the flat-tax system attractive and want more research on this proposal. They were concerned, however, about the regressive effects of a flat-rate tax system on low-income earners.

RECOMMENDED REFORMS OF THE STATE BUDGET PROCESS

Recommendation (unanimous): Amend the California Constitution to do the following:

1) **Revise the current spending limit** - In order to make the spending limit more transparent, revise it to limit spending based on population and economic growth.

2) **Reserve requirement** - In order to reduce the fiscal shock of an economic downturn, require the maintenance of a reserve.

3) **Rebalancing an unbalanced budget** - Establish a system for rebalancing the state budget when it becomes unbalanced.

4) **Multi-year budget planning requirement** - Initiate a fiscal planning requirement that will require the state budget process to plan longer than 12 months.

5) Implement changes that would foster a "**culture of accountability**" in the budget process.*

* As per the recommendations from the Bay Area Council and the Speaker's Commission on State and Local Government Financing.

FRAMEWORK FOR ANALYSIS

In determining its recommendations to alter California tax policy, the Commission was committed to evaluating tax policy within a framework of general principles of taxation. The Commission's objective was not to find new sources of revenue but to ensure that the State's tax structure meets the requirements of these guiding principles as well as the requirements of the new economy. In a broader context, fiscal and tax policy should consider both sides of the revenue dynamic:*

(1) the reasonableness of the tax source, and,
(2) the appropriateness of its dedicated use, such as the accountability for use of revenues, the alignment of revenues and responsibilities, and the return on investment.

This report presents various options for changing California tax policy. For each option, the report provides background information, the type of action required for the proposal to be implemented (such as statutory, regulatory or constitutional amendment), and the effect of the proposed option on the balance of local and state authority. Then an analysis of pros and cons of the option is presented, organized using the three categories of guiding principles listed below. Analyzing the tax policy options in this manner will help define the parameters of the debate around each proposal. In addition, the Commission is proposing structural reforms to the state budget process.

In its 2002 Interim Report, the Commission adopted the ten tax principles described by the American Institute of Certified Public Accountants (AICPA).† The Commission has grouped these principles into three major categories: Fairness and Perception, Simplicity, and Efficiency and Balance.‡

FAIRNESS AND PERCEPTION

1. **Fairness and Equity:** Similarly situated taxpayers should be taxed similarly. Equity refers to both horizontal and vertical equity. Horizontal equity describes the concept that taxpayers with equal ability to pay should pay the same amount of tax. Vertical equity means that taxpayers with a greater ability to pay should pay more tax.
2. **Transparency and Visibility:** Taxpayers should know that a tax exists, how the tax will be administered, and when it will be imposed upon them and others. The taxpayer should also know for what purpose the revenues will be used.
3. **Minimum Tax Gap:** A tax should be structured to minimize noncompliance.
4. **Neutrality:** The impact of taxes on business and consumption decisions should be kept to a minimum.

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* This framework has been adopted by the California Economic Strategy Panel and previous California Commissions considering reform measures.

† "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals," New York: Tax Division of the American Institute of Certified Public Accountants, 2001. http://www.aicpa.org/pubs/jofa/feb2002/ftta.htm

‡ The analysis in Appendix H uses the same principles of taxation, but groups them slightly differently.

SIMPLICITY

5. **Certainty:** The tax rules should clearly specify when and how the tax is to be paid, and how the amount is to be determined.
6. **Convenience of Payment:** A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.
7. **Economy of Collection:** The costs of collecting a tax should be kept to a minimum for both the government and taxpayers. Appeals should be handled fairly, easily and quickly.
8. **Simplicity:** The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

EFFICIENCY/BALANCE

9. **Economic Growth and Efficiency:** The tax system should not impede or reduce the productive capacity of the economy.
10. **Appropriate Government Revenues:** The government should be able to determine how much tax revenue will likely be collected and when. Tax systems must provide adequate, reliable revenues for both state and local governments.

DISCUSSION OF RECOMMENDATIONS

SALES TAX

Improve Collection of the Use Tax on Remote Sales

Recommendation (Unanimous): Efforts should be made by the Board of Equalization to improve collection of the use tax that is currently California law.

Background: What is commonly thought of as "the sales tax" includes both sales and use taxes. "Sales taxes" apply to retail transactions that occur within a state, while "use taxes" must be paid by buyers who use, consume, or store in-state items that were purchased out of state. States require sellers to collect sales tax on taxable sales* and remit the tax to the states for transactions within an individual state's borders. If products are shipped to nonresident purchasers, the seller is not required to collect sales tax, but purchasers are supposed to pay the use tax in their home state.

The bulk of Sales & Use Taxes (SUT) revenues are from the sales tax on in-state transactions. Individuals generally do not pay use taxes, except for transactions involving products that must be registered, such as a car. If a California resident buys a car in Nevada, for example, he or she must pay the use tax on the purchase price when registering the vehicle in California. For goods that are not registered, the state collects no use tax unless it is voluntarily remitted by the purchaser, or voluntarily collected and remitted by the remote seller. Historically, voluntary compliance with the use tax by sellers or buyers has been rare.

Attempts by various states to require a remote seller to collect and remit use tax on merchandise sold to a state's residents have been restricted by U.S. Supreme Court decisions. In 1967, the Court ruled that collecting use tax on remote sales would place an unconstitutional burden on businesses lacking a physical presence in the state (nexus) because of the complexity of the tax system. Until recently, most remote transactions were from catalog sales and, although states were irritated with their inability to collect use tax, it was not critical to state budgets. With the growth of Internet transactions, however, the incidence of remote sales has increased and is projected to grow dramatically in the near future. The percentage of transactions subject to the sales tax (and mandatory tax collection) is decreasing, while those subject to the use tax (dependent on voluntary remittance) is increasing. The growth of Internet transactions, coupled with the economic shift towards services, has many states worried about the future of sales tax revenues.

Some Commissioners suggested that better enforcement of the California use tax on remote sales could substitute for joining the Streamlined Sales Tax Project. The Board of

---

* The sales and use tax (SUT) is a tax on final sales of tangible personal property, such as clothing, household furnishings, appliances, and motor vehicles. Intermediate sales of goods are not taxed and certain individual items are specifically exempted. The largest of these tax expenditure programs involve utilities and home-consumed foods. Most services are exempt from direct taxation in California.

Equalization (BOE) is limited, however, in the measures it can take to collect the use tax unless federal law is changed. In 2002, the Franchise Tax Board included use-tax collection forms and envelopes in 540/540A booklets. Thus some data could be obtained as to how many use tax remittances were filed. Many individuals do not receive a booklet, however, and those who do could easily overlook the use-tax obligation because they do not read the booklet or because they thought the obligation could not be enforced.

One bill signed into law in September 2003 may improve enforcement of the use tax: SB 1009 (Alpert) adds a line to the personal income tax form for the reporting of use tax on online or out-of-state purchases; many people are not aware that they are liable for use tax, and a line on the income tax form might prove helpful. This bill also prohibits the state from contracting with a vendor, contractor, or an affiliate of a vendor or contractor that does not possess a seller's permit or a certificate of registration. This bill takes effect on New Year's Day, 2004.

One bill that was not signed into law was SB 103 (Alpert), which intended to clarify existing law to define when a retailer is engaged in business in this state. It also clarified that the processing of orders electronically, by fax, telephone, the Internet, or other electronic ordering process, does not relieve a retailer of responsibility for sales tax collection if the retailer is engaged in business in this state. At a Commission hearing in San Diego on October 23, 2003, Senator Alpert suggested she would try again in the next legislative session to pass a similar measure.

The Board of Equalization (BOE) has been making an ongoing effort to apply the California nexus statute to electronic commerce.[*] In BOE decisions in Borders Online and Barnes and Noble.Com, for example, the nexus statute terms "agent" and representative" include selling activities by the bricks- and- mortar operations of Borders and Barnes and Noble where their California stores accepted returns or distributed discount coupons for their online operations.[†] According to the prepared remarks of BOE Chairwoman Migden, presented by Steven Kamp to the Commission on October 23, 2003, "the message behind these decisions is loud and clear: do not try to use the Internet as a tax haven for your California stores. If the end result of your Internet commerce is a physical presence in California, you are going to be treated like every other store in the state." BOE members have also directed BOE staff to conduct a full-scale nexus audit of Barnes and Noble.Com.

Type of Action Required: Administrative

Balance of State/Local Authority: No impact

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[*] Revenue and Taxation Code Section 6203© (2).

[†] An article by BOE Chairwoman Carole Migden describing these BOE decisions is in the October 2003 issue of *Western City* magazine entitled "Leveling the Playing Field between Main Street and Out-of-State Retailers."

Improve Collection of the Use Tax on Remote Sales		
Guiding Principle	**Pro**	**Con**
Fairness	Purchases made remotely (over the Internet or by catalogue sales) should include sales tax. Currently, remote sales have a cost advantage over Main Street sales due to differential tax treatment.	The additional administrative burden to increase compliance may not be cost-effective with respect to the amount of revenue collected.
Simplicity	The use tax is already California law.	
Efficiency/ Balance	An existing tax should be enforced and collected.	Without changes in federal law, only limited measures can be taken at the state level to collect use taxes.

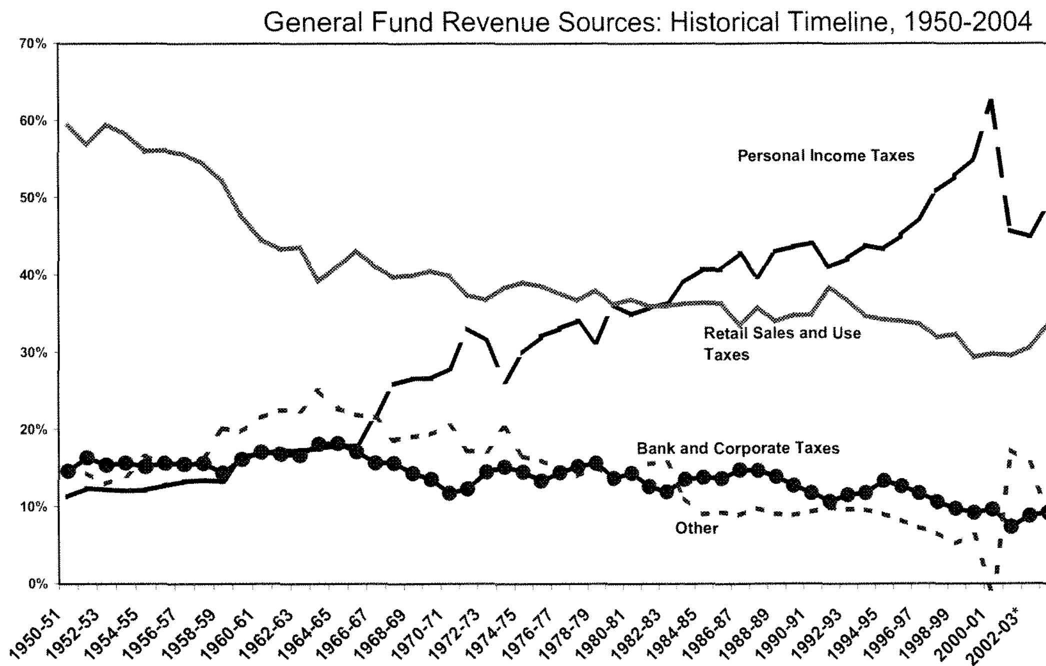
Broaden the Sales Tax Base to Include Selected Services and Reduce the Sales Tax Rate

Recommendation (8 yes votes): Broaden the sales tax base to include selected services, while lowering the rate to retain revenue neutrality. The Commissioners heard "Broaden the base and reduce the rate" frequently.

Minority View: One Commissioner voted for further study.

Comment: The Commissioners emphasized the importance of revenue neutrality in this proposal. This is not part of a 2-step process to increase the state rate at a later date.

Background: The shift in consumer expenditures from the purchase of goods to the purchase of services continues to raise concerns about the long-term vitality of state and local retail sales taxes, which traditionally are applied primarily to the sale of tangible personal property. In California, sales and use tax (SUT) revenues have not kept pace with overall economic growth over the past few decades. The chart below shows that in 1982-83, the personal income tax provided more General Fund revenue than the sales and use tax for the first time and has continued to do so ever since. Extending the SUT to services would constitute a change to the state's basic tax system and make it more reflective of the state's economy.



Compared with other states, California taxes only a few services. In its survey of sales taxation of services, the Federation of Tax Administrators found that in 1996, California taxed only 13 of the 164 services surveyed. Other large states taxed more services:

Texas (78), New York (74), and Florida (64). The states taxing the largest number of service categories were: Hawaii (157), New Mexico (152), Washington (152), and Delaware (142). More information about the sales taxation of services across states can be found at: http://www.taxadmin.org/fta/pub/services/services.html.

The Commission's recommendation to broaden the sales tax base and lower the rate is based on basic tax policy grounds. Applying the SUT to services has also been identified as one of a variety of options to address California budget problem. The Commission's recommendation is revenue-neutral and not intended to raise revenue.

An ideal sales tax would tax all retail sales once but only once, and at the same rate, to preserve neutrality. Neutrality would also require that the tax system treat the purchase of services in the same manner as the purchase of goods. This ideal sales tax would discourage retail purchases, but would not give a differential incentive to make one purchase over another. Ideally, business purchases would be exempted from the SUT. Taxing business inputs, such as accounting or legal services, as well as the goods or services sold by the business, can lead to tax pyramiding (or "cascading") and higher consumer prices.

Approximately one-third of the SUT is currently paid directly by businesses in the state, with two-thirds paid by individual consumers. Any SUT imposed on services would also be paid by both businesses and individuals, although their relative shares would depend on the specific services taxed. Even the portion of the SUT directly paid by businesses could eventually be shifted to consumers and other parties such as wage earners or shareholders.

On February 3, 2003, Assembly Members John Dutra and Jackie Goldberg presented the Commission with revenue estimates for the taxation of 36 services. A shorter list of 25 services was also presented. These services are listed on the following page in order of the size of their 2002-2003 sales receipts (and therefore potential sales tax revenues). Legal services had the highest potential sales tax receipts.* The majority of the retailers in italics have sales tax permits as they make some taxable sales. In 2002-3, the amount of revenue raised from a 6% tax would have ranged from $1.27 billion for legal services and $1.15 billion for engineering services to $79 million for taxidermy services.

The prepared remarks of BOE Chairwoman Carole Migden, presented by Steven Kamp to the Commission on October 23, 2003, proposed that the California Legislature consider taxing 18 of these services, possibly with a "sunset" clause after five years. Revenue estimates provided by the BOE Research and Statistics Section indicated that each year, state government loses $1.88 billion – and local governments lose an additional $1.1 billion – because these 18 services are not taxed by the state. Applying the California sales tax to these services would not create an incentive to leave the state because these services are taxed in many states, large and small. Moreover, many of the services are provided by California retailers that already have sellers' permits (because they sell taxable tangible personal property). The chart on the following page shows the

* Health care services, which have higher sales receipts than legal services, were not under consideration.

18 services, the number of states in which they are taxed, the number of large states in which they are taxed,[*] the percent of the population in states other than California with a sales tax that tax that particular service, and BOE revenue estimates for the particular service if it were taxed. The chart is current as of October 2003 and includes Ohio's sales tax base expansion that took effect August 1, 2003.[†] The majority of the retailers shown in italics already have California sales tax permits.

36 Services Considered for Sales Taxation by Dutra and Goldberg Sorted by 2002-03 Sales Receipts			
1	Legal services	19	Satellite/DBS TV
2	Engineering, architectural & surveying services	20	Moving – intrastate
3	Accounting and bookkeeping services	21	Landscaping services
4	*Hotels/motels lodging*	22	Linen and uniform services
5	Management, scientific & technical consulting services	23	Exterminating services
6	Cell phone services	24	Aircraft/limo charters
7	Custom computer programs	25	Pager services
8	Cable TV	26	*Swimming pool services*
9	*Repair labor*	27	Sale of memberships to private clubs
10	*Entertainment (admission)*	28	*Funeral services*
11	*Automotive repair services*	29	Telephone answering services
12	Security and detective services	30	Health Clubs, tanning booths & reducing salons
13	Janitorial services	31	*Marina services*
14	*Automotive services*[‡]	32	900 number services
15	*Laundry & dry cleaning services*	33	*Coin-operated amusement machines*
16	Custom telephone services	34	Pet grooming services
17	*Billiards/bowling facilities*	35	*Installation charges*
18	*Preliminary art services*	36	*Taxidermy services*

[*] The ten largest states (in population terms) other than California.
[†] Ohio Department of Taxation. *Tax Facts: Expansion of Sales Tax Base*. July 22, 2003. http://www.state.oh.us/tax.
[‡] Includes automobile washing, parking lots, storage and towing services.

18 Services Proposed for Sales Taxation by the Board of Equalization Sorted by Estimated State Sales Tax Receipts for California				
Service	Number of States	Number of Big States[*]	Percent of Population[†]	Ca. State Revenue Estimate[‡] ($ million)
1. *Vehicle Repair*	20	5	46.2%	$705.7
2. Real Estate Management	5	1	12%	$195.3
3. Laundries	21	4	44%	$157.6
4. *Beauty Shops*	5	1+NYC	15%	$153.7
5. *Admissions to Sporting Events*	32	5	58%	$106.0
6. *Appliance/Furniture Repair*	22	6	55%	$90.5
7. *Admissions to Amusements*	33	6	67%	$83.0
8. Security Services	12	4	37%	$82.9
9. Veterinarians	3	0	1.6%	$80.3
10. Parking	19	3	45%	$53.3
11. *Admissions/Golf*	22	4	52%	$48.5
12. *Funeral Homes*	13	3	22%	$41.5
13. Billboards	2	0	1.3%	$34.4
14. *Admissions to Bowling Alleys*	27	3	50%	$13.5
15. Crop Services	2	0	1.7%	$12.8
16. *Arcades*	18	1	29%	$11.0
17. Bail Bonds	4	0	2%	$5.6
18. *Shoe Repair*	20	4	43%	$1.5
Total				$1,877.10

Type of Action Required: Statute. Possible amendments to local ordinances.

With respect to an expansion of the base at the local level, state law and local ordinances would have to be reviewed in light of Proposition 218. There is a divergence of opinion as to whether an extension of the sales and use tax to services would be subject to the requirements of Proposition 218 as to the local portion of the tax, and as to what the impact of failure to comply with Proposition 218 would be.

Analysts at the Howard Jarvis Taxpayers' Association (HJTA), for example, argue that if there were a base expansion to cover services, then local governments would have to individually enact ordinances that include the revisions to the base. These ordinances would have to be approved by the voters pursuant to Proposition 218. HJTA further believes that a constitutional amendment, such as Proposition 218, prevails over any conflicting statutory provision, no matter when it was enacted.

BOE Chairwoman Migden's staff, on the other hand, argues that the legislature can amend Revenue and Taxation Code Section 7202 to remove all references to tangible

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[*] The ten largest states (in population terms) other than California. New York City (NYC) taxes beauty shop services.

[†] As used herein, the term "population" includes jurisdictions other than California that have a sales tax – i.e., 44 states and the District of Columbia.

[‡] These state revenue estimates do not include local revenues. The total local revenue number is approximately 58% of the state revenue number.

personal property and replace it with "the privilege of selling items of tangible personal property and services." Since local ordinances are operative only to the extent that they are consistent with Section 7202, the Legislature could simply pass, as part of the legislation, an amendment to Section 7202 that automatically amends, or requires amendment of ordinances, so as to make the local SUT base consistent with the state SUT base (the intent of Bradley Burns). BOE Chairwoman Migden's staff argues that Bradley Burns (1950s) predates Proposition 218 (1996), and essentially authorizes local sales taxes consistent (100%) with the state base.

Balance of State/Local Authority: A revenue-neutral decrease in the sales tax rate and expansion of the base to services would redistribute sales tax revenues away from cities with a relatively large retail base and towards cities with a relatively large service sector. This would affect the amount of sales tax revenues received by individual cities as well as land-use incentives faced by individual cities.

Broaden the Sales Tax Base to Include Selected Services and Reduce the Rate		
Guiding Principle	**Pro**	**Con**
Fairness	Historically, most services have been excluded from sales taxation because services are not tangible goods. An ideal sales tax would tax all retail sales once but only once, and at the same rate, to preserve neutrality. Neutrality would also require that the tax system treat the purchase of services in the same manner as the purchase of goods. This ideal sales tax would discourage retail purchases, but would not give a differential incentive to make one purchase over another. Many economists suggest that business purchases be exempted from the SUT – including the purchase of any services by businesses. This approach would eliminate tax pyramiding. Extending the sales tax to services and reducing the rate might reduce sales tax regressivity somewhat. The lower rate would help lower- income consumers who tend to have a higher consumption of goods than services. Generally, studies have suggested that expanding the SUT base to include a wide range of services would not significantly alter the regressive impact of the tax. For example, a study of Florida's sales tax on services detected only a very slight decline in the regressivity of the SUT.	Some services should not be taxed on grounds of fairness. Medical care is one oft-cited example. Taxes placed on particular services, as opposed to a broad-based tax on all services, could have some impact on the regressivity of the tax, depending on the nature of the services selected for taxation. Employment impacts of taxing services will also vary by service type and by sector, and thus result in different impacts on various income classes. Although an expansion to services would not generally affect the overall incidence of the SUT, the state's overall tax system itself could become less progressive. This would occur to the extent that SUT revenues constitute a larger share of total revenues.
Simplicity		Many service jobs are provided by small independent contractors who do not have extensive accounting and bookkeeping skills. Keeping track of and collecting sales tax would be difficult for them. These enforcement and compliance problems would also occur for "occasional labor," suggesting that a *de minimis* amount of services be exempt. The taxation of services used by multi-state companies would require additional enforcement and auditing activities in order to appropriately allocate the amount of the service "consumed" in California. Taxing services might give large firms an incentive to provide these services in-house to avoid taxation.

Broaden the Sales Tax Base to Include Selected Services and Reduce the Rate		
Guiding Principle	**Pro**	**Con**
Simplicity (continued)		Exempting services purchased by businesses could result in additional enforcement issues associated with the SUT, due to increased need to distinguish the purchase of personal services from business-related purchases.
Efficiency/ Balance	The economy is shifting toward the production of services over goods, so a goods-based sales tax will not keep up with the state's economic growth. Broadening the base and reducing the rate could result in a revenue-neutral proposal in the first year of the change. Over time, if services continue to grow, the proposal would not remain revenue neutral. These changes would decrease consumption distortions and allow for the possibility of decreasing the sales tax rate, thus reducing the burden of the tax on those buying goods.	Sales taxation of retail services might be so burdensome that small independent contractors and small firms might leave the business or evade the tax. Inefficiencies would occur if businesses shift their consumption of externally provided services to internal sources only in order to avoid the tax. The amount of revenue raised by taxing some retail services (excluding health care) would not be worth the hassle. If business purchases were exempted from the SUT, including the purchase of services by businesses, SUT revenues would be reduced substantially. Extension of the sales tax to services, such as those of lawyers and accountants, could change incentives for cities. It would not improve incentives to cities to build housing but might encourage them to build office buildings. Economists generally assume that an attempt is made to pass the SUT along to the consumer in the form of higher prices. Depending on the supply and demand characteristics for the product or service involved, production or consumption might drop somewhat if a new tax is levied or the rate on an existing tax is increased. Eventually this could also affect employment and wages in the industries directly affected. However, the ultimate impacts in such areas as overall jobs will also depend on the purposes for which any new SUT revenues are used, such as infrastructure spending.

Eliminate Selected Sales and Use Tax Exemptions or Exclusions

Recommendation for further study (unanimous): Eliminate selected sales and use tax exemptions or exclusions.

Commissioners voted that further study is necessary to identify the exclusions and exemptions to be eliminated.

Background: Various exemptions and exclusions from the sales and use tax apply to retail sales of tangible personal property. Since enactment of the Sales and Use Tax Law in 1933, many exemptions have been granted that remove the liability for tax for various types of property and certain individuals or organizations. Other transactions are excluded from imposition of sales and use taxes because of basic definitions contained in the law or because they do not involve the transfer of tangible personal property.

For example, the Legislative Analyst's Office recently recommended that the exclusion for custom computer programs be eliminated.[*] The rationale for this exemption is that custom computer programs consist largely of services delivered to the purchaser, and these services are simply embodied in the software. Since services themselves generally are not subject to the sales and use tax, the theory is that custom computer programs should also be exempt. However, this argument can equally be applied to various other items, most readily to other "off-the-shelf" computer programs, but also to books, musical recordings, and paintings. In fact, any item produced using substantial amounts of labor might fit this criterion. Eliminating this exemption would result in more consistency in the way that the sales tax is applied.

At the October 23, 2003 meeting of the Commission, the prepared remarks of BOE Chairwoman Carole Migden[†] pointed out over $500 million in sales tax exemptions listed under "Industry Benefit." The testimony recommended that the Legislature should seriously consider placing a sunset provision on each of these exemptions and determine whether the exemptions actually create sustainable jobs, or whether they simply reward business for something they would do anyway. In 2003, for example, the Legislature allowed the Manufacturers Investment Credit (MIC) to expire. The MIC was costing the state $400 million per year in lost income or sales tax revenue while the state experienced a net loss in manufacturing jobs during the 10 years of the MIC. Originally, the MIC was enacted to create 100,000 manufacturing jobs.

In 2001, retailers' sales of tangible personal property were exempted or excluded from more than $8.8 billion of sales and use taxes. Over 100 exemptions of tangible personal property were allowed from the sales tax.

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[*] Legislative Analyst Office, *Options for Addressing the State's Fiscal Problem*, February 2002 http://www.lao.ca.gov/analysis_2002/options/budget_options_2002-03.pdf.

[†] Presented to the Commission by Steven Kamp.

The top ten exemption and exclusion amounts claimed in 2001 were:*

- Residential Energy† - exemption — $3.3 billion
- Food Products - exemption — $3.2 billion
- Prescription Medicines - exemption — $709 million
- Animal Life, Feed, Seeds, Plants and Fertilizer, Drugs and Medicine - exemption — $344 million
- Custom Computer Programs - exclusion — $276 million
- Aircraft and Component Part Sales - exemption — $233 million
- Shipping Containers - exemption — $133 million
- Periodicals - exemption — $74 million
- New Mobile homes - partial exemption — $53 million
- Rentals of Linen Supplies - exclusion — $44 million

More information on sales and use tax exemptions and exclusions can be found at http://www.boe.ca.gov/pdf/pub61.pdf. This BOE Publication 61 was placed into the Commission's record in the prepared remarks of Chairwoman Carole Migden on October 23, 2003.

Information on recently exempted items, such as liquefied petroleum gas, farm equipment and machinery, diesel fuel, timber harvesting, and racehorse breeding stock, can be found at http://www.boe.ca.gov/sutax/sutexempt.htm.

General information on tax expenditures can be found at http://www.lao.ca.gov/tax_expenditure_299/tep_299_contents.html and at http://www.dof.ca.gov/HTML/FS_DATA/TAX/TE_Report_2002.pdf.

Type of Action Required: Statute

Balance of State/Local Authority: No impact

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* *State Board of Equalization 2001 – 02 Annual Report.*

† This amount does not include sales of energy to commercial users. *Sales and Use Taxes: Exemptions and Exclusions, Publication 61*, 2/02. http://www.boe.ca.gov/pdf/pub61.pdf.

Eliminate Selected Sales and Use Tax Exemptions or Exclusions		
Guiding Principle	**Pro**	**Con**
Fairness	The rationale for an exclusion or exemption can be categorized as a tax incentive to encourage certain behavior and/or as tax relief to certain groups or individuals. Some exclusions might be questionable on the principle of fairness. Moreover, since these exclusions are not reviewed annually in the budget process, exclusions that once might have been "fair" could have outlived their reason for being excluded from taxation.	On grounds of fairness, some items are justifiably exempt or excluded. The food exemption, for example, got 66% approval by the voters when they approved Proposition 163 in November 1992.[*] Many argue the food exemption also counterbalances the regressive aspects of the sales tax.
Simplicity	Fewer exemptions and exclusions would simplify sales tax collection and administration.	
Efficiency/ Balance	From an efficiency standpoint, some items are currently excluded for good reason and some are not.	Exclusions and exemptions affect the amount of General Fund and Special Fund revenues raised by the sales and use tax. They also have an impact on local government revenues since (except in certain instances) the programs affect both the state and local portions of sales and use tax receipts.

[*] David Doerr, *California's Tax Machine* (Caltax, 2000), p. 246.

PROPERTY TAX

Property/Sales Tax Swap

Recommendation (7 yes votes): Change the mix of local general-purpose revenue by decreasing the amount of sales tax revenue and replacing it with property tax revenue. The objective of this proposal is to decrease local reliance on the sales tax and increase reliance on the property tax.

Minority View (2 votes for further study): Commissioners had concerns about the impact of the swap on financing education, police, and fire. Whatever implementation plan is agreed upon by the Legislature, provisions for adequately financing education, police, and fire must be included.

Background: Under the 1955 Bradley-Burns Uniform Local Sales and Use Tax Law, cities and counties are allocated one percent of every retail purchase that takes place within their jurisdictional boundaries. The property tax allocation formula in statute provides a relatively small share of the property tax to cities. In the early 1990s, Governor Wilson and the Legislature diverted a large percentage of property tax revenues from local governments to education, often called the "ERAF shift."* This loss of property tax revenues by local governments has resulted in an increasing dependence on sales tax revenues, which are more volatile. In addition, over the last 30 years, voter-initiated propositions have reduced local governments' ability to raise tax revenue.

As a result of these developments, the only substantial local tax source that local jurisdictions can control is the sales tax. This control is exercised through land use decisions. Cities have a strong incentive to encourage the development of big-box retail stores within their city limits. It is argued that this "fiscalization" of land use skews land-use decisions toward retail use and away from housing, manufacturing and other uses that do not generate significant sales taxes revenue but are necessary for a balanced economy. The fiscal incentives embedded in California's present system of local government finance lead to endless competition among cities and counties for a finite amount of retail sales tax dollars.

Property/sales tax swaps are one way to restructure local government finance in an attempt to correct some of these problems. Different swap mechanisms have been proposed over the years; the tax-swap proposal debated in the 2003 Legislature was a bi-partisan measure introduced by Assembly Members Steinberg and Campbell, AB 1221. The general idea with this swap proposal was to reduce the one percent locally levied sales tax rate to ½ percent and replace it with an equal amount of property tax. Some observers think that a property-sales tax swap should only be done in conjunction with a revision of current property tax allocation formulas (AB 8).

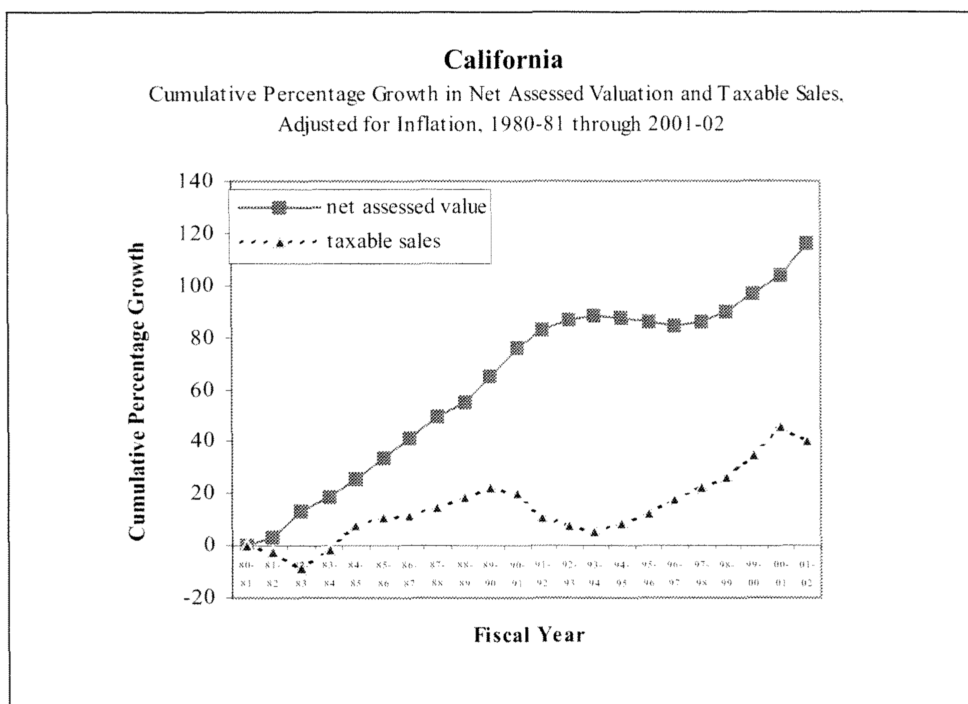
* "ERAF" refers to the Educational Revenue Augmentation Fund.

Details of how AB 1221 might work are provided on several websites:

http://www.californiacityfinance.com/.
http://www.muniservices.com/Default.asp?SID=3&SSID=45.
http://www.hdlccpropertytax.com/ab1221.asp.

A number of recent analyses have shown that California's major tax bases have grown at different rates over the past two decades.* The chart below shows that the property tax base, which is net assessed value, has grown more quickly and is more stable than the sales tax base, which is taxable sales.† Thus, proponents of swap mechanisms argue that historical patterns and economic trends show California local governments on the whole would be better off with more property tax and less sales tax. State government, on the other hand, would be worse off.

For individual cities, the critical comparison is how these two tax bases have grown over time in each city. In most cities, tax base growth trends are similar to the statewide trends: net assessed value in most cities has grown much faster than taxable sales and is also less volatile. Thus, most cities would be better off with a larger, faster-growing property tax base than with their current sales tax base.



* Steve Levy, "Analysis of California's Three Major Tax Bases," July 8, 2003 http://www.ccsce.com; Michael Coleman, "AB1221, Fiscal and Policy Implications for Cities," April 11, 2003, http://www.californiacityfinance.com/AB1221.pdf.
League of California Cities, http://www.cacities.org/doc.asp?intParentID=4337; Speaker's Commission on State/Local Govt. Finance, 2000, http://speaker.metroforum.org/links.html.

† Beginning in 1980-81, this chart shows the cumulative growth rate of each trend after adjusting for inflation. For net assessed value and taxable sales, the growth rates for each year shown on the graph are calculated using 1980-81 values as a base.

In July 2003, the State adopted the "Triple Flip," which is a modified form of the AB 1221 tax swap proposal, in its 2003-04 budget.* According to the Legislative Analyst's Office:

> Beginning in 2004-05, the budget package temporarily redirects a share of the local sales tax (equal to one half of one percent of taxable sales) to the state to use to repay the deficit reduction bonds. The budget package offsets local sales tax losses (almost $2.5 billion in 2004-05) by redirecting to cities and counties a commensurate amount of property taxes from the Educational Revenue Augmentation Fund (ERAF). Increased state education apportionments, in turn, will mitigate K-14 district revenue losses associated with the redirection of ERAF monies. This swap of sales for property taxes ends after the deficit reduction bonds are repaid.†

A crucial difference between the Triple Flip swap as enacted in the budget and the swap as proposed by AB1221 is that in the Triple Flip swap, the additional property tax revenue allocated to local governments each fiscal year equals the amount collected from the one-half-cent sales tax. Thus the Triple Flip swap is revenue neutral for each city and county every year it is in effect. Cities will get the same total amount of sales plus property tax revenue that they would have without the Triple Flip. Under AB1221, revenue neutrality occurs only in the base year; in subsequent years, differential growth of the sales and property tax bases would determine how each city and county's tax revenues would grow.

The Triple Flip makes proposed property/sales tax swaps unlikely for the five years the Triple Flip remains in effect. But the question remains: After the Triple Flip ends, should local revenues revert to the arrangement that existed before this year's budget (FY 2003-04), or should an arrangement such as the swap proposed in AB 1221 be the replacement? Moreover, voter approval in March 2004 of the $15 billion bond measure being discussed in December 2003 could completely change the outlook for a property/sales tax swap proposal once again.

Type of Action Required: Statute

Balance of State/Local Authority: In one sense, this proposal does not affect the balance of state/local authority since the state is using its current authority to set the state maximum local sales tax rate and allocate the property tax. However, local jurisdictions view the one-percent Bradley-Burns sales tax revenue as an important source of revenue and are uneasy with the prospect of swapping it away.

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* ABX1 7, Section 10, 1st Special Session, August 2, 2003.

† http://www.lao.ca.gov/2003/major_features_03-04/major_features_03-04.pdf, see p. 25.

Property/Sales Tax Swap		
Guiding Principle	**Pro**	**Con**
Fairness	The current system treats potential investors in housing less favorably than similarly-situated retail investors. The swap would make cities less reliant on sales tax revenue. We need a tax system that encourages adequate investment in housing along with investment in retail. The means of distributing sales tax and local government reliance on those sales tax revenues affect the land use decisions of local government.	High-sales-tax cities want to keep in place a system they have made work for them. Schools may not want to see property tax replaced with state general fund money.
Simplicity	To the degree that people believe that property tax revenues should be in the hands of local cities and counties, this measure would be a step towards achieving that goal.	While the allocation of sales taxes to local jurisdictions is straightforward (the locals get one percent of taxable sales), the current property tax allocation mechanism is complicated and little understood by most voters. A property/sales tax swap will make the system even more complicated.
Efficiency/ Balance	In the long run, reliance on state-controlled revenues does not provide an appropriate set of rewards and penalties for local government. The tax system is impeding the ability of the economy to produce housing at a time when housing costs are among the biggest challenges for businesses operating in California. Allowing local governments to keep a greater share of property tax revenues, perhaps in exchange for the state keeping an equivalent amount of sales tax or vehicle license fees, would reward the investments local governments make in increasing property values. The swap would also lessen the artificial impetus for promoting retail in lieu of other land uses, especially housing.	

Periodic Reassessment of Non-Residential Property

Recommendation for Further Study (6 yes votes): Periodically reassess non-residential property to market value without changing existing rates and in the context of improving the business climate in California.

Minority View (3 no votes): Some Commissioners had concerns that while periodic reassessment could correct tax disparities and therefore improve the business climate, it would also increase the tax burden on business.

Background: In the early 1970s, real estate values in California began increasing rapidly. As in most states, California's property tax system was market-based: real property was reassessed to market value on a regular basis. With soaring property values, however, California taxpayers experienced large increases in their property taxes. The legislature was unable to develop legislation to deal with the problem, but under Proposition 13, a citizen-backed initiative passed in 1978, all real property was revalued at the 1975 roll value plus an inflation adjustment of no more than two percent per year, unless there is a change of ownership or new construction. When properties change hands, the new base year value is typically the new owner's purchase price.

Although Proposition 13, which established an acquisition value-based instead of market value-based property tax system, has many advantages, certain inequities have developed. This recommendation deals with commercial and industrial properties. Similarly-situated businesses that compete with each other and receive the same public services may face widely differing property taxes. In extreme cases, these differences are as high as ten-to-one per square foot and more. For example, Macy's found its property was taxed higher than competitors' comparable property in the same shopping center.[*] Unless these properties change ownership, increasing land values are not regularly reflected into a property's assessed value.

By failing to tax increasing land values, some owners of valuable land keep that land off the market, which in turn encourages land speculation and inflates land costs for new construction and development. The tax burden weighs disproportionately on new investment, which not only pays full market value but also fees, exactions, easements and mitigations. Those who benefit from others' investments, that is, the landholders who accumulate untaxed windfall land rents, bear a much lighter tax burden. Many consider taxation of the increased value of land and property, particularly investment property, a relatively neutral and efficient way to tax. Proponents argue that it does not affect the investment decision in any way except perhaps positively, that is, it increases the intensity of property utilization, and is a highly efficient, "neutral" tax.[†]

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[*] *R.H. Macy & Co. v. Contra Costa County* (1990) 226 Cal. App. 3d 352.

[†] The following website has more information on this proposal: http://www.caltaxreform.org/ For more information on the assessment of commercial properties in California: Brian C. Brown. "Exploring Reassessment of Commercial Properties Owned by Legal Entities," Sacramento: Senate Office of Research, June 2003.

Although the proposed reassessment would increase economic efficiency, some in the business community are concerned about the overall tax burden. However, the placement of new equipment in service, in manufacturing, or in other investments, is taxed both at the sales tax level and at the personal property level. Consistent with these principles, efficiency, simplicity, and fairness might be served by a trade-off, at least in part, with regard to real and personal property tax. At the September 25, 2003 Commission hearing, it was noted that the proposal to periodically reassess nonresidential real property would increase the total property taxes owed by many businesses. To mitigate the increases due to periodic reassessment, an elimination of the tax on business personal property was proposed.

The Commission hearing also highlighted the data problems in this policy area and the need for further research. There was considerable discussion over issues such as

- Whether the property tax burden on residential taxpayers versus businesses is greater today than in 1978 because business properties do not turn over as often as residential properties.[*]
- The rate of business property turnover due to frequent remodeling.[†]
- The amount of property tax revenue gains that would result from periodic reassessment to market value.[‡]
- The definition of "non-residential" property. This recommendation includes commercial and industrial property as non-residential. Multi-family residential is not included as non-residential.

Type of Action Required: Constitutional amendment and implementing statute.

Balance of State/Local Authority: For the most part, the balance of state/local authority would be little affected because the state sets the rules covering *ad valorem* property taxation.

[*] Commissioner Lenny Goldberg argued that the property tax burden on residential homeowners has risen in recent years. See article at http://www.caltaxreform.org/empire.htm A rebuttal argument and data were presented at the Commission hearing by Terrence Ryan, Director, State and Local Taxes, Apple Computer. His testimony is included in the Proceedings of the Commission.

[†] A snapshot of the property tax roll was provided by the Public Policy Institute of California testimony before the Commission on September 25, 2003. The PPIC presentation, "Understanding California's Property Tax Roll: Regions, Property Types, and Sale Years," is available at http://www.ppic.org/content/pubs/OP_903TGOP.pdf

[‡] A statewide estimated revenue gain of $3.4 billion was estimated by Professors Terri Sexton and Steven Sheffrin in *The Market Value of Commercial Real Property in Los Angeles County, 2002*. CSU Sacramento and UC Davis: The Center for State and Local Taxation. The Los Angeles County Assessor Rick Auerbach contended that the $3.4 billion estimate was too high. Source: Auerbach, Rick. "Estimates of Los Angeles County's Commercial Property Values Too High in Proposition-13 Related Study," Press release, Los Angeles County Assessor, February 25, 2003.

Periodic Reassessment of Non-Residential Property		
Guiding Principle	**Pro**	**Con**
Fairness	Similarly-situated taxpayers should be taxed similarly. Under the current system, businesses that compete directly with each other may pay widely different property taxes.	If a split roll is passed, costs to commercial and retail businesses will in many cases be passed on to consumers and commercial tenants.
Simplicity	Current definitions of "change in ownership" are complex and subject to manipulation. Would reinstate the traditional system for assessing value for property tax purposes. The rules and methodologies are clear, and, while there are judgment calls, taxpayer compliance is a relatively simple matter.	There will be additional costs involved in recurrent commercial and industrial property inspections, appraisals, and reassessments. County assessors will have to hire additional staff. Assessment appeals hearings will increase. Under the current system, businesses benefit from knowing the exact annual increases in their tax bills.
Efficiency/ Balance	Our current system inflates the value of land and old buildings at the expense of productive investment. The proposed system with periodic reassessment would send the right incentives to local government for commercial and industrial development as well as for infrastructure.	A split roll could lead to such large increases in property taxes that it could force some firms out of business or cause them to leave California. Competition could be reduced and thus costs to consumers increased. Valuing non-residential (income-producing) property on a regular basis might increase or decrease values, depending on current economic conditions. This would worsen the budget outlook in an economic downturn by decreasing property taxes. Property taxes would be less stable as a source of revenue.

Periodic Reassessment of Non-Residential Property, Alternative Approach #1:

Recommend to the State Legislature that existing "loopholes" be closed, rather than create a "split roll." For example, consider existing change-in-ownership statutes and regulations. A change in ownership of a legal entity occurs upon acquisition of a majority share of a business's ownership. As a result, minority transfers of ownership (50 percent or less) do not trigger a reassessment, no matter how often they occur, unless a single buyer accumulates a majority share of ownership. Over the past decade, several bills have been discussed in the Legislature to address this problem, but none have passed to date. In the 2003-04 session, SB 17 (author: Senator Escutia) addressed this issue.

"Change in ownership" statutes and regulations are complicated. As a result of the many complex ways ownership interests can be held and transferred, many transfers of real property are excluded from the definition of "change in ownership" by the Revenue and Taxation Code. Educational materials prepared by the Board of Equalization's staff describe the proper application of "change in ownership" exclusions and also note that taxpayers are sometimes subject to unintentional reassessment as a result of failing to understand the statutory scheme that in some cases authorizes, and in other circumstances prohibits, "two-stage" transactions.

Complications that would be created by changing the "change in ownership" statutes as proposed in SB 17 were discussed at the September 25, 2003 Commission hearing. SB 17 would require publicly-traded corporations to track individual stock sales, so that once a cumulative 50 percent of the stock has changed ownership, a reappraisal of the entity's real property would be required. Publicly traded corporations have millions, and sometimes billions, of shares outstanding, and it is virtually impossible to track every single share. Sometimes, it is not unusual for large shareholders to trade the same 20 percent of the stock frequently in one year. Is that a change of ownership if the same 20 percent changes hands? SB 17 would also create a class of property owned by entities that are not publicly traded and would make those properties more difficult to track and create a disparity in the taxation on non-residential property. Finally, amending "change in ownership" statutes would only require a statutory change and would not require a constitutional amendment.

Periodic Reassessment of Non-Residential Property, Alternative Approach #2:

Periodic reassessment of non-residential property should be considered, provided it is structured to align revenue and responsibility in an innovative approach that will result in the highest-possible return on investment. The following are the essential components of a potentially workable approach:

a) Periodically reassess non-residential property on a cycle that approximates the average of residential property turnover in the state (perhaps as determined by the State Board of Equalization every decade).
b) The state authorizes local government through each County Board of Supervisors to establish an Infrastructure Investment Fund (which perhaps also could be used for affordable housing) that is capitalized by a periodic reassessment of non-residential property, provided it is also endorsed by a majority of the cities representing a majority of the population in the county.
c) An Infrastructure Investment Commission of reasonable size (perhaps 15 members) is appointed to advise on the investment and expenditure of funds in the Infrastructure Investment Fund, with a majority of the members representing owners of non-residential property who also reside in the county.
d) The Infrastructure Investment Commission must first develop an Infrastructure Investment Plan that is approved by the County Board of Supervisors and a majority of cities representing a majority of the population before any new non-residential assessments can be levied.
e) Infrastructure Investment Plan must be updated periodically (say, no less frequently than every five years).

LOCAL TAXES

Constitutionally Protect Local Revenues

Recommendation (8 yes votes): Provide a constitutional minimum allocation of property taxes to local governments.

Minority View: One Commissioner voted for further study.

Background: Everyone knows that Proposition 13 limited property tax revenues, but few citizens are aware that it also shifted power over those revenues from local governments to Sacramento. The separation of local responsibility for services from authority over the revenue needed to fund them has led to an unfair and unwise local tax policy. The state's allocation formula attempted to soften the blow of Proposition 13 by freezing 1978 distribution levels. This unfairly rewarded high- tax cities and penalized conservative cities.

Under the current system, the amount of property tax collected within a jurisdiction that is returned to that jurisdiction depends to a great extent on the level of government spending in that jurisdiction 25 years ago. Taxpayers in some cities receive ten percent of their money back; taxpayers in other cities get 25 percent. The state government has all the power to determine those percentages. However, voters assume that their property tax money is available to their local governments, and they hold local elected officials responsible for local public safety and infrastructure funding.

State officials' responses to complaints from local governments about property tax spending shifts have generally been that local governments should be responsible for raising additional revenues locally. This can be difficult, however. First, local officials are wary of asking for additional local taxes in an environment when existing local revenues are at risk of being taken away by the state. Second, the two-thirds vote threshold for special taxes means that very little opposition is needed to defeat revenue initiatives. In recognition of this, the state voters recently lowered the threshold for approval of school bonds to 55 percent.

These proposals would provide a constitutional minimum allocation of property taxes to local governments and would empower local officials to raise money for infrastructure, public safety, and other local public investments.

Type of Action Required: Constitutional Amendment

Balance of State/Local Authority: The proposal would prevent the state from reallocating a tax that is locally levied and tax revenue that is allocated to a local government by state statute, such as the property tax.

Constitutionally Protect Local Revenues		
Guiding Principle	**Pro**	**Con**
Fairness	A constitutional minimum allocation of property taxes to local governments could redress the differential distributions of tax revenues and could prevent further shifts of local money from local governments.	The proposal will constitutionally exchange one set of inequities in the local finance system for another. Cities with a narrow tax base and high tax rates would be frozen in the constitution (e.g. cities with a high reliance on the sales tax or utility user tax).
Simplicity	A consistent apportionment of property tax revenues to localities throughout the state would be simple and transparent.	The local finance system is currently complex and the local tax payer/voter has little understanding of where the money comes from to pay for services. Placing this system in the constitution will not improve its simplicity or understanding.
Efficiency/ Balance	The current tax system prevents local governments from determining how much revenue will be available and when. That uncertainty interferes with local government's ability to plan for investments that could support the productive capacity of the economy.	

Reduce the Vote Threshold for Local Tax Measures

Recommendation (6 yes votes): Reduce the vote threshold now required for approval of local special tax measures from two-thirds to 55 percent.

Minority View (3 no votes): Reducing the vote threshold to 55 percent would make it too easy to increase local special taxes.

Background: Seeking a two-thirds vote for deciding important issues has a long history. A two-thirds vote requirement can be found ten times in the United States Constitution, including the two-thirds vote needed to override a presidential veto or approve a treaty. Similarly, the two-thirds vote appears a number of times in the California Constitution. A legislative two-thirds vote for some tax increases appeared and then disappeared from the California Constitution prior to Proposition 13.

Several vote thresholds are currently in place for local revenues. Tax increases for general taxes need a simple majority to pass. Proposition 13 established the constitutional requirement of a two-thirds vote of the people for raising special taxes. When this provision of Proposition 13 was legally challenged, the California Supreme Court recognized that the initiative's intent for overall tax relief would not be achieved if reduced property taxes could easily be replaced by other taxes. The two-thirds vote of the people to raise taxes to support local general obligation bonds first appeared in the 1879 California Constitution. Currently, all local general obligation bonds except for school bonds require a two-thirds majority to pass. School bonds can pass with a 55 percent majority.

Type of Action Required: Constitutional Amendment

Balance of State/Local Authority: Lowering the vote threshold on local special taxes would make it easier for local government to raise local revenues and would increase local autonomy. Lowering the vote threshold would not affect the balance of state/local authority.

Other Related Proposals:

Related proposals discussed by the Commission include:

1. Lower the vote threshold for voter-approved local bond measures for purposes other than education bond measures, which are now at 55 percent.
2. Flip the two-thirds approval now required for "special purpose" local tax revenue measures and apply it to "general purpose" revenue measures. The simple majority approval now required for general- purpose revenue measures would then be applied to special purpose tax revenue measures. The vote threshold should be lower for special purpose revenue measures because voters and taxpayers by definition have more control over special purpose revenue measures.

Reduce the Vote Threshold for Approval of Local Tax Measures		
Guiding Principle	**Pro**	**Con**
Fairness	One "No" vote should not offset two "Yes" votes. It has also been argued that any requirement authorization of a vote of the people interferes with government officials' ability to manage local budgets.	The two-thirds vote is an established and recognized device in democratic government. The two-thirds vote standard offers some sense of consensus on tax-raising issues, particularly when off-time elections have low voter turnout. Under a majority vote standard, a tax on all the people could be raised by, say, the five percent of registered voters who vote at a low-turnout election.
Simplicity		
Efficiency/ Balance	Infrastructure improvements would provide economic benefits to local jurisdictions.	A lower vote requirement for general and special taxes probably would quickly lead to heavier tax burdens.

OTHER TAX POLICY OPTIONS

State Tax Court

Recommendation (unanimous): California should establish a state administrative body to operate like the U.S. tax court. This body would resolve all tax disputes, including personal income tax, corporate income tax, sales and use tax, property taxes,* payroll taxes, and excise taxes in accordance with the principles set forth in Professor Simmons' September 23, 2003 letter to the Commission.

Background: Proposals to form a state tax court have been discussed in California over the last 30 years. The Commission's recommendation is to create an administrative body to hear tax disputes, rather than a court under the judicial branch. This recommendation is based, in part, on the long-held opposition of the Judicial Council and other major stakeholder groups to tax courts and other specialty courts. Also, the creation of an administrative-level tax body conforms with the federal system, which has value in developing procedural rules. The process of decision-making in the U.S. Tax Court is not nearly as constrained by technical rules of process and evidence as that in judicial courts. Nonetheless, the existence of a dispute resolution process apart from elected administrators and policy advisors would help assure fairness in the resolution of cases on the basis of the facts and the law pertaining to the particular parties involved.

According to advocates of establishing a state tax court, the current system for both the administrative and judicial resolution of tax disputes in California does not provide a fair, reliable, or efficient means of resolving tax disputes, especially in comparison to the

* Including property tax disputes will require a constitutional amendment. Future discussion of this recommendation might consider eliminating jurisdiction over property tax issues from the proposed state administrative body.

procedures available to resolve federal tax disputes. The problems with the current tax-dispute resolution system in California may be summarized as follows:

1. The Board of Equalization ("BOE") is the only body in California to hear tax disputes on a prepayment basis. To get to a judicial resolution in Superior Court, taxpayers must pay the full amount of tax and interest assessed. Most taxpayers cannot afford this option and are therefore stuck with whatever the BOE or its staff decides. In contrast, federal tax disputes can be brought before the U.S. Tax Court without payment of tax. The mere possibility that taxpayers may exercise this option helps level the playing field between the Internal Revenue Service (IRS) and taxpayers and leads to more rational settlements.

2. Members of the BOE are elected officials and are not required to have any particular tax training or expertise. They are also, in a general sense, perceived as part of the same agency that administers the tax system. In contrast, Tax Court judges are well-trained and experienced tax professionals viewed as independent of the IRS and impartial.

3. Tax cases can be particularly technical and complex. The BOE only allows 10 minutes to present a case. Many practitioners feel compelled to contact Board Members in advance of the hearing (on an *ex parte* basis) to try to explain their cases. In contrast, a federal tax case can be presented in the format of a trial without absurdly short time restrictions.
4. The BOE publishes few of its decisions, thus providing little guidance to taxpayers. Since so few taxpayers avail themselves of a trial in Superior Court, there is very little judicial development of the state tax law. In contrast, the Tax Court publishes all of its decisions, thus providing valuable precedent as guidance to both taxpayers and the IRS.

Other policy reasons for an administrative state tax body, including the problem of an elected tax administrator, are set forth in Professor Simmons' letter, included in Appendix D.

The overriding theme of the proposal is conformity with federal procedures. Also, the creation of a state tax body should shorten the dispute- resolution process by reducing the number of steps needed to resolve a case. The system would not be duplicative; one level of administrative appeal and the hearing before the Board of Equalization could be eliminated. In addition, this proposal would reduce the need for staff at the Board of Equalization to find facts and draft decisions proposed for Board adoption. Some of the staff might be shifted to the tax body. Overall, an administrative tax body would create efficiencies in the decision making process that could result in cost savings to the State.

Example of an Administrative Tax Body Structure:

- The body could include five administrative law judges, appointed by the Governor and confirmed by the Board of Equalization or the Legislature. The administrative body would be formed under the legislative power rather than a court with stature equivalent to the Superior Court.

- The terms of appointment should be from 12 to 15 years.
- Each administrative law judge would probably require three law clerks and a secretary. The administrative body also would require a clerk's office and clerical personnel. The total number of people required would be in the range of 50.
- Cases would be heard by a single administrative law judge, who would make findings and draft an opinion. At the request of the chief administrative law judge or some number of the other judges, cases would be decided by the full body.
- The administrative body would develop its own procedures and rules of evidence. Following the lead of the U.S. Tax Court, strict evidentiary rules may not be necessary.
- The administrative body would publish its opinions as deemed by the judges to be significant. Other cases might be decided by unpublished memorandum decision.
- The administrative body might appoint masters to hear small tax cases, cases involving less than $5,000 of tax deficiency and for which the taxpayer elects a small case procedure. Decisions in small tax cases would be final, with no right to appeal.
- Decisions of the administrative body would be reviewable by the California Courts of Appeal.
- Appeals would be allowed both to the taxpayer and the Franchise Tax Board.
- Petitions for hearing before the tax body would be filed after an assessment by the Franchise Tax Board becomes final. Taxpayers would not be required to pay the tax before filing with the tax body.
- The administrative procedure before a final assessment could be shortened to include a single appeal before an appeals officer of the Franchise Tax Board or Board of Equalization.
- The tax body jurisdiction would include the individual income tax, the corporate and bank franchise taxes, sales tax disputes, and disputes over other taxes as the Legislature would determine. The list might include all taxes administered by the Board of Equalization. The tax body might also be empowered to here appeals of local tax assessments following denial by a county board of supervisors.[*]
- An alternative option to the tax body would remain for taxpayers to pay the tax and file a suit for refund in the Superior Court, in which case the taxpayer would forego recourse to the tax body.

Comments from the Employment Development Department (EDD): Since the proposed state tax body would cover payroll tax disputes, this would impact the role of the EDD in tax dispute resolution. The EDD is responsible for administering California's payroll tax programs, along with the Unemployment Insurance (UI) and Disability Insurance (DI) benefit programs that provide wage replacement for California's workers.

[*] The right to appeal might be restricted to questions of law, rather than a reassessment of fair market value.

The four taxes administered by EDD are: UI and Employment Training Tax (employer-paid) and DI and Personal Income Tax withholdings (worker-paid).

Although the term "payroll taxes" was not defined, it would most likely include, at a minimum, the four payroll taxes administered by EDD: UI, ETT, DI, and PIT. It is unclear whether this definition would extend to other taxes and fees for which employers are responsible, such as workers' compensation.

It should be noted that substantial analysis would be necessary to determine how EDD's payroll tax functions could be incorporated, while maintaining conformity with U. S. Department of Labor requirements for States' UI tax structures. Additionally, further exploration would be needed to define the future role of the California Unemployment Insurance Appeals Board with regard to the UI benefit program appeals process.

Type of Action Required: Statute and Constitutional Amendment.
A constitutional amendment would be needed if property tax were to be handled by the proposed state tax court instead of local assessment appeals boards for locally assessed property and instead of the Board of Equalization for Section 11 property.

Balance of State/Local Authority: No impact. At the Commission's September 9, 2003 hearing, there was some discussion about whether the state tax body would have jurisdiction over local tax disputes. It was clarified that local tax disputes were not included in this proposal.

State Tax Court		
Guiding Principle	**Pro**	**Con**
Fairness	The highest forum to which most taxpayers can pursue their tax appeals without payment of tax, interest, and penalty is the State Board of Equalization. Board members serve for limited terms and are not required to be trained specialists in tax law. With certain limited exceptions, an administrative resolution of disputes does not take into account the "hazards of litigation." This factor, when objectively applied by independent tax resolution specialists, encourages the settlement of tax disputes. Instead, for many taxes, California maintains an all-or-nothing policy, thereby forcing taxpayers to concede the entire amount in dispute or pursue litigation.	California already has a tax court that is open to the public and directly accountable to the voters. It's called the Board of Equalization (BOE), though perhaps the Board's name should be changed to the California State Tax Commission. Both the BOE and the Franchise Tax Board have settlement programs, affording taxpayers the opportunity for administrative resolution with a staff of trained accountants, auditors and attorneys. In addition, taxpayers may take their case to a public hearing before the elected Members of the Board of Equalization. Each of the 5 members is advised by an independent staff of trained accountants, auditors, and attorneys, but unlike the proposed tax-body judges, they are accountable to the voters.

State Tax Court		
Guiding Principle	**Pro**	**Con**
Fairness (continued)	In the context of resolving disputes between taxpayers and the tax collector, the elective nature of the Board of Equalization causes an inherent structural conflict. One can easily imagine that a campaign slogan for an elected tax collector would be, "Elect me and I will not collect taxes from you (even if those taxes are due under the law)."	
Simplicity	There is no practical judicial alternative to dispute resolution. In the federal system, taxpayers unable to settle with the Internal Revenue Service can present their case to the U.S. Tax Court without paying any tax, interest, or penalty. In contrast, the resolution of most tax disputes in California in Superior Court requires the payment of tax, interest, and penalty in full before the Court gets jurisdiction. The argument is made that this requirement deprives most California taxpayers of any judicial resolution. Additionally, the judges of the U.S. Tax Court are trained and experienced in tax law. In contrast, virtually all Superior Court judges have no particular tax expertise.	The issue of pre-resolution payment of tax liabilities can be addressed without replacing the Board of Equalization with a Tax Body (then-Speaker Hertzberg introduced a bill to allow posting of a bond as an alternative to payment). The Tax Body proposal would take only tax cases away from Superior Court judges, even though there is no requirement that Superior Court judges have any particular legal specialization. The current system gives taxpayer an opportunity for a three-part resolution: (i) before the agency staff in the settlement programs; (ii) before the elected Board of Equalization; and (iii) in Superior Court, if the taxpayer chooses to pay the liability in full before suing for a refund. Substantial analysis would be necessary to determine how EDD's payroll tax functions could be incorporated, while maintaining conformity with U. S. Department of Labor requirements for States' UI tax structures. Further exploration would be needed to define the future role of the California Unemployment Insurance Appeals Board with regard to the UI benefit program appeals process.
Efficiency/ Balance	The publication of decisions by the U.S. Tax Court provides a growing body of judicial precedent that can serve as guidance to all taxpayers. In contrast, California has a very limited number of published decisions on tax disputes.	The Board of Equalization publishes decisions on tax disputes. There is no need to create an unaccountable new agency primarily for this purpose.

Flat-Rate Taxes

Recommendation for Further Study (7 yes votes): Eliminate all current taxes in California except for "sin taxes," such as cigarette and alcohol taxes, and establish two new taxes, a six-percent flat-rate personal income tax and a six-percent flat-rate business value-added-tax.

Comment: Commissioners found the simplicity of the flat-tax system attractive and want more research on this proposal. They were concerned, however, about the regressive effects of a flat-rate tax system on low-income earners.

Minority View (2 no votes): Those who favor progressive taxes believe rates should be based on ability to pay.

Background: Like the proposal to extend the sales tax to services and reduce the tax rate, the flat-tax proposal broadens the tax base and reduces rates. The value-added tax (VAT) base, for example, includes services as well as tangible products. The low VAT rate and the simplicity of the flat-tax system are what make this proposal politically attractive.

Dr. Arthur Laffer presented his proposal to the Commission on April 23, 2003 and July 18, 2003. His flat-tax system is designed to minimize the disincentives induced by tax rates and yet still provide the requisite amount of revenues to provide the services Californians want and need. As a revenue-neutral proposal, it is designed to raise the same amount of revenue as the current system. The revamped tax structure with a six-percent tax rate for both taxes would replace, on a revenue-neutral basis, the $120-billion now generated by California's state and local taxes.

A flat-rate tax applies a single tax rate equally to all sources of income, and that rate does not change as a result of the taxpayer's income. All other taxes should be repealed. In their place would be two flat-rate taxes of equal rates on personal unadjusted gross income and on business value-added. There should be one and only one tax for people and businesses to pay.

Discussion of the Flat-Tax Proposal - At the July 18, 2003 hearing, Mr. Phil Spilberg from the California Franchise Tax Board argued that the flat-tax proposal:

- Would have to overcome certain conceptual and perception problems.
  - The flat-tax proposal would need to overcome the perception that income is being taxed twice. For example, take a doctor who files as a sole proprietorship. Under current law, income is passed through to a personal income tax (PIT) return, but under the flat-tax proposal, income is taxed under both the PIT and the VAT.
  - Destination-based VATs are simple in concept: you start with the value of goods and services sold in California and subtract the value of inputs acquired in other states. But it is very difficult and highly contentious to calculate the value of inputs because many are acquired from commonly owned corporations. No state has adopted a destination-based VAT.
  - An origin-based VAT (such as Michigan's Single Business Tax, described below) would be levied largely on wages and salaries and other labor inputs. The VAT is conceptually quite different from the corporate income tax.

- Would need substantially higher rates than six percent for the PIT and the VAT to be revenue-neutral.
- May prove difficult to administer.
- Would create many winners and losers.
  - Likely losers are businesses and low-income taxpayers.
  - Likely winners are property owners and high-income taxpayers.
- Would impose substantial transition costs
  - New technical and administrative systems would have to be developed.
  - During the transition period both the old and the new tax systems would need to be administered, which will drive up costs.
  - Revenues could substantially deviate from estimates.
  - There would be economic disruptions, which are costly in and of themselves.
- Would further reduce the link between taxpayers and consumers of public goods.
  - Except for user fees, local governments would lose their own revenue sources.

Implementing this flat tax proposal would be very complicated. For example, if all current taxes in California except for "sin taxes" were eliminated, then presumably this would eliminate California's unemployment insurance (UI) tax, which is administered by the Employment Development Department (EDD).* If so, it should be noted that the UI tax and benefit program is administered in accordance with both federal and State laws. Under federal law, the UI tax program must contain an experience-rating component (and so could not be supplanted with a flat tax). Failure to do so would result in a finding of nonconformity by the U.S. Department of Labor, and loss of the federal UI tax credit for all affected California businesses. The result would be a substantial net increase in UI costs for California businesses.

Details of the Flat-Tax Proposal - Despite the seemingly uncomplicated nature of the theory behind the flat tax, practical application requires some unavoidable complications. For example, mortgage interest rates have to remain deductible as long as interest income is taxable. If someone borrows $100,000 at seven percent and lends $100,000 at seven percent clearly that person should not be liable for taxation. That person is simply a conduit for a loan. And yet if a person borrows $100,000 at seven percent and lends $100,000 at ten percent, then that person should be liable for taxation on the difference. All interest income should be taxable and all interest expense should be deductible. To avoid fraud and manipulation, individuals' interest deductions should be limited to mortgage interest. Allowances should also be made for personal charitable contributions. "Sin taxes," such as excise taxes on cigarettes and alcohol, exist both to raise revenue and to discourage certain behaviors. These "sin taxes" would need to remain in place along with fines, penalties, etc.

For business value-added, there should not be any specific deductions other than all purchases from other companies. One unusual feature of business value-added under the flat-tax is that all purchases from other companies—including capital equipment—would be expensed when purchased. This has the effect of leaving undepreciated capital on the books of firms. Therefore, during a transition period this proposal would allow

* It is not clear from the proposal whether the intent is to eliminate California's UI tax.

businesses to continue their depreciation over time, leaving the tax rate a little higher than it otherwise would be.

Starting with personal income and gross product as the base measures for the personal income tax base and business value-added tax base, respectively, the appropriate adjustments are made as discussed above to arrive at approximations for both tax bases.

The appropriate flat tax rate is obtained by dividing targeted revenues by the total tax base. Dr. Laffer's FY 1990 analysis* suggested that the business value-added tax base was a little larger than the personal income tax base, resulting in a recommended flat tax rate of slightly less than six percent on both the business value-added tax base and the personal income tax base. These calculations have been updated through FY 2000 using the most current state and local data available. To raise the targeted level of state and local revenue, the required flat tax rate on the personal income tax base and the business value-added tax base has ranged between 5.81 percent and six percent. Therefore, a six-percent flat rate would be more than enough to achieve the necessary state and local tax revenues.

Type of Action Required: Constitutional amendment and implementing statute.

Balance of State/Local Authority: This proposal would establish a set of uniform rates that would pre-empt local taxation. Local authority to increase/decrease levels of local taxation to meet increases/decreases in local services would be limited.

* Dr. Arthur Laffer, Victor A. Canto and Associates, "A Proposal for California Complete Flat Tax," October 1990.

Michigan's Single Business Tax (SBT) - Michigan is the only state in the U.S. that has enacted a value added tax (VAT). The Michigan SBT, however, is an origin-based VAT in contrast to the European VAT and Dr. Laffer's proposed VAT for California, which are both destination-based VATs.* One reason Michigan was attracted to the VAT was because the previous system was highly unstable, leading to boom and bust cycles. Michigan's 1975 Tax Reform Goals also included simplicity and equity across types of business organization, among other goals. In Michigan's experience, the SBT has produced more stable revenues, but it has tended to grow more complicated over time. Constant pressure to enact special provisions erodes the tax base. In addition, the apportionment formula has changed and made the tax more complex.

It should also be noted that Michigan is in the process of phasing out the SBT by 2009. The reasons for this phase-out should be considered in evaluating whether California should consider imposing a VAT based upon the Michigan SBT or a European model. The following table summarizes some advantages and disadvantages of the SBT as they were presented to the Commission on July 18, 2003.

Michigan's Single Business Tax	
Advantages	**Disadvantages**
More stable revenue source	Unpopular to pay taxes when business loses money
Tax neutral to labor/capital choices	Excess compensation reduction favors labor
Does not penalize profits	Gross receipts reduction favors integrated firms
No rate or base increase since inception	Statutory exemption favors partnerships
Base decreases from beginning and rate cuts since 1999	Higher compliance costs
Small business relief reduces revenue only about 10%	Only 33% of all filers pay tax based on pure value-added...BUT over 65% of excess compensation filers are included as VAT filers.
Tax neutral to choice of legal organization	

* The difference lies in the fact that with a destination-based VAT, the incidence of the tax is on the consumer (similar to a sales tax), and with an origin-based tax, the incidence falls on the firm. With an origin-based tax, the firm will be in a position to pass the tax along to the customer, but it will not be obvious because it will probably not be disclosed as part of the purchase price. In the case of a destination-based tax, the tax is disclosed as part of the purchase price.

Flat-Rate Taxes		
Guiding Principle	**Pro**	**Con**
Fairness	The tax is uniform, meaning that all taxpayers' pay the same rate and are treated the same. Reducing the number of deductions for income tax payers, but allowing both a deduction for rent as well as mortgage payments, would help ensure equitability.*	Those who favor progressive taxes believe rates should be based on ability to pay. Reducing the number of deductions and credits for income tax payers would remove, for example, the personal independent exemption. For two persons with equal incomes, this would result in a single person paying the same amount of tax as a family household head with children. There would be winners and losers: Likely losers: businesses and low-income taxpayers Likely winners: property owners and high-income taxpayers.
Simplicity	Individuals and businesses would be aware of their income tax or value-added tax liability, and with reduced deductions could easily figure out their tax obligation. This plan is specifically designed to increase tax compliance by having a simple, broad-based, low tax rate for individuals and businesses to comply with. Personal income tax and business value-added tax would be due on a regularly scheduled basis.	Methods of distribution of revenues to local jurisdictions would have to be established. This proposal would add enormous complexity to the filing of personal income tax returns. The current system taxes adjusted gross income, which does not include income sources such as health benefits, life insurance benefits, IRA and 401K income, interest on federal obligations, and employer contributions to pensions. Dr. Laffer is proposing to tax personal income, which does include these income sources, but calculating personal income would be very complex for individuals. No state has adopted a destination-based value-added tax. In concept it is simple: you start with the value of goods and services sold in CA and subtract out the value of inputs acquired in other states. But it turns out that it is very difficult and highly contentious to calculate the value of inputs because many are acquired from commonly owned corporations. Records are not kept on cross-state border transactions. New technical and administrative systems would need to be developed for the new tax system. During the transition, both the old and the new tax systems would need to be administered, driving up costs. Under federal law, the unemployment insurance (UI) tax program must contain an experience rating component and so could not be supplanted with a flat tax) to remain in conformity with federal law. Failure to do so would ultimately increase UI costs for California businesses.

* Homeowners effectively rent from themselves with pre-tax dollars. Renters, on the other hand, pay their rent in after-tax dollars. Therefore, to be kept on an even footing with homeowners, renters should be allowed to deduct rent on their primary residence from their overall tax base.

Flat-Rate Taxes (continued)		
Guiding Principle	**Pro**	**Con**
Efficiency/ Balance	The cost of complying for the income tax payer should not change from the current situation. By reducing the income tax to one rate and simplifying or eliminating deductions and credits, the current income tax system would be simplified. Moreover, the extent of real simplification will depend on how easy it is to convert federal taxable income to CA taxable income. By lowering the top personal income tax rates, concerns that high-end taxpayers will leave the state to avoid excessive taxation should end. This flat tax system is designed to create dynamic change for the economy, bringing in more revenue soon and into the future.	Loss of local control: Except for user fees, local governments would lose their own revenue sources. Economy theory suggests that there is a loss in efficiency when the link between the taxpayer and the public goods received is loosened. Business may react to the value-added tax provisions by bringing certain services in-house rather than contracting for those services, thus avoiding a value-added tax on those particular services. Business will need to change procedures to calculate the value-added tax instead of current corporate and personal property tax collection as well as other taxes. The state may not know what to expect in revenue since the income tax is volatile and would make up a larger portion of the tax system than it does presently. During the transition period, there would be economic disruptions, which are costly in and of themselves. The uncertainties of tax calculations could mean that the initial tax collection could be off. The FTB argued that the value-added tax would need to be higher than the proposed 6%, but somewhat lower than Armey's flat-tax rate of 13%.*

* Representative Dick Armey (H.R.2060, July 19, 1995), U.S. House of Representatives

PROPOSED STRUCTURAL REFORMS OF THE STATE BUDGET PROCESS

The current state fiscal structure does not provide for an effective and understandable limitation on state spending, an adequate reserve to meet uncertain economic conditions, a method for rebalancing a budget that is in deficit, and a longer fiscal planning horizon for fiscal policy.

Recommendation: Amend the California Constitution to do the following: 1) In order to make the spending limit more transparent, revise it to limit spending based on population and economic growth, 2) to reduce the fiscal shock of an economic downturn, require the maintenance of a reserve, 3) establish a system for rebalancing the state budget when it becomes unbalanced, and 4) initiate a fiscal planning requirement that would require the state budget process to plan longer than 12 months. Part 5 of this proposal describes changes that would foster a "culture of accountability" in the budget process.

1. Revise the current spending limit:

   Growth in state general fund spending would be tied to growth in the state's economy and its population. The interface between the spending limit and constitutional obligations such as the K-14 spending guarantee contained in Proposition 98 would need to be worked out.

2. Reserve requirement:

   Revenue exceeding the spending limit would be placed in a reserve account. The maximum reserve would be 10 percent of general fund spending measured by the prior- year general- fund expenditure level. Once the 10 percent requirement is met, revenues in excess of the amount needed to fund the budget under the spending limit and to maintain a 10 percent reserve would be available for appropriation for one-time infrastructure spending or one-time tax rebates.

3. Rebalancing an unbalanced budget:

   When the state runs a deficit of more than one percent of general fund spending, the following-year budget growth would be limited to "current services" as provided in the prior fiscal year, adjusted for case load growth and the amount of spending growth needed to meet the K-14 funding level required by the Proposition 98 guarantee.

4. Multi-year budget planning requirement:

   Beginning in an odd-numbered year, require that the governor present a two-year budget plan along with the annual submission of the budget. The spending plan would cover two fiscal years and would provide a two-year spending and revenue blueprint into which the two annual fiscal year budgets would fit. The budget plan would be enacted by statute at the same time that the first annual budget is signed. The spending plan legislation would provide the basis for the second year budget.

5. Foster a "culture of accountability" in the budget process:*

A "culture of accountability" and an "ethic of customer service" must be infused throughout all of government so that taxpayers can better evaluate performance by their representatives. Increased accountability will help taxpayers view government operations not just as expenditures, but rather as "investments" from which they can expect certain "dividends" that benefit them. A public spotlight on outcomes and performance may also foster a greater willingness by taxpayers to "invest" more for particular purposes based on expected results.

- To improve accountability, require the state and all political subdivisions to prepare budgets that delineate measurable objectives.
- To eliminate barriers and promote efficiency, require each county along with all political subdivisions within that county to periodically hold joint hearings (e.g., once every ten years) to determine the smallest number of separate taxing authorities and political subdivisions needed to efficiently and effectively achieve the performance outcomes specified in the collective budgets. Such a plan could be required to be submitted to the voters for approval to increase individual responsibility and accountability. This approach to efficiency is complementary to the concept of a "Community Charter" (as recommended by the Constitution Revision Commission) and ensures that the citizenry has an opportunity to regularly review and engage in the design and structure of government.

Type of Action Required: Statute

Balance of State/Local Authority: Limited impact

* As per the recommendations from the Bay Area Council and the Speaker's Commission on State and Local Government Financing.

OTHER TAX ISSUES DISCUSSED BEFORE THE COMMISSION

PARTICIPATION IN THE STREAMLINED SALES TAX PROJECT

One of the charges of the Commission was to discuss taxation issues relating to the Internet. As part of this charge, the Commission heard testimony on the taxation of remote sales and considered whether California should participate in the Streamlined Sales Tax Project (SSTP) as a voting member. On October 8, 2003, legislation authorizing California's participation as a voting member in the SSTP was approved by Governor Davis.* While this legislation made it unnecessary for the Commission to vote on this proposal, the Commissioners all agreed that further study is necessary to determine whether California should change its sales and use tax laws to conform to the Streamlined Sales and Use Tax Agreement.

Analysts from the Board of Equalization have advised the Commission that such changes would require a major overhaul of California's sales and use tax laws and regulations. California is ready for any federal legislation that results from the SSTP, but should enact SSTP legislation only after ensuring that the legislation passed by Congress does not limit the state's business activity taxes or its SUT revenue base, other than the requirement that each state use a single rate† for taxing remote sales. California has been in compliance with this requirement for more than a decade.‡

Background: The Streamlined Sales Tax Project is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The Project's proposals include tax-law simplifications, more efficient administrative procedures, and utilization of emerging technologies to substantially reduce the burden of tax collection. When a minimum of ten states that impose sales taxes and comprise 20 percent of the U.S. population have amended their laws to comply with the SSTP's final product, the Project's participants will petition Congress to address the issue of remote sales. Hopefully, this process will conclude with a level playing field for remote sellers and brick-and-mortar firms – those firms with a physical presence in California – with regard to the collection of sales and use taxes.

There are three levels of SSTP participation: public participation, observer, and voting participant. California attained observer status in March 2003 due to a vote of the Board of Equalization; legislation to attain voting status (SB 157, Bowen) was approved by Governor Davis in October 2003. To represent California and vote at SSTP meetings, SB 157 established a Board of Governance consisting of two Members of the Senate chosen by the Senate Committee on Rules, two Members of the Assembly chosen by the Speaker

* SB 157, author: Senator Bowen.

† The Streamlined Sales and Use Tax Agreement does allow for a second state rate of zero for drugs.

‡ In 1987, when the remote sales issue related to "catalog sales," California enacted Revenue and Taxation Code Section 6203 © (4)(B) – Statutes of 1987, Chapter 1145 – which applies the basic California sales tax rate (i.e., no local add-on taxes) to remote sales upon the enactment of any congressional act that authorizes states to compel the collection of state sales and use taxes by out-of-state retailers."

of the Assembly, one member of the State Board of Equalization, one member of the Franchise Tax Board, and one member of the Governor's Department of Finance.

More information on the SSTP and the SSUTA can be found at these websites:

- The official website of the Streamlined Sales Tax Project tracks the general level of participation at: http://www.streamlinedsalestax.org/statestatus.pdf.
- National Governors Association http://www.nga.org/nga/salestax/1,1169,,00.html.
- National Conference of State Legislators http://www.ncsl.org/programs/fiscal/stateactionchart2.htm.
- The Equipment Leasing Association http://www.elaonline.com/GovtRelations/State/Streamometer/index.htm.

Type of Action Required: Statute, Administrative

Balance of State/Local Authority: No Impact. Although California has separate tax rates at the state and the local level, there is a uniform tax base for taxation of retail sales.

Participation in the Streamlined Sales Tax Project (SSTP)		
Guiding Principle	**Pro**	**Con**
Fairness	Remote sellers currently are not required to collect state sales taxes while retailers with a physical nexus in the state are required to collect such taxes. By streamlining the sales tax, the SSTP agreement will help move towards a more level playing field between remote sellers and firms with physical nexus.	California has one of the largest economies in the world; yet, under the SSTP, the state would have one vote and would be buying into a proposal that is 85 percent complete. California would be joining the SSTP too late to influence the process. Participation in the SSTP in and of itself will not level the playing field by allowing for taxation of all remote sales. Implementation will still require federal approval. Real fairness will prevail when this matter is addressed by the Congress and becomes a national policy.
Simplicity	Currently there are approximately 7,500 different sales- tax collection districts in the United States, using a wide variety of rates and definitions. The Project's goals are to provide uniform definitions, rate simplification, ease of administration, simplified exemptions, and uniform audit procedures.	Conforming California's laws to the SSTP will require an overhaul of California's sales and use tax system. Under the SSTP, legislatures choose what is taxable or exempt in their state. However, participating states must agree to use the SSTP's common definitions for key items in the tax base. There are definitional differences between California law and the existing SSTP definitions. To conform to the common definitions, some products currently exempted from taxation in California might have to be taxed, or alternatively, some products currently taxed would be exempted.* The entire sales -tax system must be brought into compliance with the SSTP, not just that for remote sellers. SSTP would still allow different tax rates. Exemptions would still allow states to have 50 different codes.
Efficiency /Balance	Compliance with the SSTP's final product will allow for a more predictable sales- tax base since it will stop the leakage resulting from the growth of remote sales. Administrative burdens on the state will be decreased. The SSTP has resulted in the development of software and technology models to aid in the administration of sales and use tax collection. These changes would decrease consumption distortions and allow for the possibility of decreasing the sales tax rate, which would reduce the burden of the tax.	Conformity with the SSTP will not necessarily result in additional taxes being collected and will not stop the leakage resulting from remote sales growth. Only if Congress enacts a federal statute authorizing states to compel the collection of state sales and use tax by out-of-state retailers will states be able to impose and obligate the collection of taxes. Businesses would be burdened with identifying the location of the purchaser.

* One example of a consumer product whose tax status might have to be changed if California were to conform to the SSTP is drugs. In California, prescription drugs are currently exempted from sales tax and over-the-counter drugs are taxed. As a general rule under the SSTP, all drugs would have to either be taxed or exempted.

TELECOMMUNICATIONS TAXES

Telecommunications taxes were discussed at several Commission hearings. This is a very complex issue and is one of the areas under the Commission's mandate. The Commissioners did not formally vote on telecommunications tax proposals. They felt they did not have the time and resources to delve further into the issues. They agreed, however, that this tax policy area is extremely important and needs further study and consideration.

Two academic studies on telecommunications taxes in California were made available to the Commissioners. Professor Terri Sexton presented the 2003 report, *The Taxation of Telecommunications in California in the Information Age,* to the Commissioners on April 21, 2003. The second study, by Mr. Dean Andal, *The Andal Report: Taxation of Telecommunications and Energy in California, 1996* was distributed to the Commissioners after a November 2003 discussion with the Tax Policy Group of Governor-Elect Schwarzenegger's Transition Team. These two studies are briefly summarized on the following pages.

The Commissioners discussed two tax policy reform proposals regarding telecommunications:

1. Simplifying all telecommunications taxes into one statewide tax.
2. Levying an eight percent tax on direct broadcast satellite television service.

As used herein, the term "telecommunications taxes" means property taxes, franchise fees, utility user taxes, and surcharges. The surcharges, which are administered by the Public Utilities Commission (PUC), include charges for rural, low-income and deaf-assistance services, emergency services and PUC reimbursement fees.

Property taxes may be state-assessed or locally assessed, depending on the entity providing the telecommunications services. State-assessed providers are not subject to Proposition 13 protections and are assessed annually at fair market value by the Board of Equalization. Locally assessed property is assessed by county assessors and, because it is protected by Proposition 13, it will potentially enjoy lower assessed valuation than fair-market value.

Franchise fees are imposed on gross receipts by local governments for use of local rights-of-way and for the right to do business.[*] Telephone companies are not subject to franchise fees, but cable television providers are subject to them.[†]

Utility user taxes (UUT) are imposed by cities or counties on residential and commercial users of utilities, including telephone services and cable television services. These taxes are usually imposed at a fixed percentage of the cost of the service, although some local jurisdictions have low-income or senior-citizen reductions or exemptions.

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[*] Public Utilities Code sections 6001 et seq. and 6201 et seq.

[†] Public Utilities Code section 7901, *County of Los Angeles v. Southern California Telephone Company* (1948) 32 Cal. 2d. 373 and the California Government Code section 53066.

PUC-administered surcharges were first authorized in 1983 by the Moore Universal Telephone Service Act.* The Act authorized up to a four-percent tax on intrastate telephone service to fund what has grown into three programs: the Universal Lifeline Trust Surcharge (providing subsidized minimum monthly service for low-income persons); the California High Cost Fund Surcharge (a subsidy to customers of smaller local exchange carriers) and the Deaf Equipment Acquisition Trust Fund (a subsidy to companies for the cost of providing telephone services to deaf or hearing disabled customers). Other surcharges include the Emergency Telephone Users Surcharge, which provides funding to local government for the state-mandated 911 systems,† and the PUC Reimbursement Fee.‡ These two surcharges are also imposed as a percentage of the cost of intrastate telephone service.

* California State Statutes, 1983, Chapter 1143.
† Revenue and Taxation Code section 41030.
‡ Public Utilities Code section 431.

Summary of Major Findings: James E. Prieger, Terri A. Sexton, and Annette Nellen. *The Taxation of Telecommunications in California in the Information Age,* 2003

> "The telecommunications industry is undergoing rapid change due to technological advances and deregulation. The industry that began with the telephone now includes cable, wireless and satellite communications, and the Internet. California's tax system has not kept pace with the telecommunications industry. The myriad taxes and charges on telecommunications in California were established for an industry that was legally, technologically, and structurally very different than it is today. Many taxes remain targeted to a specific technology (e.g. telephone taxes or cable franchise fees), despite the blurring of distinctions between technologies that provide similar services (e.g., the telephone and Internet telephony). The convergence of formerly distinct communications technologies renders the existing tax structure difficult to justify in terms of economic efficiency or equity."[*]

Some of the findings of this study are that in California:

- Cumulative tax rates (including all taxes, fees, and surcharges) are higher for telecommunications services than other goods and services.
- The distribution of the burden of current telecommunications taxes is not equitable according to any accepted equity principle.
- The tax burden varies across technologies, with little economic justification.
- The current set of telecommunications taxes leads to at least a 4% efficiency loss. The existing tax structure may also result in dynamic efficiency losses, which compound over time.
- Consumers' choices between competing telecommunications services are affected by differences in taxes on these services.
- Telecommunications costs vary among cities and counties due to variations in the local utility user tax (UUT) and local franchise fees. The UUT ranges from zero to 11% across cities; the UUT tax base also varies.
- A comparison to neighboring and other large states shows that California does not impose relatively higher tax rates, but does have a greater number of state telecommunications taxes, which raises administrative and compliance costs for telecommunications companies doing business in the state. Telecommunications taxes, therefore, probably play a negligible role in business or household decisions to locate in California, but may influence the ***siting?*** choices of some heavy users of telecommunications within the state.

[*] James E. Prieger, Terri A. Sexton, and Annette Nellen. *The Taxation of Telecommunications in California in the Information Age.* Berkeley: Regents of the University of California, California Policy Research Center, 2003. http://www.ucop.edu/cprc/telecomtaxrpt.pdf

Summary of *The Andal Report: Taxation of Telecommunications and Energy in California*, 1996

> "California's system for taxing telecommunications and energy companies was developed long before technological advances made open competition inevitable. It was designed around a rate-based model for utilities selling one service and possessing a government-sanctioned monopoly. Open competition with multiple telecommunications and energy products offered by many well-capitalized competitors is upon us. Competition benefits the average Californian as it brings high quality, diverse services, lower prices, and extraordinary job growth. Unfortunately, California's present tax system is a clear and present barrier to achieving these benefits of open competition."*

What's wrong?

A. Tax system retards development of the information superhighway (i.e. a predominantly fiber-optic broadband information network). Examples of impediments include:

   a. The need for cable companies to negotiate franchises with each city increases administrative and compliance costs both for companies and local governments.
   b. There is no assurance that similarly situated cable operators pay the same proportionate amount of franchise fees.
   c. Wireless television companies are not subject to franchise fees, creating a competitive advantage relative to cable companies.
   d. Telephone companies may be able to use existing free rights-of-way to expand into new technologies while non-telephone companies may not.

B. Property tax system is too litigious and burdensome.

C. Open competition is discouraged by an uneven tax system. The best example here is the difference between the property tax assessment of cable television and local exchange telephone carriers.

D. Excessive utility taxes create poverty. As of fiscal 1994, 17 cities had utility taxes that exceed 8 percent. Manufacturing plants have a strong incentive to avoid these cities because of their heavy usage of electricity and the threat of millions of dollars in utility taxes they wouldn't need to pay in other jurisdictions. It's no coincidence that many of these same cities with high utility taxes also have higher-than-average unemployment rates.

E. Telecommunications Surcharges† are abused...The largest of these surcharges is the Universal Lifeline Trust Fund Surcharge...Unfortunately, although income guidelines exist for program eligibility, there is no verification of *actual* eligibility. Many people who are not low-income could be receiving this service simply by asking for it....Moreover, California forgoes approximately $50 million dollars annually in federal funds conditioned on state verification of eligibility in the lifeline service program.

The Solution:

- remove differential taxation as an obstacle to the advancement of telecommunications,
- reduce the costs to state and local government for administering the property tax system,

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* Dean Andal, "Taxation of Telecommunications and Energy in California." *State Tax Notes*, March 18, 1996, page 891. The *Andal Report* was also published by the Board of Equalization in January 1996.

† The five telephone surcharges are Universal Lifeline, High Cost Fund, D.E.A.F. Fund, Emergency Telephone Users (911), and the PUC Regulatory Fee. Electricity surcharges are the PUC Regulatory Fee as well as the Low Income Ratepayer Assistance and Energy Resources Surcharge.

- eliminate the need to separately negotiate and collect franchise fees on a company by company basis,
- ensure the replacement of existing revenue streams to local government and offers a dedicated revenue source.

The Andal Report suggested that Californians should adopt a constitutional amendment creating a single telecommunications tax structure in lieu of the existing property tax and franchise fee system. This new structure would treat all participants the same whether they are delivering telephony or video by fiber-optic or wireless systems. This proposed constitutional amendment would establish a single gross receipts tax at a rate fixed in the constitution. The proposal caps local utility user taxes at a maximum of eight percent and creates the Universal Telecommunications Surcharge.

Statewide Communications Simplification Tax

Proposal discussed before the Commission: Combine all state and local taxes, fees and surcharges charged on providers of electronic communications services (e.g. telephone companies, cellular companies, cable television companies, satellite companies) and their customers into one statewide tax on customers' communications bills. This statewide tax would be collected by distributors and allocated by the State Board of Equalization to state and local jurisdictions currently receiving revenues from existing taxes, fees and surcharges on a revenue-neutral basis, meaning that the total amount of revenue collected from all sources under the simplified tax would be essentially equivalent to the amount collected currently.

Background: Digital communication is at the heart of the New Economy. One important result is convergence: the power of monopolies, legal or perceived, is diminishing; providers, which traditionally offered only one service, are now capable of offering multiple services subject to various tax and fee obligations; and, technology is rapidly offering a host of new alternatives to providers and consumers. Increasingly, the federal, state and local government regulation of providers and services is put at issue by the deployment of new technologies to accommodate consumers. Simply put, current taxes, fees and surcharges on communications predate the Internet, or the Internet Tax Freedom Acts. Moreover, no one can reasonably predict future market choices consumers will make and the consequences for state and local taxes and fees. For example, will traditional telephone markets be altered significantly by cellular or Internet Protocol (IP) telephone? Or, will WiFi technology* displace landline broadband market share? Or, what will be the impact of bundling of services by a single provider into a single rate when those services are subject to different taxes and fees at the state and local level?

Old-paradigm taxes, fees and surcharges on communications providers and consumers designed to meet the revenue needs of the state and its political subdivisions - including, but not limited to, franchise fees, utility user taxes, property taxes, and California Public

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* WiFi, or Wireless Fidelity, is a wireless Local Area Network (LAN) standard that is a fast-growing wireless broadband technology. It is a wireless substitute for landline broadband Internet access like Digital Subscriber Line (DSL) or cable-modem services.

Utilities Commission (PUC) telephone surcharges - are premised on monopolies offering discreet services with stable technology. They, therefore, cannot insulate the state's revenue base from technological change, competitive choice, or regulatory flux, and call for consideration of structural reform.

Florida is an example of a state that has already put a simplified communications tax in place,* but its experience demonstrates that structural reform is a time-consuming process. It took Florida two years for the state government, local government, industry, and other interested parties to agree on the final form of legislation. Moreover, any such reform cannot take place at the cost of important state policies such as safety (i.e.: 911 support) and universal service.

Other suggestions before the Commission concerning a simplified tax system include:

- The consideration of a single statewide telecommunications tax should be coupled with a dedication to statewide infrastructure, including accelerating the deployment of broadband.
- This area needs immediate attention: The strategy of letting the telecom industry evolve to a new steady state and then adapting tax policy sometime in the future is not acceptable because existing tax policy is influencing the evolution itself.
- There should be an examination of the goals and objectives of our universal service program in light of changing technology.

Type of Action Required: Statute, Regulation, possible Constitutional Amendment

Balance of State/Local Authority: To the extent that the State moves toward a uniform tax for communications, the issue of the uniformity of the tax base and tax rates will need to be addressed. In a fashion similar to the state sales tax, where the state has levied uniform rates for distinct purposes, the desire for a uniform rate for communications will need to consider the effects on local tax rates. Options include a maximum permitted local rate (similar to the sales tax) or a state rate high- enough to establish a subvention to local governments for the revenue lost due to a statewide uniform tax rate. A system with subventions to local governments is likely to be viewed by the local jurisdictions with unease, however. If new local taxes were imposed, approval by the voters would be necessary because of Proposition 218. To the extent that the proposal removes the ability of local governments to levy franchise fees or the utility user tax on communications providers, this could reduce local fiscal authority.

* Florida Communications Services Tax Simplification Law, Taxation and Finance Code, Title XIV, Chapter 202.

Statewide Communications Simplification Tax		
Guiding Principle	**Pro**	**Con**
Fairness	Ensures that tax differences would no longer play a role in a consumer's decision to choose a provider or technology.	Undermines the system of locally levied taxes on communications. Today, not all cities have a telecom utility users tax. With the state collecting what would be a new tax for some cities, local voters would need to approve the tax due to Proposition 218. The state would need a system to allocate a portion of the tax to local governments. Certain modes of communication may naturally require less regulatory oversight and have less expensive cost structures than other modes of communication. It may not be fair to tax all modes equally. If the state tax weren't coordinated with federal taxes across the different technologies, current disparities might be increased.
Simplicity	Permits taxpayers and providers (who collect these taxes) to understand the rules and comply with them correctly, and in a cost-efficient manner.	It is not explicitly stated how funds will be allocated to provide services such as universal service and 911 support.
Efficiency/ Balance	Insulates state and local tax revenues, broadens the tax base, eliminates multiple tax filings, and gives providers the greatest flexibility to deploy technologies and services with certainty as to the burdens associated with such offerings. This will encourage investment in California infrastructure and customer choice. Deployment of the most efficient technologies and elimination of consumption distortions.	Current locally levied taxes on communications might be replaced by state subventions, which might disappear during economic downturns.

Direct Broadcast Satellite (DBS) Tax

Proposal discussed before the Commission: Impose an eight-percent tax on Direct Broadcast Satellite service that approximates the tax and fee burden on cable television operators and subscribers.

Background: Rather than trying to revamp and modernize the entire telecommunications tax system with a simplified tax structure, this approach would work within the current tax system and attempt to impose a state tax on satellite television operators that is equal to the total state and local taxes and fees currently imposed on cable operators. Taxing satellite is an example of an incremental approach: keep adding taxes to a less-than-perfect system to try to adjust one part of the system. One problem with the incremental approach is that it continues to consider the delivery of the service instead of the overall type of tax desired. Another problem is that it ignores the fact that some of the current taxes and fees paid by cable, particularly the franchise fees paid to local government, are paid in exchange for benefits (such as access to public rights-of-way) that satellite does not receive. If there are particular costs to local governments to build and maintain infrastructure, or a particular benefit received from state or local governments, perhaps a user fee on the industry that imposes the costs or receives the benefits – such as the franchise fee paid by cable -- makes sense. If the objective is to generate revenue from consumer use of telecom or broadcasts, consumption should be taxed.

The following table summarizes taxes and fees for cable television and direct broadcast satellite (DBS). Cable television is locally assessed and as a result, receives the benefit of Proposition13's acquisition-based valuation system and annual cap on valuation growth. Cable companies also pay property tax on the value of their use of the public rights-of-way (possessory interests). Cable companies pay a franchise fee to local government for the right to use public rights-of-way to connect with subscribers' premises of as much as five percent on their gross revenues.[*] Cable television had about 8 million subscribers in California. Cable companies had revenues of $3.8 billion; cable representatives report that these companies and their subscribers paid over $300 million in local taxes, utility user taxes, and local franchise fees combined. For cable companies, this would amount to paying an average of five percent of their revenues in franchise fees, and three percent in property taxes, other local taxes and utility user taxes combined.[†] The Andal Report (1996) asserts that the "imposition by local governments of a franchise fee on wire communications skews the competitive advantages in favor of wireless communications."[‡]

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[*] *State Tax Notes*, March 18, 1996, p. 891-2.
[†] The data in this paragraph were provided by the Cable industry to the Commission.
[‡] *State Tax Notes*, March 18, 1996, p. 904.

	Local Telecommunications Taxes and Fees				FCC Orbit Slot Fee
	Property Tax		Franchise Fees	Utility User Tax	
	Locally-assessed	Taxable Possessory Interest	Cable Rate Regulation Act		
*Pass through?***	*NO*	*NO*	*YES*	*YES*	*NO*
California Reference	*Cal. Const. Art. XIIIA.*	*Cal. Const. Art XIII, § 1; Rev & Tax § 107 (a); Rule 21*	*Gov Code § 53066; 47 U.S.C.A 542 (a)*	*Cal. Const Art. XI § 5; Gov. Code § 37100.5*	
Cable TV	X	X	X	X	
DBS	X				X
Source for local telecommunications taxes and fees: The Andal Report, *State Tax Notes*, March 1996 p.911 **A pass-through tax or fee is one that is levied on the subscriber, but collected by the telecom company.					

As of April 2003, the DBS industry had 2.2 million California subscribers, approximately one-third the number of cable subscribers.* DBS companies generate gross revenue of over $1.5 billion in California. DBS providers pay the same locally assessed property taxes, income taxes and equipment taxes as are paid by cable. DBS companies do not pay local franchise fees because they do not use public rights-of-way. Instead, DBS providers today must pay very significant amounts, to the FCC or in the secondary market, for the DBS orbital locations above the Equator where their satellites must be located, in addition to the significant investments in constructing and launching their satellites. Cable companies do not need to obtain these scarce orbital/spectrum resources from the federal government and do not incur such expenses. Pursuant to Section 602 of the Federal Telecommunications Act of 1996, which prohibits local governments from imposing a tax on DBS, and also because they do not use local rights-of-way, neither DBS companies nor subscribers pay local franchise fees or utility user taxes. Neither DBS companies nor cable companies pay California Public Utilities Commission surcharges and taxes.

Nineteen states and the District of Columbia apply state sales taxes equally to satellite and cable TV.† Only two states, Ohio and North Carolina, tax DBS customers but not cable viewers. The satellite industry has initiated legal action in both of these states, challenging the constitutionality of these laws. Tennessee and Florida tax both satellite and cable TV, but provide more favorable tax treatment to cable TV. The satellite industry has initiated legal action in Tennessee challenging the constitutionality of the difference in tax treatment and is reviewing its legal options in Florida.‡

The cable and satellite industries disagree as to whether a DBS tax is consistent with the Commission's charge under Revenue and Taxation Code Section 38065§. Cable

* According to the satellite industry testimony before the Commission on May 22, 2003, there were 2,234,357 DBS subscribers in California as of April 1, 2003. DTH subscription counts, provided by Sky Research, are an aggregate total of DIRECTV, ECHOSTAR and C-Band subscriptions.

† Arkansas, Connecticut, Hawaii, Indiana, Iowa, Kansas, Maryland, Minnesota, Mississippi, Nebraska, New Mexico, Pennsylvania, South Carolina, South Dakota, Texas, Utah, Vermont, West Virginia, and Wisconsin.

‡ The information in this paragraph was provided by satellite industry testimony on May 22, 2003.

§ See section 602(c) of the Federal Telecommunications Act of 1996.

representatives argue that California added Part 15 to the Revenue and Taxation Code many years ago to ensure tax parity between cable companies and other providers, but that code has not been amended to keep pace with the DBS industry. Satellite representatives argue that the current code does result in parity, that the cable franchise fee is not really a tax but a fee paid by cable companies for benefits they receive, and that a state tax on satellite but not on cable would be contrary to the Commission's charge.

At the May 22, 2003 meeting of the Commission in El Segundo, a lively debate was held between advocates and opponents of taxing DBS services but not cable services. The main issue of debate was the relationship between the proposed state DBS tax and the local franchise fees paid by cable.* Satellite television providers testified that imposition of a state satellite tax would not "level the playing field," but would give the dominant cable providers another competitive advantage. In their view, a DBS-only tax would unfairly charge their customers for costs only applicable to cable service, such as the right to use local rights-of-way for which cable operators pay local governments a franchise fee. Further, a DBS-only tax effectively would give cable companies a credit for their payment of franchise fees, a cost of doing business, but no credit to DBS providers for FCC payments, also a cost of doing business. They also cited DBS's spectrum handicap as one example of the many advantages of cable over satellite. The DBS spectrum constraint makes it much more difficult for satellite than for cable to provide subscribers availability of local stations as an important criterion in choosing their multi-channel video provider. Moreover, in rural areas where there is no cable service at all, a DBS-only tax would unfairly penalize rural consumers for whom satellite service is the only available option. Satellite providers urged that if the Commission recommends a state tax on DBS, it should recommend an equal state tax on cable as well.

Type of Action Required: Statute

Balance of State/Local Authority: No impact, assuming the proposal would not limit the ability of local governments to levy franchise fees and utility user taxes.

* The *Joint Venture Tax Policy Workbook* has an explanation of the difference between taxes and fees on pages 30-31: http://www.jointventure.org/taxpolicyworkbook/JVSVTaxWorkbook.pdf . There is also a reference to this discussion on page 46 of James E. Prieger, Terri A. Sexton, and Annette Nellen. *The Taxation of Telecommunications in California in the Information Age*. Berkeley: Regents of the University of California, California Policy Research Center, 2003. http://www.ucop.edu/cprc/telecomtaxrpt.pdf

Direct Broadcast Satellite (DBS) Tax		
Guiding Principle	**Pro**	**Con**
Fairness	A tax on subscribers that is collected by DBS operators through subscribers' bills would provide for transparency and visibility by delineating that the tax exists, and how and when it is imposed upon them and others. Like currently existing sales-and-use taxes, it can be structured to minimize non-compliance. Most importantly, a tax on DBS provides competitive neutrality in an important area of the new economy by balancing the burdens between providers of multi-channel video service. Tax differences would no longer play a role in a taxpayer's decision to choose cable or DBS.	The proposed DBS tax attempts to create regulatory parity between cable and DBS providers, but it ignores other technologies, such as telephone services (broadband and standard services), which are substitutes for cable and DBS services. Certain taxes and fees may apply only to certain technologies (e.g. local taxes and fees for cable, federal fees for orbital spectrum for satellite). A state tax on DBS-only that is supposed to equalize the taxes and fees imposed on cable at the local level may penalize a more efficient technology. How do federal fees on DBS play into the proposed equalization of the burden between cable and DBS at the state level? A tax on DBS and not cable is a discriminatory tax and therefore unconstitutional. Imposing a tax on DBS but not cable would almost certainly result in legal action against the State. A tax on DBS unfairly discriminates against Californians who live in rural areas not served by cable. The DBS-only tax unfairly charges satellite customers for costs only applicable to cable service. Cable franchise fees are a normal cost of doing business, no different from the fees DBS providers pay to the Federal government, but a DBS-only tax would not take into account those federal payments. Such a tax only concerns itself with attempting to equalize the local payments made by cable.
Simplicity	A tax paid by a subscriber at the time of payment of a DBS bill will be at a time or in a manner that is most likely to be convenient for the taxpayer. It will also permit taxpayers to understand the rules, and comply with them correctly and in a cost-efficient manner. Collection by the DBS provider and remittance to the State will keep collection costs to a minimum for both the government and taxpayers.	Creates a new tax rather than incorporating it into the current tax structure.

Direct Broadcast Satellite (DBS) Tax (Continued)		
Guiding Principle	**Pro**	**Con**
Efficiency/ Balance	A tax on DBS will give the State a reliable revenue base: migration of customers to DBS will no longer result in decreased revenues because, even if local governments are losing tax and fee revenues, the State tax will shift any overall revenue reduction from cable subscribers to satellite subscribers. A DBS tax will also promote economic growth by encouraging competition based on innovation and consumer satisfaction, not tax and fee differential.	Requires a structure to be set up to administer the tax. Cable is losing customers to satellite not because of cost disadvantages due to "unfair" tax policy, but because cable companies have raised rates almost 50 percent over the last few years. A tax on DBS could encourage cable to continue their annual rate increases, to the detriment of consumers. The DBS-only tax would stifle economic growth by penalizing companies that made substantial investments in new technologies. These new technologies bring digital entertainment and information to Americans at a more affordable cost. It is unfair to burden DBS customers with a punitive tax.

APPENDIX A: COMMISSIONER BIOGRAPHIES

Commissioners Appointed By the Governor:*

The Honorable William J. Rosendahl, of Mar Vista, Chairman, is the Vice President of Political Affairs for Adelphia Communications. He is also producer, host, and moderator of Public Affairs shows, which feature comments and commentary on the people and issues of the day. Currently, Mr. Rosendahl is Chairman of the California Cable Telecommunications Association and serves on the boards of the California Channel and Cable Positive.

The Honorable Sean Burton, of Los Angeles, is the Senior Vice President of Pacific City Home, a real estate investment fund and master developer focused on building housing for working families in California. He was formerly the Vice President, Corporate Business Development & Strategy for Warner Bros. Mr. Burton is an officer (Intelligence) in the United States Naval Reserve and also served in the Clinton Administration on the President's Task Force on National Health Care Reform, for the Office of the Vice President, and with the Democratic National Committee.

The Honorable Larry Carr, of Morgan Hill, is a Council member for the City of Morgan Hill, having been elected in November 2000. Before taking office as a Council member, he served as an elected member of the Morgan Hill School Board. Mr. Carr is the Director of Education and Workforce Preparedness for the Silicon Valley Manufacturing Group. He also serves on the Board of Workforce Silicon Valley and the Industry Initiative for Science and Math.

The Honorable William Dombrowski, of Davis, is the President of the California Retailers Association, a position he has held since 1994. He represents major retail stores, mass merchandisers, major grocery store and drug store chains, and convenience stores. Mr. Dombrowski was appointed by Governor Davis in 1999 to serve on the Industrial Welfare Commission, and serves as its chair.

The Honorable Scott Peters, of San Diego, is a member of the San Diego City Council, having been elected in November 2000. He is a former partner at Peters & Varco LLP, where he represented businesses, local governments and public interest groups on environmental law issues. Mr. Peters is a City Representative on the Metropolitan Transit Development Board and the San Diego Association of Governments' Regional Planning Committee. In 2002, Speaker Wesson appointed Mr. Peters to the California Coastal Commission.

* These appointments were made by Governor Gray Davis.

California Commission on Tax Policy in the New Economy

Commissioners Appointed by the Senate Rules Committee

The Honorable Lenny Goldberg, of Davis, is Executive Director of the California Tax Reform Association and owner of a public interest advocacy and consulting firm.

The Honorable Glen Rossman, of San Jose, is Vice President of Cisco's Tax Department. Glen is directly responsible for all income, federal, franchise, sales/use, property, and local county taxes.

Commissioners Appointed by the Speaker of the Assembly

The Honorable Marilyn C. Brewer, of Newport Beach, is a former member of the California State Assembly, where she created the School Facilities Task Force, bringing together community leaders, school officials, and business executives to focus on the need for local school facilities. Prior to being elected to the Assembly in 1994, she was an Executive Assistant to Orange County Supervisor Thomas Riley.

The Honorable William Weintraub, of Los Angeles, is a partner in the law firm of Jeffer, Mangels, Butler and Marmaro, where he specializes in estate and tax planning, as well as client representation in resolution of tax disputes. He is also a former Adjunct Professor at the University of Southern California.

APPENDIX B: COMMISSION HISTORY AND LIST OF PRESENTATIONS

Chronological History

September 24, 2000	SB 1933 (Vasconcellos) establishes the California Commission on Tax Policy in the New Economy and identifies its mandate. The Act requires the Commission to submit to the Governor and Legislature an interim report not later than 12 months from the date of its first public meeting and a final report not later than 24 months from the date of its first public meeting.
September 25, 2001	SB 934 (Sher) continued the California Internet Tax Freedom Act (moratorium on taxing internet access and online computer services) until January 1, 2004, *unless*, the California Commission on Tax Policy in the New Economy fails to submit its interim report to the Governor and Legislature by December 1, 2002, *in which case*, the California Internet Tax Freedom Act is continued until January 1, 2003 (repealed one year sooner).
January 29, 2002	Public meeting held in Sacramento
March 20, 2002	Public meeting held in Sunnyvale
May 16, 2002	Public meeting held in Santa Monica
July 29, 2002	Public meeting held in Bakersfield
September 18, 2002	Public meeting held in San Diego
November 19, 2002	Public meeting held in Redondo Beach
November 25, 2002	*Interim Report* submitted to the Governor and Legislature in accordance with SB 934
February 3, 2003	Public meeting held in Sacramento
February 12, 2003	Conference Call
February 24, 2003	Public meeting held in Sacramento
March12, 2003	Public meeting held in Sacramento
March 24, 2003	Public meeting in San Francisco cancelled
April 14, 2003	Public meeting held in Los Angeles
April 21, 2003	Public meeting held in Sacramento
May 22, 2003	Public meeting held in El Segundo
June 15, 2003	*Options for Revising the California Tax System* submitted to Governor Davis, at the Governor's request.
July 18, 2003	Public meeting held in Beverly Hills
September 9, 2003	Public meeting held in Los Angeles

September 25, 2003	Public meeting held in San Francisco
October 16, 2003	Conference Call
October 20, 2003	Conference Call
October 23, 2003	Public meeting held in San Diego
November 17, 2003	Public meeting held in Newport Beach
December 31, 2003	Final report due to the Governor and Legislature in accordance with SB 1933.
January 1, 2004	SB 1933 repealed

January 29, 2002: Sacramento

How the Internet Affects the Board of Equalization
Honorable John Chiang - Chair, California Board of Equalization

Tangible and Intangible Taxable Property
Mike Brownell - Multi-state Technical Legal Coordinator, Franchise Tax Board

The Shifting Tax Base from Tangible Goods to Services and E-commerce and its Effect on State Revenues
Alan Auerbach, Ph.D. - Chair, Department of Economics, UC Berkeley

The Changing Economy in California and its Impact on Tax Revenues
Terri Sexton, Ph.D. - Associate Director, Center for State and Local Taxation, UC Davis Chair, Department of Economics, CSU Sacramento

The Dos and Don'ts of Tax Policy for the New Economy
The Nuttiness of State and Local Taxes – And the Nuttiness of Responses Thereto
Charles McLure, Ph.D. - Senior Fellow, Hoover Institution, Stanford University

Bagley-Keene Open Meeting Act
Kathryn Doi - Chief Counsel, Counsel to the Secretary, Technology, Trade and Commerce Agency

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March 20, 2002: Sunnyvale

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

Financing Cities: A Status Report on California Cities and the Need for Serious Reform
Chris McKenzie - Executive Director, California League of Cities

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

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

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

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

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

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

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

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

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May 16, 2002: Santa Monica

Streamlined Sales Tax Project (SSTP)
Charles Collins - North Carolina Department of Revenue
Diane Hardt - Wisconsin Department of Revenue

Streamlined Sales Tax Project (SSTP)
Steven Kranz - Tax Counsel, Council on State Taxation (COST)

Arguments against California Participating in the SSTP
Dean Andal - Member, California Board of Equalization

Real Property and Personal Property Taxes Conundrums
Rich Auerbach - Los Angeles County Assessor

Critical Issues for California's Tax Structure
Jean Ross - Executive Director, California Budget Project

Tax Simplification Task Force 2000, "Conformity, Simplicity, Fairness, Investment"
Kathleen Connell - California State Controller

California Tax Imbalances of the "Internet Rush"
Edward Leamer, Ph.D. - Director, UCLA Anderson Forecast, Professor of Management, Economics and Statistics, UCLA

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 Davis' 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; California Technology, Trade and Commerce Agency

Strategy for Report Writing
Jesse Szeto - Assistant Secretary, Division of Science, Technology and Innovation; California Technology, Trade and Commerce Agency

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September 18, 2002: San Diego

Comments on Tax Reform
Senator Steve Peace

San Diego's Diversified Economy and Tax Policy
Julie Meier Wright - San Diego Economic Development Corporation

Cable Industry Perspective on Tax Policy
Bill Geppert - Cox Communications

Biotech Industry Perspective on Tax Policy
Joe Panetta - BIOCOM San Diego

High Tech Industry Perspective on Tax Policy
Curt Nelson - Silicon Space

Impact of Tax Policy on Energy and Telecommunications
Loretta Lynch - Chair, California Public Utilities Commission

Tax Policy Impact on County Governments
Steve Szalay - Executive Director, California State Association of Counties

Taxation Issues on Commercial Property
Commissioner Lenny Goldberg - California Tax Reform Association

Discussion of Interim Report
Doug Brown - Senior Consultant, Senator Vasconcellos
Roger Dunstan - Assistant Director, California Research Bureau, California State Library
Kimberly Bott – Chief Consultant, California Assembly Revenue and Tax Committee

Tax Policy Impact on Regional Infrastructure

Jessie Knight – San Diego Regional Chamber of Commerce

Tax Policy Impact on Local Governments

Jack Thompson – President and CEO, Consumer Credit Corporation

Tax Policy Impact on Housing Development

Sandor Shapery – Principal, Shapery Enterprises

November 19, 2002: Redondo Beach

Discussion of *Interim Report*

February 3, 2003: Sacramento

Testimony

Steve Peace - Director, California Department of Finance
Tal Finney - Director, Governor's Office of Planning and Research
Clark Kelso, Ph.D. - California Special Advisor on Information Technology and Chief Information Officer
Howard Roth, Ph.D. - Chief Economist, California Department of Finance

Revenues Expected from Various Tax Rates on 25 Selected Services
Revenues Expected from Various Tax Rates on 36 Selected Services
State Sales & Use Tax (SUT) Breakdown
Budget Revenue Enhancement Proposals, 2003 - 2004

Honorable John Dutra - California State Assembly Member
Honorable Jackie Goldberg - California State Assembly Member

California Economic Forecast

Tom Lieser - Senior Economist, UCLA Anderson Forecast

Taxes Can Preserve our Quality of Life

Steve Levy - Director, Center for the Continuing Study of the California Economy

Silicon Valley Innovation and the California Economy

Doug Henton - President, Collaborative Economics

Testimony

Honorable Herb Wesson - Speaker, California State Assembly
Honorable Gray Davis - California Governor
Honorable Gilbert Cedillo - California State Senator
Honorable Dick Ackerman - California State Senator

February 24, 2003: Sacramento

A Framework for Fiscal Responsibility

Honorable Dick Ackerman - California State Senator

Testimony

Commissioner Scott Peters
Chris Norby - Orange County Board of Supervisors
Honorable John Campbell - California State Assembly Member
Scott Farris - Governor's Office of Planning and Research
Nick Bollman - President, California Center for Regional Leadership
Jonathan Coupal - President, Howard Jarvis Taxpayers Association
Honorable Jim Brulte - Minority Leader, California State Senate
Assemblyman Dave Cox - Minority Leader, California State Assembly

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March 12, 2003: Sacramento

State Budget Debate Letter

Honorable Phil Angelides - California State Treasurer

Testimony

Honorable Steve Westly - California State Controller

Streamlined Sales Tax Project

Charles D. Collins Jr. – Director, Government Affairs, Taxware
Bruce Johnson – Co-Chair, Streamlined Sales Tax Project
Scott Peterson – Director, Business Tax Division, Department of Revenue, State of South Dakota

SB17 Property Tax Reform

Honorable Martha Escutia - California State Senator

SB157, Internet Sales Tax

Honorable Debra Bowen - California State Senator

Perspective on Use Taxes

Betty Yee – California State Board of Equalization

Reforming California's Tax System

Elizabeth Hill - California Legislative Analyst

Bipartisan Perspective on Tax and Budget Reform

Honorable Joe Canciamilla - California State Assembly Member

Analyzing State Tax Policy

Commissioner Glen Rossman

Impact of Tax and Revenue Policies on the State Budget Crisis

Honorable Tom McClintock - California State Senator

Overview of Sales and Use Taxes

Commissioner Bill Weintraub

April 14, 2003: Los Angeles

Perspectives

Sunne Wright Mc Peak - California Economic Strategy Panel, Ex-Officio Member of the Commission

The FY2004 California Budget Proposal

Arthur Laffer, Ph.D. - President, Laffer Associates

Blue Ribbon Panel

David Abel - ABL, Incorporated
Nick Bollman - President, California Center for Regional Leadership
Fred Silva - Senior Advisor, Public Policy Institute of California

Testimony

Antonio Villaraigosa - Former Speaker, California State Assembly
Bob Hertzberg - Former Speaker, California State Assembly
Dan Carrig - Legislative Representative, League of California Cities
Rusty Hammer - President / CEO, Los Angeles Area Chamber of Commerce
Art Pulaski – Executive Secretary – Treasurer, California Federation of Labor

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April 21, 2003: Sacramento

Policy Approach to Analyzing Tax Systems

Annette Nellen, CPA. Esq. – Professor, College of Business, San Jose State University; Chair, Tax Policy Group, Joint Venture: Silicon Valley Network

The Taxation of Telecommunications in California in the Information Age

Terri Sexton - Center for State & Local Taxation, UC Davis

Testimony

Fred Silva - Senior Advisor, Public Policy Institute of California

Civic Entrepreneur Summit 2003

Nick Bollman – President, California Center for Regional Leadership

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May 22, 2003: El Segundo

Welcome Remarks

Honorable Richard Riordan - Former Mayor, City of Los Angeles

DBS Taxation Issues

Michael McDonnell - Senior Vice President & Chief Financial Officer, EchoStar
Michael Palkovic - Senior Vice President & Chief Financial Officer, DirecTV
Randy Dryden – MBIA MuniServices Company
Jeffrey Sinsheimer – member of the public
Don Nadeau – member of the public

Objectives for *Options for Revising the California Tax System, June 2003*
Scott Farris – Governor's Office of Planning and Research

July 18, 2003: Beverly Hills

Scoring the Current California Tax System
Annette Nellen, CPA. Esq. – Professor, College of Business, San Jose State University; Chair, Tax Policy Group, Joint Venture: Silicon Valley Network

A Flat Tax Proposal for California State and Local Governments, 4/28/03
Second Flat Tax Testimony of Dr. Arthur B. Laffer Before the California Commission on Tax Policy, 8/6/03
The Only Answer: A California Flat Tax, 10/2/03
A Proposal for a Complete California Flat Tax, 10/1990
Arthur Laffer, Ph.D. - Laffer Associates

A Flat Tax Proposal for California
Phil Spilberg, Ph.D. - Director, Economic and Statistical Research Bureau, California Franchise Tax Board

Comments on a Value Added Tax
Benjamin F. Miller – Counsel, Multistate Tax Affairs, California Franchise Tax Board

An Overview of the Michigan Single Business Tax
Should Michigan Reform its Current Business Tax System?
Douglas C. Drake, Associate Director, Wayne State University State Policy Center, Lansing, Michigan

Selected Data Tables from: The Michigan Single Business Tax, 1998-99. A report by the Michigan Department of Treasury, Office of Revenue and Tax Analysis, July 2002. http://www.michigan.gov/treasury

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September 9, 2003: Los Angeles

Testimony on the California Budget
Steve Peace - Director, California Department of Finance

Budget Structural Reform Panel
Commissioner Sean Burton
Moderator:
Charlene Wear Simmons, Ph.D. – Ca. Research Bureau, Ca. State Library
Panelists:
George Passantino - Reason Public Policy Institute
Steve Levy - Center for the Continuing Study of the California Economy
Craig Stubblebine, Ph.D. - Claremont McKenna College
Jean Ross - California Budget Project

California State Tax Court Panel

Commissioner Bill Weintraub

Moderator:

Marcy Jo Mandel, Deputy Controller, State Controller's Office

Panelists:

John Warren - Loeb & Loeb, LLC
Steve Kamp - State Board of Equalization
Professor Daniel Simmons - UC Davis School of Law
Eric Miethke - Nielsen & Merksamer

September 25, 2003: San Francisco

Welcoming Remarks

Matt Gonzalez – President, San Francisco Board of Supervisors

Perspectives on the Property Tax

Fred Silva - Senior Advisor, Public Policy Institute of California
Tracy Gordon – Research Fellow, Public Policy Institute of California

Periodic Reassessment of Non-Residential Property

Commissioner Lenny Goldberg

Panelists:

Terri Sexton - Center for State and Local Taxation, UC Davis
Terry Ryan - Director State Taxes, Apple Computers
Bill Harris - Property Tax Manager, Intel Corporation

Local Finance Issues

Commissioner Scott Peters

Panelists:

Pat Leary - California State Association of Counties
Michael Coleman - Coleman Advisory Services
Dwight Stenbakke - Director of Legislation, League of California Cities
Tim Frank - Sierra Club / Surface Transportation Policy Project
Peter Schaafsma - Director, Assembly Republican Fiscal Staff

Testimony

Dave Wilbur - Office of Supervisor Matt Gonzalez

A Comparison of the Growth in Property and Sales Tax Bases for 222 Cities in California, 1980-1999

Martha Jones, Ph.D. – California Research Bureau, California State Library

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October 23, 2003: San Diego

Welcoming Remarks

Commissioner Scott Peters - San Diego City Councilmember

Board of Equalization Perspectives on Sales Tax Issues

Steve Kamp - Senior Tax Counsel to BOE Chairwoman Carole Migden
Dave Hayes - Manager, BOE Research and Statistics Division

Economic and Fiscal Impacts of Taxing Services

Mark Ibele - Principal Fiscal and Policy Analyst, California Legislative Analyst's Office

SB 1009 Use Tax Collections

Honorable Dede Alpert - California State Senator

November 17, 2003: Newport Beach

Welcoming Remarks

Commissioner Marilyn C. Brewer
Homer Bludau - City Manager

Report on Meeting with Governor-Elect Schwarzenegger's Transition-Team Tax Policy Group

Martha Jones, Ph.D. - California Research Bureau, California State Library
Marshall Graves - California Department of Technology, Trade, and Commerce

Voting on Commission Recommendations Discussion of Final Report

Martha Jones, Ph.D. - California Research Bureau, California State Library

APPENDIX C: VOTES ON THE RECOMMENDATIONS, NOVEMBER 17, 2003

Recommendations were voted on by the nine Commissioners:

Sales Tax	Yes	No	Further Study	Abstain
Efforts should be made by the Board of Equalization to improve collection of the use tax that is currently California law.	9	0	0	0
Broaden the sales tax base to include selected services, while lowering the state rate to retain revenue neutrality.	8	0	1	0
Eliminate selected sales and use tax exemptions or exclusions.	0	0	9	0

Property Tax	Yes	No	Further Study	Abstain
Property/Sales Tax Swap: Change the mix of local general-purpose revenue by decreasing the amount of sales tax revenue and replacing it with property tax revenue. The objective of this proposal is to decrease the reliance on the sales tax and increase the reliance on the property tax.	7	0	2	0
In the context of improving the business climate in California, periodically reassess non-residential property to market value without changing existing tax rates.	0	3	6	0

Local Taxes	Yes	No	Further Study	Abstain
Provide a constitutional minimum allocation of property taxes to local governments.	8	0	1	0
Reduce the vote threshold now required for approval of local special tax measures from two-thirds to 55 percent.	6	3	0	0

Other Tax Policy Options	Yes	No	Further Study	Abstain
State Tax Court: California should establish a state administrative body to operate like the U.S. tax court. This body would resolve all tax disputes, including personal income tax, corporate income tax, sales and use tax, property taxes, payroll taxes, and excise taxes in accordance with the principles set forth in Professor Simmons' September 23, 2003 letter to the Commission.	9	0	0	0
Flat-Rate Taxes: Eliminate all current taxes in California except for "sin taxes," such as cigarette and alcohol taxes, and establish two new taxes, a six-percent flat-rate personal income tax and a six-percent flat-rate business value-added-tax.	0	2	7	0

State Budget Process	Yes	No	Further Study	Abstain
1) **Revise the current spending limit** - In order to make the spending limit more transparent, revise it to limit spending based on population and economic growth. 2) **Reserve requirement** - In order to reduce the fiscal shock of economic downturn, require the maintenance of a reserve. 3) **Rebalancing an unbalanced budget** - Establish a system for rebalancing the state budget when it becomes unbalanced. 4) **Multi-year budget planning requirement** - Initiate a fiscal planning requirement that will require the state budget process to plan longer than 12 months. 5) Implement changes that would foster a "**culture of accountability**" in the budget process.*	9	0	0	0

* As per the recommendations from the Bay Area Council and the Speaker's Commission on State and Local Government Financing.

APPENDIX D: STATE TAX COURT PROPOSAL

DANIEL L. SIMMONS
Professor of Law
School of Law
University of California
400 Mrak Hall Drive
Davis California 95616
Telephone (530) 752-2757
FAX (530) 754-5311
E-Mail dlsimmons@ucdavis.edu

September 23, 2003

Commission on Tax Policy for the New Economy
William Rosendahl, Chair
1102 Q Street, Suite 6000
Sacramento, California 95814

STATEMENT PROPOSING THE CREATION OF
A TAX COURT FOR THE STATE OF CALIFORNIA

Dear Commission Members:

This paper elaborates on my remarks to the Commission at my appearance on September 9, 2003. It was a pleasure to appear before the Commission and to participate with a panel of talented and informed advocates. I thank the Commission for the opportunity to address a topic that has been of interest to me for many years.

In 1978 I chaired a task force of the California Commission on Governmental Reform (Post Commission) that examined conforming the California income tax with the federal tax system. Since that time California has made great strides conforming the Revenue and Taxation Code with the Internal Revenue Code. I believe that anyone who thinks seriously about state tax issues would agree that state-federal conformity contributes to simplicity, efficiency, and economy in the collection of state individual and corporate income taxes. Recently, along with Professor Joseph Bankman from the Stanford Law School, I had the privilege of working with legislative staff, Franchise Tax Board personnel, representatives of California CPA's, representatives of the State Bar, and representatives of other interested parties, in drafting legislation to combat abusive tax shelters (SB 614 and AB 1601, which has passed both houses of the Legislature and has been sent to the Governor). All parties to those discussions asserted that conformity with Federal legislation is an important policy goal in crafting a California response to abusive transactions. Conformity remains a central policy goal in all California tax legislation. I suggest that conformity with Federal procedures in tax dispute resolution with a matching dispute resolution process is an equally compelling concept.

The Framers of the Constitution of the United States envisioned a governmental structure based on a separation of the powers of the legislative, executive, and judicial branches. This separation of function is one of the recognized hallmarks of our system of government. Executive and policy functions are in the hands of the elected executive officers of government and the members of legislatures. The judicial function of interpreting and applying enacted laws to individual cases is in the hands of the judiciary. Of course, in California as in many other states, members of the judiciary are elected, most often after being appointed by the Governor.

The framers of United States' government were also careful not to provide for an elected tax collector. In its 2001-2002 annual report (page 5), the Board of Equalization describes itself as "the nation's only elected tax commission." The members of the California Board of Equalization are elected political people. Some are, or have been, members of the State Legislature subject to term limits, some members are, or have been, people who aspire to higher statewide political office. Only one member of the current Board had any particular expertise in taxation prior to serving on the Board.

In the context of resolving disputes between taxpayers and the tax collector, the elective nature of the Board of Equalization causes an inherent structural conflict. One can easily imagine that a campaign slogan for an elected tax collector would be, "Elect me and I will not collect taxes from you (even if those taxes are due under the law)." One member lists as an accomplishment of his current tenure on the Board the fact that he "is responsible for increasing the percentage of relief received by California taxpayers before the Board of Equalization." While that may be an appropriate position for an elected policy maker, it illustrates the inherent conflict between the executive function of the Board of Equalization, which is to supervise the collection of numerous taxes (and its concurrent role in developing tax policy and making recommendations to the Legislature), and a judicial function that involves the application of existing law to the facts of a particular case.

On the one hand, the job of the tax collection agency is to protect the State's revenue by collecting taxes that are due under the laws enacted by the legislature and signed by the Governor. An individual could campaign for the Board of Equalization on a position that big corporations and other big business, along with wealthy individuals, don't pay enough taxes. Another individual may campaign for the Board on the premise that taxes are bad for the California economy because they stifle investment. As elected officials, the members of the Board of Equalization have a legitimate policy role in the structure of the tax system which may be influenced by these varying positions. The overall position of the Board of Equalization could vary with each election cycle as the philosophy of the majority changes with new membership. That result is appropriate for the Board in its executive and policy functions. However, when these varying and changeable political views are brought to the judicial function of deciding individual cases, the result is an inconsistent jurisprudence that does not provide guidance, and therefore certainty, to taxpayers planning transactions for the future. Current interpretation of the tax law could change after the next election. In addition, the

application of the elected member's political philosophy to the decision of individual cases may lead to results that are unfair either the taxpayer or to the State of California.

Two cases recently decided by the Board of Equalization illustrate the conflict. In LCI Logic Corp. and Cypress Semiconductor Corp., on a two to one vote, the Board allowed the refund of research credits in excess of the taxpayers' state tax liabilities. One member of the Board was disqualified from participating because the member owned stock in one of the parties. One member was disqualified because of a campaign contribution from a company with the same issue pending before the Board. Of the three members deciding the case, one member was reported in the press as stating that granting the refunds was important "to encourage companies to invest in California"; a laudable policy goal but not an appropriate factor in applying the law to a specific case. Another member was reported as complaining about the "tally of givebacks that day," which also is an appropriate policy position but not a grounds for deciding individual cases. In addition, the President Pro Tem of the Senate attempted to affect the decision with a letter claiming that, "a misreading of this statute in favor of LSI Logic would result in revenue losses in the hundreds of millions of dollars, as other taxpayers would attempt to use the same inappropriate interpretation to yield a sales tax refund on top of fully utilized research credits."

The case illustrates another flaw in the existing structure. The taxpayer-favorable decision is the end of the road. Although a taxpayer who is dissatisfied with the ruling of the Board of Equalization may file a claim for refund and then file suit for a refund in the Superior Court (after again going through the administrative process), there is no equivalent provision for the Franchise Tax Board to challenge a taxpayer-favorable interpretation by the Board of Equalization.[*] There are two problems here. This system results in an unbalanced state of the law where taxpayer-favorable positions are not subject to review. In addition, because Superior Court Judges do not publish opinions, there is no readily available way to discover the law in this area. As a consequence the law becomes a "private" body of law known only to the practitioners who handle significant numbers of cases before the Board of Equalization, but unknown to business people who are trying to plan transactions that are affected by the State tax law.[†] This uncertainty can have a detrimental impact on business expansion plans.

A state tax court would eliminate the dilemma currently caused by California's politically oriented dispute resolution body. Creation of a state tax court also would achieve an economy and efficiency in the administration of the state tax law consistent with the principles adopted by the Commission. The concept of a state tax court offers several advantages.

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[*] For an example of a challenge to a taxpayer favorable decision by the Board of Equalization see Proposition 22 Legal Defense and Education Fund v. State Board of Equalization, Sacramento Co. Superior Court No. 01CS00718 (2001), which is cited in the Board of Equalization 2001-2002 annual report, p. 47, but not otherwise readily available for study.

[†] Board of Equalization opinions, although not all are regularly published, are available on commercial electronic legal databases.

(1) A centralized tax court would develop a consistent body of discoverable interpretative law, based on precedent, to serve as a guide to the application of California tax statutes. Judges could be appointed with sufficiently long terms to provide consistency in the decision making process. Members of the court could be selected on the basis of expertise in the tax law and the possession of judicial temperament to decide cases by applying the law to the facts as found. Thus, the law would be applied based interpretation of the intent of the Legislature and the Governor, rather than on the basis of the policy views of independent elected officials sitting as judges.

(2) The creation of a tax court would free the Board of Equalization to better function as a policy and executive organization. Creation of a tax court does not suggest termination of the important role of the Board of Equalization.* This also may positively influence the effectiveness of the Board as the State's principal tax collection agency. Like the United States Treasury Department, the Board of Equalization could influence tax policy through legislative recommendations, adoption and approval of regulations, and decisions on litigation positions.

(3) Development of a consistent and accessible body of law interpreting California tax provisions would help to improve the California business climate. Investment decisions are based on assessment of after-tax rates of return. Calculating that return requires some level of confidence that there will not be retroactive applications of the tax law through varying and changeable interpretations of the law. The turnover of an elected board every four years increases the risk that the law will change. The possibility of an anti-taxpayer position increases the risk of an investment causing the investor to require a higher before-tax rate of return to compensate for the increased risk. That puts California at a competitive disadvantage. The possibility of a taxpayer-favorable shift in the Board of Equalization offers a lottery for higher after-tax rates of return. The uncertainty on either side discourages investment.

(4) A state tax court could develop a fairer and more accurate dispute resolution system based on rules of evidence, findings of fact, and application of the law to the facts as found. The existing system relies on factual development by staff and optional brief appearances before the Board. Decisions are often made at the staff level, which is the repository of expertise for interpreting the law. Appearance before the Board may affect the outcome through attempts to sway the Board with emotional appeals. One Board member indicates that a more taxpayer-favorable outcome can be achieved through the simple expedient of demanding an immediate vote by the Board members. A look at the Board's crowded agenda for its monthly two-day sessions makes it clear that the proceedings do not involve substantive hearings on individual cases. A state tax court would result in cases more thoroughly considered by judges whose sole responsibility would be

* Because the Board of Equalization would maintain its authority mandated in the State Constitution, there is no need for a constitutional amendment to create a tax court as an arm of the Legislature.

resolution of disputes brought before it, with a reduced reliance on staff expertise for final decisions.

(5) Finally, conformity with the Federal tax litigation process would result in increased efficiency in the decision-making process. Practitioners familiar with Federal tax litigation procedures would be familiar with California procedures. This conformity would reduce costs inherent in a system that requires California specialists focused on varying procedural requirements. The structure could be simplified with a single administrative review of proposed assessments by a hearing officer attached to the Franchise Tax Board or Board of Equalization.* Appeals from the tax court, by both parties, could be taken to the Courts of Appeal, thereby unburdening the Superior Court from having to decide tax issues and removing one level of hearing from the process. For parties who prefer a decision in the Superior Court, like the Federal system, taxpayers may be given an option to pay the tax and file a refund suit in Superior Court, which thereafter may be appealed to the Courts of Appeal. I believe that this arrangement would produce a balanced and discoverable body of interpretation of the California tax law that would reduce uncertainty in the application of the Revenue and Tax Code.

STRUCTURE OF A CALIFORNIA TAX COURT

Subsequent to my appearance before the Commission, I have given some thought to how I would structure a California tax court. These thoughts are preliminary and require further study, but might be a starting point. Again, the overriding theme is conformity with Federal procedures. Also, I believe that creation of a state tax court would shorten the dispute resolution process by reducing the number of steps taken before a case is resolved. The system would not be duplicative, one level of administrative appeal and the hearing before the Board of Equalization could be eliminated. In addition, this proposal would reduce the need for staff at the Board of Equalization to find facts and draft decisions proposed for Board adoption. Some of the staff might be shifted to staff the tax court. Overall the tax court would create efficiencies in the decision making process that could result in cost savings to the State.

- The court could include five judges, appointed by the Governor and confirmed by the Board of Equalization or the Legislature. The court would be an administrative court formed under the legislative power rather than a court with stature equivalent to the Superior Court.
- The terms of appointment should be from 12 to 15 years.
- Each judge would probably require three law clerks and a secretary. The court also would require a clerks' office and clerical personnel. The total number of people required would be in the range of 50.

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* This is analogous to the appeals function of the Internal Revenue Service.

- Cases would be heard by a single judge who would make findings and draft an opinion. At the request of the chief judge or some number of the other judges, cases would be decided by the full court.
- The court would develop its own procedures and rules of evidence. Following the lead of the U.S. Tax Court, strict evidentiary rules may not be necessary.
- The court would publish its opinions as deemed by the judges to be significant. Other cases might be decided by unpublished memorandum decision.
- The court might appoint masters to hear small tax cases, cases involving less than $5,000 of tax deficiency and for which the taxpayer elects a small case procedure. Decisions in small tax cases would be final, with no right to appeal.
- Decisions of the tax court would be appealable to the California Courts of Appeal. The appropriate appellate court might be the District Court of Appeal for the district of the taxpayer's residence, or all appeals could be concentrated in the Third District (Sacramento) which might have one or two judges appointed with some experience in tax matters.
- Appeals would be allowed both to the taxpayer and the Franchise Tax Board.
- Petitions for hearing before the tax court would be filed after an assessment by the Franchise Tax Board becomes final. Taxpayers would not be required to pay the tax before filing with the tax court.
- The administrative procedure before a final assessment could be shortened to include a single appeal before an appeals officer of the Franchise Tax Board or Board of Equalization.
- The tax court jurisdiction would include the individual income tax, the corporate and bank franchise taxes, sales tax disputes, and disputes over other taxes as the Legislature would determine. The list might include all taxes administered by the Board of Equalization. The tax court might also be empowered to here appeals of local tax assessments following denial by a county board of supervisors.[*]
- An alternative option to the tax court would remain for taxpayers to pay the tax and file a suit for refund in the Superior Court, in which case the taxpayer would forego recourse to the tax court.

In summary, I believe that creation of a tax court for California tax disputes would avoid the conflict that is inherent in combining the executive and policy making roles of the elected members of the State Board of Equalization, and would enhance the efficiency of the tax collection process by conforming dispute resolution with the Federal Income tax system. The stature of the Board of Equalization as the central policy agency for California taxes would be enhanced by removing it from the dispute resolution process.

[*] Here I think I might restrict the right to appeal to questions of law, rather than a reassessment of fair market value.

Respectfully submitted,

Daniel L. Simmons

C: The Honorable Carole Migden, Chair, California Board of Equalization
The Honorable Bill Leonard, Member California Board of Equalization
John Warren, Steven Kamp, Eric Miethke

APPENDIX E: INTERIM REPORT, NOVEMBER 2002

California Commission on Tax Policy in the New Economy

Letter to the Governor and the Legislature

TO: The Honorable Gray Davis, Governor
Members of the California Senate and Assembly

FROM: William J. Rosendahl, Chair, California Commission on Tax Policy in the New Economy

RE: Publication of *Interim Report*

DATE: November 25, 2002

Consistent with the mandates of the legislation that created the California Commission on Tax Policy in the New Economy, attached please find the Commission's *Interim Report*.

Our initial charter is to "examine the impact of Internet and other forms of electronic technology on various types of taxes." The Commission's mandate is broad. The enacting legislation, sponsored by Senator Vasconcellos, directed the Commission to look at and examine four major elements of the State's tax structure within the context of the New Economy: sales and use taxes; telecommunication taxes and fees; income taxes; and property taxes.

In five hearings held throughout the State, the Commission has heard from over 40 witnesses on a wide range of issues relevant to our mission. Our hearings have been open to the public. We have made our hearings available to millions of Californians many of whom have jobs tied to the New Economy via cable television. Our web site, http://www.caneweconomy.ca.gov, has become a repository of information, data and opinions on the nexus between the New Economy and tax policy. This *Interim Report* reflects the broad range of perspectives of the Commissioners on that testimony and on the task we face in the coming year to advise you on tax policy considerations that arise in an era dominated by great technological change.

As we point out in the *Interim Report*, the spread of Internet technology throughout our society has given people, businesses and the State new ways of communicating and transacting business. But, the New Economy reaches far beyond the Internet. Balancing innovation, investment and deployment with tax policy is, in and of itself, a complicated task. The fundamental change brought on by the acceptance of new technologies, however, has an even more profound impact on California because so many of the technologies involved in the New Economy have been and are being developed by California businesses, which play an important role in making California the fifth largest economy in the world. Moreover, the downturn in the high technology sector reflected in

lower stock values and decreased revenues from capital gains, and which coincidentally coincided with the commencement of the Commission's work, has had a profound impact on the State and local governments, and dramatically exposed inherent weaknesses in traditional tax structures and the revenues derived from them.

In that context, it is our hope that the Commission can perform a valuable public service by delving into the entire spectrum of tax and revenue issues, and offering sound recommendations that may preclude financial trauma for our citizens, our businesses and State and local government in the future. This is the right critical moment to be engaging in this work so that established taxes can be comprehensively examined in light of the New Economy.

This *Interim Report* sets the stage for the Commission's work in 2003 to determine whether there is, among the Commissioners, a consensus that any adjustments in tax policy are or are not required. As always, comments, particularly from you given that some legislation may be necessary to enact the Commission's recommendations, on the Commission's work and this *Interim Report* are strongly desired.

Respectfully submitted,

William J. Rosendahl, Chair

CC: California Commission on Tax Policy in the New Economy

Introduction

On September 23, 2000, Governor Davis signed SB 1933 (Vasconcellos) which established the California Commission on Tax Policy in the New Economy. The Commission's charter is defined by Revenue and Taxation Code Sections 38061-38067. These Sections mandate that the Commission examine a wide variety of tax policy questions in light of the "New Economy." The legislation describes the constitution of the Commission and, in Section 38066 mandates that we issue this Interim Report.

The tax policy implications of the new economy, particularly given the wide range of issues assigned for the Commission's examination in Section 38065, are at once novel, complicated, and profound. Our hearings and deliberations to date reflect the concerns of a variety of public and private stakeholders in the impact of the new economy on California's economy and on state and local tax revenues.

The purpose of this Interim Report is to describe to the Governor and the Legislature the range of issues that have arisen in the Commission's year of hearings. While our process has yet to resolve many issues, the Commission is on track to fulfill the goals set forth by the Legislature.

The term "new economy" has a wide range of definitions. The Commission considers that the new economy, in the context of our legislative mandate, revolves around the information revolution spawned by the adoption throughout society of information technology, the Internet and advanced methods of telecommunications. The new economy has changed many aspects of how people communicate and how people transact business. Consequently the Legislature formed the Commission to examine the tax aspects of these changes.

The new economy has had a profound impact on the overall economy, particularly in California. Many businesses connected to high technology are located in California and they export hardware, software and services around the world. One would have to look hard to find major sectors of the California economy that have not been significantly affected by innovations in information technology and telecommunications. The service- and knowledge-based economy encompasses many sectors including computing, communications, the Internet, software, pharmaceuticals, biotechnology, cars, chemicals, health, education, and many other research-intensive industries.

This report is being written at a time when the new economy still feels new, but also feels battered. Recent events such as the "dot com" implosion and its ripple effects have had a disproportionate impact on California's economy and have shown that the new economy is not immune to economic cycles. Technological innovation and investment, however, will continue to drive the California economy through this down cycle and into the recovery. As a result, it is important to examine the tax policy questions that arise when people use new technologies that change how they communicate and how they transact business.

What Tax Policy Questions Arise in the New Economy?

Testimony to date has yielded the following list of the tax policy questions asked of the Commission in legislation:

1. Has the new economy resulted in the overall tax structure becoming more regressive or progressive?
2. Has the existence of the new economy resulted in unintended horizontal inequities, i.e., are we taxing the same product differently depending upon the way in which it is delivered or the form in which it is accessed?
3. Have any of the economic changes increased or decreased California's tax competitiveness relative to other nearby states?
4. Has the existence of the new economy changed the tax burdens on different types of industries? Are industries that are more affected by the economic changes bearing a proportionate burden?
5. Do our existing taxes encourage or discourage innovation? Economic growth?
6. Does our existing tax structure make it easier or harder to create public/private partnerships in the new economy? Do individual taxes encourage or discourage public/private partnerships?
7. Has the new economy caused the state to become overly reliant on one type of tax?
8. What are the ramifications for local governments of the development of the new economy? In particular, what are the fiscal impacts?
9. Has the new economy improved the ability of the tax structure to grow and change with the economy?
10. Is the current tax system, which to a great extent relies on the geography of transactions, relevant in the new economy?
11. Will new technologies allow people to avoid excise taxes on goods such as tobacco and alcohol?
12. Does the current tax policy affect local land use decisions? If so, how?
13. Does the current tax policy encourage more local purchasing of products (including business-to-business), or out-of-state purchases?

The Commission's process has used the technology of the new economy. To the extent that written testimony has been submitted to the Commission, it has been placed on the Commission's website. By this reference, we include in the Interim Report the video tapes of the Commission's public meetings and the information contained on the Commission's website at: http://www.caneweconomy.ca.gov

What General Principles of Taxation Should Govern Our Consideration of Tax Policy in the New Economy?

The Commission has held hearings throughout the state. Based on presentations and testimony, we believe that our consideration of tax policy in the new economy must be tied to general principles of taxation. These principles should serve both the State and its citizens. The Commission considers its inquiry should take place in the context of the following tax principles:[i]

11. **Fairness and Equity:** Fairness and equity are critical components of any tax structure. Are similarly situated individuals or businesses taxed similarly? Are individuals and businesses paying the appropriate amount of taxes given their income and other goals of the tax system? How progressive is the tax structure, that is, how does the tax amount increase as income increases?
12. **Certainty, Transparency and Visibility:** Taxpayers should know that a tax exists, how the tax will be administered, and when it will be imposed upon them and others. Consumers and businesses should know with certainty the rules that they will have to comply with. The tax rules should specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.
13. **Convenience of Payment:** A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.
14. **Economy of Collection**: The costs to collect a tax should be kept to a minimum for both the government and taxpayers. Appeals should be handled fairly, easily and quickly. We have received testimony that some taxpayers perceive that California is one of the least fair states in handling tax appeals.[ii]
15. **Simplicity**: The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner. We have received testimony that taxpayers perceive the tax system as too complex and/or too costly.
16. **Compliance:** The tax should be structured to minimize noncompliance.
17. **Neutrality:** The impact of taxes on business and consumption decisions should be kept to a minimum. Otherwise, there can be significant distortions in the economy.
18. **Economic Growth and Efficiency:** The tax system should encourage and promote the productive capacity of the economy. The tax system should promote national economic goals, such as economic growth, capital formation, and international competitiveness. This principle is achieved by a tax system that is aligned with the economic principles and goals of the jurisdictions imposing the tax.
19. **Ability to Meet Revenue Needs:** The government should be able to determine how much tax revenue will likely be collected and when. Tax systems must provide adequate, reliable revenues for both state and local governments. Does the tax system for state and local government provide enough funds for the

services that taxpayers demand? How does the stream of funds adjust during different stages of the business cycle?

The Sales Tax Base of State and Local Governments

Sales tax revenues have not kept pace with California's overall economic growth over the past few decades. As a percentage of personal income, taxable sales in California decreased from about 48 percent of personal income in 1984 to about 40 percent from 1991 to 1999.

The sales tax base of state and local governments has eroded for several reasons. First, it is easy to avoid the sales tax by purchasing tangible goods either through the Internet or mail order catalogues from retailers who do not have a presence within the state. As such, the state cannot compel the retailer to collect the sales tax and the buyer rarely pays the use tax that is owed. This results in unequal treatment of both sellers (based on their sales method) and consumers (based on their means of purchase). In addition, if lack of Internet access is more predominant among lower-income households, an increased share of the sales tax burden could be shifted towards the lower end of the income spectrum.

The second threat to the sales tax base is the growing share of consumption expenditures that are not subject to taxation. The sales tax is levied on tangible personal property sold to final purchasers. A growing share of consumer purchases is for intangibles, especially services, which are not subject to taxation. One of the most significant outgrowths of the new economy involves an acceleration of the shift to a service- and knowledge-based economy. The Internet has contributed to this issue as tangibles (books, reports, movies, music, etc.) are converted into a digital, intangible form and then sold. Such sales are not subject to state sales tax. One of the presentations to this Commission pointed out that when computer software is purchased on disk or other tangible media, it is taxable, but when software is transmitted electronically, it is not taxable.

Internet commerce has grown markedly, but a major portion is business-to-business sales. A large share of business-to-business transactions is exempt from the sales tax and is taxed at the retail level. The rest of these purchases are subject to the use tax, most of which is paid by the businesses. The consumer portion of Internet sales (also called business-to-consumer, or B-to-C sales) is growing but estimates of revenue losses due to these purchases vary widely. The California Board of Equalization estimated that in 2001, California B-to-C sales over the Internet were $3.7 billion, resulting in revenue losses to California's state and local governments and transit districts of $147 million, assuming half of these sales are from firms with nexus in California. Estimated B-to-C mail order revenue losses were an additional $309 million in 2001.[iii] A study by the California Legislative Analyst's Office found that the potential total revenue loss to state and local governments in 1999 from B-to-C sales over the Internet was between $80 million and $200 million.[iv] A national study done by Professors Donald Bruce and William Fox estimates that the cost of e-commerce in lost tax revenues to California state and local governments will grow from about $925 million in 2001 to $3.2 billion by 2006.[v] All such estimates are speculative of course, but it is possible that the revenue loss may be a significant and growing amount. This is an area for additional investigation.

A third reason the sales tax base has eroded is that the state's housing construction sector has not returned to the levels of activity that were prevalent in the 1970s and 1980s. During those two decades, housing starts averaged in excess of 200,000 units annually, while during the 1990s, the annual average declined to 110,000 units. Housing construction is closely linked to sales and use tax performance.

Collecting Sales Taxes on Internet Transactions and Access

This is probably the most controversial and potentially contentious topic. It is also the genesis for the creation of the Commission, albeit the Commission's mandate encompasses a broader perspective and range of issues. The entire gamut of Internet transactions, from sales of tangible goods to transfers of intellectual property to downloading entertainment media, has been the subject of debate. Much discussion transpired on what constitutes nexus as well as on interpretations of the U.S. Supreme Court ruling in *Quill vs. North Dakota.*

Some presenters before the Commission opined that the issue of taxing Internet transactions is not worth pursuing since Internet sales in the California economy constitute approximately two percent of total sales. Also, representatives of brick-and-mortar businesses who have nexus in California complained that they are subject to collecting sales tax for the state of California, which places them at a disadvantage compared to out-of-state competition over the Internet.

California has passed its own version of the Internet Tax Freedom Act (ITFA) measure. The California IFTA Chapter 351, Statutes of 1998 (AB 1614 [Lempert]) was signed into law by Governor Wilson on August 24, 1998. The California ITFA imposed a three-year moratorium on specifically identified new or discriminatory taxes, including taxes on Internet access or online computer services, "bit" or bandwidth taxes, or any discriminatory tax on online computer services or Internet access. The California ITFA did not preclude new or existing taxes of general application that are imposed in a uniform and nondiscriminatory manner. This moratorium was extended recently by Governor Davis to either 2003 or 2004 (SB 394, Chapter 343, Statutes of 2000).

Participation in the Streamlined Sales Tax Project (SSTP)

To date, 36 states are collaborating in this initiative, with each state having an equal vote in the deliberative actions. The objectives of the SSTP are fivefold on the national level: simplify procedures and practices, reduce the current compliance burden, move toward a level playing field between brick-and-mortar and internet sales organizations, reduce administrative costs for government entities, and enhance voluntary compliance from remote vendors.

The Commissioners have received letters from California businesses (and businesses from other states) advocating California's participation in the project. They all cite the above objectives as being very beneficial to the California and national economies by reducing the administrative burdens and costs of compliance with approximately 7,500

taxing authorities and jurisdictions nationwide. It was perceived California's participation would lend a huge boost to the SSTP effort and, for that benefit, the State should consider how to obtain the key measures it wants in the bargain.

Strong opposition to California's participation was also evidenced. The Commission heard testimony that included the following: California's sales tax collections provide a much smaller revenue stream as a percentage of total state tax revenue than most of the participating states. California's influence in the SSTP would be seriously diluted by having only a single vote, on an equal basis with the other participants, since many of the participating states are much smaller in size and economic activity than California. Additionally, California would be late in joining the SSTP effort and would not have influence over much of the substantive decisions made with respect to simplification and streamlining measures.

There was some sentiment that a national sales tax simplification would be adopted at the federal level based on the SSTP and if California didn't get involved now, the state's destiny would be totally in the hands of others.

The options for the Commission's consideration are:

- Recommend joining the SSTP as a partner
- Abstain from a recommendation to join the SSTP as a partner
- Investigate joining the SSTP as an observer, without voting rights
- Recommend working at the federal level with business and government groups to craft a national simplification plan that California approves.

Instability of California's Tax Base

California's tax structure relies heavily upon personal and corporate income taxes, capital gains taxes, and sales and use taxes. Many of these revenue sources are tied to economic cycles. When the state economy is booming, tax collection increases are directly proportional to the size of the boom (or bubble). During economic downturns such as the current recession, which is tied in no small measure to the decrease in value of new economy companies, state tax revenue is significantly reduced. The state's fiscal instability hinders efforts to fund many government services such as basic research, education, and infrastructure development, which are critical to the new economy.

Determining whether or how to resolve the instability of the tax base will be critical to our deliberations. The Commission heard a wide range of ideas about whether or how to insulate tax revenues from economic cycles and technological change. These include:

Income Tax: The progressive nature of California's income tax acts to magnify the swings: a large percentage of income tax receipts are from high-income individuals, who enjoyed large increases in capital gains in recent years.[vi] In the late 1990s, much of the State's remarkable revenue growth was driven by stock market-related capital gains, which are highly volatile. The current decline in state revenues largely reflects the market's decline. The volatility of the stock market and thus capital gains also

complicates personal income tax revenue forecasting. Not only are stock and real estate market gains inherently difficult to predict, but holders of capital assets are usually very high-income taxpayers who are subject to the maximum tax rate and can frequently time the realization of gains and the payment of tax to their advantage.

Finally, state spending and its relationship to the income tax base is a critical consideration, particularly in light of the changes brought on by the new economy. Proposals to broaden the tax base may play an important role in this regard.

Property Tax: Another way to ameliorate the problem of volatile revenues is to evaluate other, more stable revenue sources, such as property taxes. Property values rarely decline, almost always increase and could provide a more stable base as one of the state's revenue streams. Swings between huge budget deficits, such as the deficit California is currently experiencing and is expected to experience for the next few years, and large surpluses could be avoided.

Tax base instability is also an issue for local governments because the state government has in the past used its power to appropriate local property tax revenues to address state government budget problems. As the property tax shifts of the early 1990s illustrated, the current state-controlled allocation of revenues leaves local governments vulnerable to changes in their base revenue levels. This continuing threat may be undermining any incentive for local governments to attempt to supplement revenues locally. Any significant changes to the property tax structure, however, would have to address the limitations of constitutional choices such as Proposition 13.

Another reason property tax revenues are low is because property tax allocation policies provide little incentive for local tax assessors and government jurisdictions to maintain tax rolls consistent with true property values. In addition, the Commission heard testimony calling for changes in the way that commercial and industrial properties are reassessed. The concern was that a major portion of California real property can easily avoid reassessment.

The Corporate Income Tax

For most corporations that operate in multiple states, corporate income taxes are based on the geographic apportionment of income. In California, this apportionment is based on a formula that incorporates property values, employment levels, and sales volumes (with sales being doubly weighted). With respect to the sales component, Internet activity raises questions about how sales should be attributed to different states, and thus how the amount of income earned by a particular corporation should be allocated amongst such states. In addition, Internet activity raises issues regarding "nexus" (degree of presence) rules for corporate income tax purposes.[vii]

The Commission heard from some business proponents that California should change its income tax apportionment formula for multi-state businesses to a single sales factor. Proponents conclude that this type of apportionment formula, which is used by a handful

of other states, rewards those companies employing personnel and capital within the state.

Tax Conformity and Simplification

Conformity with federal tax law should be a primary goal for income and franchise tax laws, recognizing that not every federal tax law provision will have relevance to California's situation. Legislation in 2002 conformed California's tax laws with the recent federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), as well as provisions relating to qualified tuition plans and the dependent care credit. Other changes will conform California's rules for estimated payments to federal rules, and provide that any federal election for corporations applies for State tax purposes.[viii]

In the corporation tax area, California largely conforms to federal corporate tax law but exceptions exist. Federal law offers more generous depreciation allowances, does not levy an entity-level tax on Subchapter S corporations, and allows 100 percent of net operating losses (NOLs) to be "carried forward" as well as to be "carried back" to prior years.[ix] In 2002, California conformed with the federal 100 percent NOL "carry forward" provision starting in 2004. As a budget-balancing measure, California suspended the NOL deduction for 2002 and 2003 taxable years.

Tax simplification is also important. In many instances, California's regulations regarding depreciation schedules, net operating losses, and charitable contributions vary only slightly from federal requirements but require separate, equally difficult formulations.

Testimony heard at the Commission's hearings suggested that complying with the California Revenue and Tax Code is becoming increasingly burdensome to California businesses. Speakers asked the Commission to consider (1) recommending a repeal of the Alternative Minimum Tax (AMT), (2) allowing full deductions for dividends received by corporations, and (3) making unitary business tax credits available to other members of the business group to preclude those tax credits from being unused.

Telecommunications Taxes

Telephony, cable, satellite, and wireless communications are becoming direct competitors and their technologies are converging. The tax structure does not reflect this. Their taxation is based on the historical structure in which the industries were quite separate and distinct. Telephone service in particular has evolved from a monopoly franchise to an increasingly competitive industry. Statewide monopoly franchises and right-of-way access were awarded to telephone companies and, in exchange, companies provided common-carrier service and were subject to special tax treatment. Telephone surcharges and other fees were levied on monopoly telephone utilities in an effort to extend service to high-cost areas and to increase access to all, at reasonable rates. The growth of competition in the telephone-service market has weakened the original justification for many of these taxes and has resulted in growing inequities.

Existing state and local telecommunications taxes include (1) various state surcharges on telephone service; (2) local utility taxes on telephone and cable services; (3) local franchise fees on cable service; (4) various federally-assessed surcharges, fees, and taxes. California does not impose or allow state or local taxes on Internet access. Internet activity may be subject to certain taxes using telephone access, different taxes when cable access is used, and another set of taxes if wireless Internet connections are employed. For example, a cable customer may pay a utility users tax levied by the local government, but his or her neighbor, who receives a television signal via satellite, is not subject to the same tax. These types of tax inequities might influence customers to migrate to telecommunication modes that are not taxed, resulting in lost tax revenues and distortions of the competitive environment. While these revenue losses are currently small, potential losses from utility user taxes and franchise fees might be important for local governments in the longer term.

Tax-Related Issues Facing the New Economy: Biotechnology

Tax issues facing the new economy encompass issues broader than the taxation of Internet activity. At Commission hearings, tax-related issues of concern to the biotech and biomed communities in San Diego, for example, were described as:

- Research and Development Tax Credits as well as Net Operating Loss (NOL) Deductions: Presenters emphasized the importance of these tax benefits to biotech companies. However, it was pointed out that the NOL carryover and the research credit are of minimal value until companies become profitable. Most biotech companies require 12-15 years to achieve profitability.
- Manufacturing Investment Credits (MIC): These are important for computer and electronics manufacturing.
- Capital gains taxes on employee and investor stock options: Companies rely on stock options to attract and retain employees and investors. Since stock options can make up a significant portion of potential compensation, California should evaluate competitive concepts such as eliminating or reducing capital gains taxes on initial stock option grants.
- Declaration of employee stock options as an operating cost: One presenter claimed that this would be difficult as there is no accurate way of establishing the cost to a company of issuing stock options until the options are exercised. This is more of a federal issue for the Securities and Exchange Commission, however, than a state tax issue.

The New Economy Needs Government Services

The needs of government and the new economy are complementary: healthy, cutting-edge, high-tech businesses in the new economy are important sources of high-paying jobs. In addition, profitable firms generate tax revenues for the state. The new economy also needs state services. Adequate transportation, infrastructure and energy sources are necessary for the industries of the new economy to operate in California. An education system capable of producing highly qualified workers for the industries of the new economy is also essential. Finally, university research institutions such as the University

of California are an integral part of the knowledge-based environment where firms operating in the new economy thrive. The importance of the research programs of the University of California at San Diego to the local biotech and biomed industries, for example, was emphasized at Commission hearings.

Funding the Commission's Work

The ability of the Commission to fulfill its mandate is seriously compromised without adequate funding and staff support. The tasks incorporated in the enacting legislation are far ranging and complex. The first year of the Commission's effort leading up to this report has been primarily dedicated to education and some data collection. However, the process of further discovery, analysis, public commentary and Commissioners' deliberations leading to the recommendations in the final report cannot be conducted as a charitable enterprise. To focus on areas of interest, the Commission will need staff support.

Much is at stake. The health of the world's fifth largest economy can be significantly affected by legislative actions in response to the Commission's work. Access to the very best economic research and national experts in this field is a precursor to developing recommendations for sound public policy. This requires an infusion of funds to acquire these services and to provide for administrative staff support to bring these objectives to fruition.

APPENDIX F: LEGISLATION SB 1933 (VASCONCELLOS)

BILL NUMBER: SB 1933 CHAPTERED

BILL TEXT

CHAPTER 619

FILED WITH SECRETARY OF STATE	SEPTEMBER 24, 2000
APPROVED BY GOVERNOR	SEPTEMBER 23, 2000
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	APRIL 25, 2000
AMENDED IN SENATE	APRIL 6, 2000

INTRODUCED BY: Senator Vasconcellos
(Coauthors: Senators Chesbro, Costa, and McPherson)

FEBRUARY 24, 2000

An act to add and repeal Part 18.3 (commencing with Section 38061) of Division 2 of the Revenue and Taxation Code, relating to taxation.

LEGISLATIVE COUNSEL'S DIGEST

SB 1933, Vasconcellos.

- Taxation and the new economy.
- Existing law provides for various taxes.

This bill would establish, until 2004, the California Commission on Tax Policy in the New Economy. The commission would examine the impact of Internet and other forms of electronic technology on various types of taxes. The commission would be required to submit a report to the Governor and the Legislature on its findings.

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

SECTION 1. The Legislature finds and declares all of the following:

(a) With the rapid development of the Internet and electronic commerce, policymakers at all levels of government are confronted with the challenge of

finding ways to encourage this new technology and its impact on our economy continuing to develop prosperously, while addressing the needs for tax equity and assurance that governments at all levels have sufficient revenue to continue providing essential services critical to our economy's continuing growth.

(b) The current national debate on Internet taxation has focused almost entirely on the collection of sales tax on remote sales of tangible products and has produced a myriad of proposals for immediate action that have ranged from allowing states to collect sales taxes on all transactions to imposing a permanent moratorium on any taxes on the Internet.

(c) The Advisory Commission on Electronic Commerce, created by federal law in 1998 to develop "tax and technologically neutral" recommendations, thus far has failed to achieve a two-thirds majority vote on a recommendation that it can send to Congress for a national solution that would apply in all states. Furthermore, the commission's charter did not lead it to examine the critical interrelated policy issues of tax equity and government sustenance.

(d) A roundtable of tax and technology experts that convened recently at the University of California Berkeley School of Information Management and Systems cautioned that "critical decisions about e-commerce taxation should not be made without further neutral and unbiased research." Its report specified several areas for detailed study that relate, not only to sales tax issues, but to technology and consumer behavior in the new economy, as well.

(e) The Legislative Analyst, in a January 2000 report titled "California Tax Policy and the Internet," recommended that the Legislature undertake a comprehensive review of the sales and use tax, as well as telecommunications taxes and the corporate income tax, in relation to e-commerce activity and its impact on tax administration, tax equity, and overall state revenue.

(f) California's current tax structure is largely based on a 20th century industrial economy that produced most of its wealth from manufacturing and agriculture. California's 21st century technology-dependent economy is already based largely on information and services, part of a new global economy that is built on the rapid development of ideas and the exchange of information using multiple communications media. It is characterized by rapid restructuring of business-to-business and business-to-customer relationships in the state and across the world and a shift from production and consumption of tangible goods to use of intangible goods and services.

(g) Numerous reports, including the California Economic Strategy Panel's "Collaborating to Compete in the New Economy" have identified the characteristics of our state's economic transformation at the end of the last century. That report concluded that the state's developing economy is one that is "fast, flexible, global, networked, and knowledge-based." There is a need to

reevaluate our entire system of tax policies and collection mechanisms in light of this new economy. California should lead the way for all states in designing a 21st century tax system.

(h) State and local revenues are generally performing well, based on the state's strong economic performance. This situation provides an opportunity to assure that the tax system performs as well as possible during periods of weaker economic performance, and altogether to assure that sufficient revenues are available for governments to continue providing the services essential for an economy to expand and prosper, by:

(1) removing inconsistencies and inefficiencies,

(2) addressing equity and fairness concerns, and

(3) improving administration, and (4) considering base-broadening measures.

(i) Our tax policies must continue to be formulated in ways that recognize the need for government to provide resources for investment in the infrastructure necessary for economic growth, as well as to provide for the legitimate health, public assistance, and safety needs of our citizens.

(j) It is the purpose of this act to create an open, public, fair, and balanced participatory process for the development of a long-term strategy for revising state and local tax structure for California that eliminates needless complexity and nurtures and expands the state's global leadership in key emerging industries and for businesses that are repositioning to take advantage of the new economy. That policy must balance tax restructuring with the generation of sufficient resources to continuously improve California's educational system, its physical and information infrastructure, its quality of life, and promote shared prosperity.

SEC. 2. Part 18.3 (commencing with Section 38061) is added to Division 2 of the Revenue and Taxation Code, to read:

PART 18.3. CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY

38061. This part is known and may be cited as the "California Commission on Tax Policy in the New Economy."

38062. The California Commission on Tax Policy in the New Economy is hereby created.

38063. The commission shall be comprised as follows:

(a) Nine voting members of the commission, of which three members shall be public members representing business, three members shall be public members

representing local government, and three members shall be at-large members who may represent various segments of the public, including, but not limited to, academia, organized labor, and public interest groups.

(1) The Governor shall appoint five members, taking into consideration the importance of bipartisan representation of public members. The Governor shall designate one of the public members as Chair of the Commission.

(2) The Senate Rules Committee shall appoint two members, including one upon recommendation of the minority party.

(3) The Speaker of the Assembly shall appoint two members, including one upon recommendation of the minority party.

(b) Ex officio nonvoting members shall include all of the following:

(1) The Executive Officer of the Franchise Tax Board, or a designee.

(2) The Chair of the State Board of Equalization, or a designee.

(3) The Director of Employment Development, or a designee.

(4) The Chair of the California Public Utilities Commission, or a designee.

(5) The Director of Finance, or a designee.

(6) The Controller, or a designee.

(7) A public member of the California Economic Strategy Panel to be appointed by the Secretary of Trade and Commerce.

(8) The Chair of the Senate Committee on Revenue and Taxation, or a designee.

(9) The Chair of the Assembly Committee on Revenue and Taxation, or a designee.

38064. The commission may form additional technical assistance workgroups, including experts from government, academia, and the private sector, and interested public stakeholders, as necessary to complete its work.

38065. 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.

38066. 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.

38067. This part shall remain in effect only until January 1, 2004, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2004, deletes or extends that date.

APPENDIX G: TAX SIMPLIFICATION

Executive Summary
Tax Simplification Task Force 2000
Kathleen Connell, California State Controller

Two themes conformity and competitiveness quickly emerged during the Task Force discussions. The group readily agreed that the relationship between all Californians and the taxes they pay to the Franchise Tax Board should be simplified. At the same time, there was a strong sense that California should be made an attractive location for people and businesses to establish themselves and grow.

Conformity. The Task Force recognized that income tax simplification for Californians means, first and foremost, conformity to federal income tax law. Thus, the Task Force squarely identified conformity as the primary goal for California's income and franchise tax laws.

The Task Force acknowledged the constitutional and practical problems that having automatic conformity or using a percentage of the federal tax (piggybacking) present for California. Also, not every federal tax law provision will have relevance to California's situation. While elective piggybacking may be an option, the Task Force believes California's current practice of selective conformity will continue and therefore recommends that the Legislature:

- Draft the Revenue and Taxation Code in a more user-friendly format so that at the very least tax practitioners can readily decipher where conformity starts and where it ends;
- Make conformity with federal law an express policy; and
- Articulate clearly, when choosing not to conform to a particular federal tax law change, a non-revenue reason why California's tax policy should differ.

The Task Force also identified specific existing non-conformity items for which conformity should be achieved without further delay:

- Phase-out for itemized deductions;
- Depreciation;
- Net operating losses; and
- Charitable contributions of appreciated property.

Simplicity. Achieving conformity will greatly assist in achieving simplicity. The Task Force believes, however, that conformity is only a piece of the simplification puzzle. The Task Force therefore recommends:

- Demonstrating leadership to the federal government by acting to eliminate elements that unnecessarily complicate compliance and burden taxpayers and,

in particular, by repealing the alternative minimum tax;

- Eliminating problem elements peculiar to California law to make California's combined report as similar to a federal consolidated return as possible and, in particular, by allowing a full deduction for dividends received by corporations and allowing the use of credits on a unitary group basis;
- Treating all pass-through business entities equally by repealing the differing fees and imposing only an annual tax equal to the minimum franchise tax on each form of pass-through entity that affords limited liability;
- Revamping the limited liability company fee and making it more predictable and consistent as the minimum goal; and
- Coordinating the filing requirements for pass-through business entities and, if possible, creating a single form that could serve every entity.

Fairness. Burden necessarily becomes part of any discussion of taxes. The Task Force focused on elements it perceived as fundamentally unfair. The Task Force therefore recommends:

- Removing persons in the bottom 50 percent of adjusted gross incomes (excluding business income) from the tax rolls completely;
- Reducing the top personal income tax rate so that the people of California are not paying tax at a higher rate than corporations;
- Increasing, in addition or alternatively, the topside of each personal income tax bracket by 10 percent and then indexing tax brackets according to the provisions of current law;
- Allowing a $250 tax credit to single filers with AGIs up to $50,000 and a $500 tax credit to joint filers with AGIs up to $100,000; and
- Giving taxpayers credit for withholding or estimated tax payments before calculating the demand penalty.

Under the Task Force recommendations, none of the 50 percent of Californians whose adjusted gross incomes (excluding business income) are below approximately $25,500 would pay income taxes. Californians with adjusted gross income from the current median up to $50,000, if single, and $100,000, if joint, would enjoy a tax reduction as a result of reducing the top marginal tax rate, increasing the threshold for each higher marginal tax rate, and allowing the targeted tax credit. All other Californians would receive a tax reduction as a result of reducing the top marginal tax rate and increasing the threshold for each higher marginal tax rate.

Investment. The Task Force resolved to urge creation of a tax environment making California competitive with other states for both individuals and businesses. Specifically, the Task Force members believe that California should use the power of its tax law to encourage relocation and expansion in the state and discourage the flight of talent and capital. Thus, the Task Force recommends:

- Excluding 50 percent of certain capital gains from income in order to approximate the federal rate differential for capital gains;
- Ensuring business income treatment for investment income that the business people consider part of the corporation's overall business operations;

Allowing individual taxpayers a lifetime exclusion of $50,000 on realization of income from stock options; and replacing the current apportionment formula with a single factor "sales" formula.

APPENDIX H: SCORING OF SELECTED CALIFORNIA TAXES

Prepared by the Tax Policy Group
Of Joint Venture: Silicon Valley Network

http://www.jointventure.org/tax/

For the California Commission on
Tax Policy in the New Economy

November 2003

The taxes selected for scoring are:*
- Personal Income Tax
- Sales and Use Taxes
- Property Tax
- Utility User Tax

*The Scoring for Bank and Corporate Franchise Taxes is included in the *Proceedings* of the Commission, November 17, 2003.

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Tax Analysis:		
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Sales & Use Tax	115	132
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Note: The background information for each tax analyzed is provided at the end of the report so as not to distract from the scoring for each tax. The background serves as a reference to support the scoring and to help in developing ways to improve the tax.

Joint Venture: Silicon Valley Network (www.jointventure.org) is a regional, non-partisan voice and a civic catalyst for solutions to problems, which impact all sectors of the community. Joint Venture brings together established and emerging leaders from business, labor, government, education, and community organizations. It also involves citizens in the region and is a neutral forum for new ideas and creative solutions. Real benefits for people, business, and community organizations are its goals.

Joint Venture's Tax Policy Group consists of individuals from high tech industry, government, and academia who analyze various state and federal tax rules and proposals to consider the impact to local governments and high tech industries. The Group's current work encompasses international tax reform, worker classification, R&D incentives, major federal tax reform, incentives for donations of technology to K-14, and sales tax issues of electronic commerce. The Group works to promote better understanding of tax and fiscal issues of significance to the Silicon Valley economy through distribution of its reports, sponsorship of seminars and discussion forums, and submission of testimony to legislators and tax administrators.

For copies of the Tax Policy Group's publications visit:

http://www.jointventure.org/tax/

Comments: Send to anellen@sjsu.edu

Background on the Preparation of This Report

In February 2003, Joint Venture's Tax Policy Group published a workbook containing a tool to help policymakers and others analyze existing tax and fiscal structures and proposals to determine how well they satisfy the basic principles of good tax policy. The analysis requires the user to consider the purpose of the tax or proposal, how it works, its degree of fairness, and whether it will operate efficiently. The analysis points out where there are plusses and minuses (areas for improvement) in the item being analyzed.

The analysis also helps to stimulate debate and discussion on the finer points of tax proposals and alternatives. This leads to a deeper understanding of tax and fiscal systems and issues.

Joint Venture's Tax Policy Group used the American Institute of Certified Public Accountants' (AICPA) tax policy statement to create the tool. The AICPA's statement—*Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals,*[*] provides ten principles for determining if an existing tax or a proposal to modify a tax rule follows good tax policy. The framework recognizes that it is not always possible to incorporate all ten principles into tax systems – that some balancing is needed.

The workbook created by Joint Venture to help policymakers and others evaluate plusses and minuses in either existing taxes or proposals to change existing tax rules regroups the AICPA's principles within three broad categories:

1. Fairness
2. Operability
3. Appropriate Purpose and Goals.

Joint Venture's Tax Policy Group was encouraged by members of the California Commission on Tax Policy in the New Economy to use the ten principles framework to analyze California's key taxes. This work was aided by a presentation by Annette Nellen, chair of the Tax Policy Group to the Commission on July 18, 2003 where questions were raised by the Commissioners, and a forum held by the Tax Policy Group on October 1, 2003 to obtain input from tax directors, CPAs, local government finance and policy directors and others.[†]

For more information about the workbook and the principles of good tax policy, see:

http://www.jointventure.org/taxpolicyworkbook/index.html

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[*] AICPA Tax Policy Statement No. 1 - Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals, 2001; available at http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf. Joint Venture extends its gratitude to the AICPA for granting Joint Venture permission to use Tax Policy Statement No. 1.

[†] Joint Venture's Tax Policy Group acknowledges and thanks the following individuals for their contributions to the creation of this report: Bill Barrett, Lisa Bruner, Rebecca Elliott, David Ginsborg, Marshall Graves, Bill Harris, Linda Holroyd, Jeremy Joseph, Jim Joyce, Caroline Judy, Brian Moura, John Murphy, Annette Nellen, Dennis Ondyak, Jim Regan, Pete Rincon, Alan Schultz, Connie Verceles, Dat Vu, Ellen Wheeler, and Marguerite Wilbur.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY

CALIFORNIA PERSONAL INCOME TAX (PIT)

Scoring

+ works well
0 needs improvement

Principle	Application and Analysis	Rating
	Fairness	
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	As with the federal income tax, "ability to pay" is defined by a set of personal exemptions and deductions that might not truly tie to a person's "ability to pay." For example, a person may be paying medical expenses for a person who does not qualify to allow the payer to deduct the expenses whereas another person with the same income and medical expenses pays them for a qualified person. In addition, two investors with similar income will not pay the same tax to the extent one has investments in tax-exempt bonds while the other is invested in taxable investments. However, it is generally thought that the mix of deductions, exemptions and credits provides results in individuals with similar incomes paying similar amounts of tax. The PIT is very progressive in that many low to middle income individuals pay little or no PIT while those with higher incomes pay a significant amount of the total PIT collected. Strong arguments can be made that the PIT is too progressive by having so much of the tax paid by a small number of high-income individuals. In addition; the maximum PIT tax rates are high relative to other states. While California has the highest threshold for when PIT is owed, the mix of taxes must be considered to determine if the system as a whole is "fair."	0
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Californians pay the PIT either through withholding or estimated tax payments. Thus, individuals are generally aware that the PIT is being assessed or is due. While some phase-outs and the California Alternate Minimum Tax (AMT) may make it difficult to easily compute the PIT on a transaction, it is possible to do so.	+
	Operability	
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Generally, the PIT is certain. There are well-established regulations and case law to help interpret the PIT statute. Yet, complexity of transactions can lead to uncertainty for some transactions. Generally, though, this is the same uncertainty that individuals encounter under the federal income tax system.	+

Operability		
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	As most PIT is paid through withholding or quarterly estimated payments, payment is fairly convenient. Taxpayers who find a need to challenge a Franchise Tax Board (FTB) audit decision beyond the State Board of Equalization (SBE) appeal must pay the disputed liability before filing in Superior Court and may therefore find this route infeasible.	+
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	The concentration of revenue in relatively few returns and the expansion of e-filing amongst lower-income taxpayers makes the California PIT fairly efficient for the government to collect. Information sharing agreements with the federal government provide a great audit tool for the Franchise Tax Board. The expansion of e-filing, and the high filing threshold will continue to address taxpayer compliance costs; moreover, the relatively high level of conformity to federal tax law makes the PIT a reasonable one with which to comply.	+
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	The PIT is far from simple, although the complexity of the law most likely increases with the sophistication of the taxpayer. Much of the complexity stems from the federal income tax system upon which much of the PIT is based. Areas where California does not conform to the federal rules add to complexity in that taxpayers must spend more time with both compliance and recordkeeping. The fact that 63% of individuals must file the long form (Form 540) rather than the somewhat easier Forms 540A and 540EZ, is another indication of some complexity. A PIT based solely on the federal income tax paid would certainly be simpler.	0
Minimum Tax Gap A tax should be structured to minimize non-compliance.	There is a great deal of debate about the size of the PIT "tax gap". Much of the focus has been on the problem of cash payments, particularly in some types of businesses. The California tax gap likely isn't too much different than that for the federal income tax system. The IRS estimates that the amount of taxes not voluntarily paid is about 17 percent of total federal income taxes each year (83 percent compliance rate). IRS enforcement efforts eventually raise the compliance rate to about 87 percent each tax year. [GAO, *Reducing The Tax Gap - Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157, June 1995, pp. 2-3.]	0
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Much has been said about the revenue "bubble" caused by stock options and capital gains in the past few years, and that this was caused by the growing reliance on high-wealth taxpayers to pay the bulk of the PIT. The short-term, "one-time" nature of the phenomenon was well documented, and warnings went out from the FTB and the Legislative Analyst that the rate of growth of the PIT would not be sustained at that high level. In short, the PIT has been "unpredictable" and "volatile" in the sense of moving up and down drastically and unpredictably. Certainly, to the degree the PIT continues to concentrate on high-income taxpayers with fluctuating incomes, the potential for volatility will continue. With the PIT being primarily generated by a small number of taxpayers, it is affected more significantly (both positively and negatively) when there are changes in the incomes of this small group of taxpayers.	0

Operability		
Appropriate Government Revenues (continued) The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Unlike the sales and use tax, the personal income tax is deductible for individuals who itemize their deductions on their federal income tax return. For some taxpayers, this deduction is reduced due to the federal alternative minimum tax. Thus, the state is able to shift some of this tax burden to the federal government. While lack of complete conformity with the federal income tax rules creates complexity, an advantage is greater ability for the state to control its revenues. However, revenue adjustments could instead be made by changing the tax rates, rather than making the tax base have less conformity to the federal income tax base.	
Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	The income tax system has many provisions designed to encourage or discourage certain activities. For example, the PIT allows individuals who itemize to deduct charitable contributions. Favorable depreciation rules are designed to encourage capital investment. High tax rates may lead individuals who do not need to work or live in California to move to a lower tax state. The high tax rates can also lead entrepreneurs to start a business outside of California.	0
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	As a greater percentage of the PIT is borne by fewer and fewer high-wealth taxpayers, a fear arises that the PIT could drive some of these taxpayers to move to low- or no-income- tax states. These taxpayers are often the most productive and innovative in the economy. Moreover, to the degree that any such departures also result in a decline in California investment, future economic expansion is compromised.Relative to other states, California's tax rates are high. This, though, needs to be weighed in relation to other types of taxes, use of appropriate tax credits, and how the overall tax burden is distributed across income levels. While the PIT is very progressive, consideration should be given as to whether it offsets the regressivity of the sales tax.* Or, should the sales tax be made more progressive (such as by taxing the types of consumption that higher income individuals tend to have such as services) and the income tax less progressive. To help align the goals of cities/counties and the state, consideration should be given to sharing the income tax with local governments, as is done in Arizona. Such an approach could better incentivize both levels of government to attract high wage jobs to California and provide them with the infrastructure (such as housing) that they would need. Consideration needs to be given to what the possible economic disadvantage is to California when it does not conform to a federal provision designed to provide an incentive to individuals, such as lower capital gains rates.	0

* A tax is progressive if it represents a higher percentage of a high-income taxpayer's income relative to the percentage it represents of a low-income taxpayer's income. A tax is regressive if it represents a higher percentage of a low-income taxpayer's income relative to the percentage it represents of a high-income taxpayer's income.

Application of the Guiding Principles of Good Tax Policy

California Sales & Use Tax (SUT)

Scoring

+ works well
0 needs improvement

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	All California taxpayers pay SUT at the same rate (with slight variations by county), making it appear to be "fair." However, the tax is regressive because consumption of tangible personal property (and thus the amount of SUT paid) represents a higher percentage of a low-income person's income relative to a higher income person.* The California SUT was originally intended to do what it still does today – tax purchases of tangible personal property. It was not created decades ago to tax *all* consumption. However, over the past several years, consumption of services has increased while consumption of goods has declined. For taxpayers who consume a lot of services, they will not proportionately pay as much SUT on their consumption as would someone who has a high consumption of goods. The California SUT does not apply to intangible goods, such as software delivered via the Internet, but does apply to the tangible equivalent, such as off-the-shelf software purchased at an electronics store. Thus, where one person downloads the software and manuals, while another person purchases the same software on a diskette or CD, the first person pays no sales tax and the second one does even though each ends up with the same software. A use tax complements a state's sales tax and is imposed at the same rate. A use tax generally applies when a taxpayer buys a taxable item outside the state for use inside the state. For example, when a resident buys a book from a remote (non-present) vendor, the resident is responsible for submitting the use tax to the state-taxing agency. California has made no meaningful effort to collect the use tax from individuals (note, most businesses are use-tax compliant). The tax is mentioned in the instructions to Form 540, but not where people would likely see it, and many people today don't get the instructions because they use a software package to prepare their return. The State Board of Equalization (SBE) released Publication 79B a few years ago that explains the use tax and includes a form for calculating and remitting it. However, this publication is not sent to individuals. Several states try to collect the use tax by including a line item on the state income tax form (such as Maine, Michigan and North Carolina). Failure or inability to collect use tax from consumers on mail or Internet ordered tangible goods raises two equity issues:	0

* The degree of regressivity of the sales and use tax is not clear due to significant consumption exemptions in the system that benefit both low and high income individuals, such as housing and health care.

Fairness		
Equity and Fairness (continued) Similarly situated taxpayers should be taxed similarly.	1. A consumer purchasing a tangible item, such as a computer, via the vendor's web site where the vendor has no physical presence in California, will not be charged sales tax, but owes use tax.* If the tax is not paid, the consumer has not been treated similarly to a consumer who purchases a computer from a vendor located in California. 2. Main street vendors are concerned that because they must charge sales tax to customers who purchase goods within their stores, while remote vendors selling the same items online or by mail order do not have to charge the tax. The vendors are not being treated similarly. Note: SB 1009 (Chapter 718) enacted in October 2003 will add a use tax line to the California personal income tax form. The FTB will remit the collected tax to the SBE. The California SUT is also flawed in that businesses also pay the tax on tangible personal property other than those that will be resold or incorporated into manufactured items to be sold (raw materials). SUT paid by businesses is then built into the cost of the goods they sell and consumers, in essence, pay a tax on a tax. This is referred to as a cascading or pyramiding effect. Cascading affects industries differently depending on the amount of taxable purchases a business makes, thereby violating the equity principle. While the Streamlined Sales and Use Tax Agreement (SSUTA) should provide uniformity in tax compliance, thus benefiting multistate vendors, it may also present some new complications for businesses and may lead to winners and losers among local jurisdictions if the point of sale is changed from origin to destination. The effect of the SSUTA on California businesses and local jurisdictions needs to be reviewed.	

* The 1992 U.S. Supreme Court decision in *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), held that a state may not impose sales and use tax collection obligations on sellers who do not have a physical presence in the state. The Court modified its earlier ruling in *National Bellas Hess, Inc. v. Dept. of Rev.*, 386 U.S. 756 (1967), by ruling that a physical presence was no longer needed under the Due Process Clause. North Dakota had challenged the 1967 ruling as being out of date with today's ways of conducting business. Today, a company doesn't need a salesperson in a state to obtain a sale. Instead, a catalog and a mail-order sales system can be just as successful for a company. The Court agreed that conducting business in the state was sufficient to satisfy the Due Process Clause to allow a state to subject the vendor to taxation. However, the Court ruled that physical presence is still necessary under the Commerce Clause in order for a state to impose sales tax collection obligations on a remote (non-present) vendor.

Fairness		
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Sales and use taxes are visible because they are shown on the customer's invoice. Even invoices prepared at Internet sites will show any sales tax charged. However, many consumers may not know that a use tax exists on particular transactions. For example, many consumers who are not charged sales tax on online sales likely believe it is due to the Internet Tax Freedom Act moratorium[*] when it is most likely due to the *Quill* decision.[†] Also, customers likely don't know all that the sales and use tax applies to – for example, will it apply to "free" items obtained from online vendors? Does it apply to shipping charges?	0
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	For the most part, the rules and tax forms are fairly clear. However, issues can arise as to whether a vendor has nexus (physical presence) in California and is thus obligated to collect SUT.	0
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Vendors selling taxable items should collect the sales tax at time of payment which is convenient for the buyer. Where a use tax is owed, to be paid by the buyer, payment is due at a later date. Payment of use tax by individual consumers is inconvenient: it requires that they maintain a list of purchases for which SUT was not collected and which items and charges are subject to SUT.	+
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Because the sales tax is collected by vendors, there is economy of collection. Because the use tax is paid by buyers, costs of collecting use tax, particularly from consumers, are high. The costs to collect the sales tax are heavily borne by vendors. Some states compensate vendors for a portion of these costs. Such a compensation system should be considered in any sales and use tax reform in California. Given the various reports in the past calling for elimination of the SBE and the economies of scale that might be achieved with a single state tax agency, these recommendations should be considered.	0

[*] The Internet Tax Freedom Act, enacted in 1998, prohibits certain state and local taxes on Internet access, unless the tax was generally imposed and actually enforced before October 1, 1998. The moratorium also prohibits state and local governments from imposing *multiple* or *discriminatory* taxes on e-commerce. The moratorium was originally created by the Internet Tax Freedom Act, which imposed a 3-year moratorium (from 10/1/98 through 10/21/2001) [Public Law 105-277, 10/21/98]. This moratorium was extended to November 1, 2003 by Public Law No. 107-75 (enacted 11/28/01).

[†] See explanation of *Quill* decision at earlier footnote.

Operability		
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	Generally, within a single state, the SUT is fairly simple in that efforts have been made through legislation, regulations and rulings to identify the tax base. In many states, including California, the tax rate can vary from county to county and it may not always be clear in which county a taxpayer is located. From a multistate perspective, vendors face a myriad of tax bases and rates. In a few states, such as Colorado, the state and local SUT bases may vary. In the 1992 *Quill* decision (discussed earlier), the Court noted that there are over 7,500 jurisdictions in the U.S. imposing an SUT with varying bases, rates and filing procedures, which poses complications for vendors. Thus, multistate vendors face additional complexities.	0
Minimum Tax Gap A tax should be structured to minimize non-compliance.	The use tax causes a tax gap because so few consumers (and even some businesses) know what a use tax is or that it exists to complement the sales tax. While some states have made efforts to inform residents about the use tax, such as by adding a line on the state personal income tax form for it, as evidenced by the GAO report released in 2000 (discussed earlier), compliance is very low. Improvement could be made by states educating consumers about the use tax and simplifying compliance; simplifying sales tax systems such that Congress might exercise its authority under the Commerce Clause and allow states to collect use tax from remote vendors; or, replacing the sales tax with another type of consumption tax. The Internet not only makes it easier to purchase items from a vendor in another state, but also in another country. While Congress could require a remote vendor to collect a state's sales and use taxes, it will be far more difficult, to get a vendor in a foreign country to collect a state's sales tax. Thus, if the tax is to be collected, states will need to get consumers to voluntarily comply or to exempt foreign sales, which would violate the neutrality principle. An alternative consumption tax to the sales tax would be for consumers to measure their consumption as Income less Savings. Of course, this would also involve extra recordkeeping and it would broaden the consumption tax base over what it is today (it would tax all consumption rather than just tangible personal property).	0
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Tax agencies should be able to derive reasonable estimates of sales and use tax collections based on prior years' data and consumption data. However, declines due to increased on-line purchases from remote vendors (for which use tax may not get collected), and a shrinking base of consumption subject to California sales tax may lead to less reliability of the sales tax for California jurisdictions. Individuals may not treat sales and use tax as an itemized deduction on their federal income tax returns, in contrast to property and income taxes which are deductible. Thus, there is a greater cost of the SUT although many individuals do not itemize their deductions. The sales tax base is shrinking due to the fact that it primarily only includes consumption of tangible personal property and excludes services and intangibles. Also, the increased ability for consumers to purchase from remote vendors via the Internet shifts more of the SUT from a sales tax collected by vendors to a use tax owed by consumers, most of whom don't know that the use tax exists.	0

Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	The current situation where remote (non-present) vendors are not required to collect sales tax can cause sales tax to play a part in a customer's decision as to how and where to purchase goods and services. For example, a customer may decide to purchase a computer online to avoid sales tax rather than purchase the computer from a Main Street vendor. Also, in a few states, such as California, software (and other digitized goods) transferred online are not subject to sales tax, while their tangible counterpart (that is, a boxed music CD or software) is subject to sales tax. Thus, the sales tax law is not neutral in that it will play a role in a customer's decision as to how and where to purchase certain products.	0
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	Cities in California have become more and more dependent on the sales tax for revenues over the past several years. This is due to restrictions upon local governments to raise revenues (such as Proposition 218, approved by the voters in 1996). This has led to a phenomenon referred to as *fiscalization of land use*, which means that the focus of decisions on how to best use land is driven more by the tax revenues to be generated than by how the land can best serve the needs of the community. While a city needs a majority vote of its citizens to raise the sales tax (or other tax) rate, it could instead have a large retailer or industrial sales office locate within its borders to generate sales tax revenues. Regulation 1802 encourages cities to entice manufacturers to locate a sales office within its borders, particularly where customers are located outside of the borders. Because the sales tax base does not include digitized items (intangibles), when software vendors switch from selling software on CDs or diskettes to transferring the software electronically, the cities that house the sales offices for such vendors are seeing a drop in sales tax revenues. Finally, due to the increase in consumption of services, rather than tangible goods, cities continue to see a drop in sales tax and a base that becomes more regressive, which adversely impacts lower income residents.	0

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY

CALIFORNIA PROPERTY TAX

Scoring

\+ works well
0 needs improvement

Principle	Application and Analysis	Rating
	Fairness	
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	Some owners of owner-occupied property view the property tax system as unfair because newcomers to a neighborhood pay more property taxes than their neighbors who arrived earlier, although the properties have the same value (the "welcome stranger" characteristic). These newcomers use the principle of horizontal equity to argue for taxing all similarly valued property at the same amount—that is, those similarly situated should pay the same amount of tax. But, others argue that the property owners are not similarly situated because some individuals living in homes with a low-assessed value could not afford to purchase their home at its current value and, thus would argue that they are not similarly situated income-wise to newcomers who can afford to buy the home at its current market value. A new business that purchases real property (rather than lease it) will also view the system as unfair because its property taxes will be higher than those of a local competitor who has owned real property for a longer time. This puts the new business at a competitive disadvantage. Of course, not all new businesses purchase the real property needed for their business. When a new business leases the property, the property tax disadvantage may not exist, depending on how long the owner/lessor has owned the property. It is likely that most new businesses lease their real property. Also, businesses that own real property may sell it for business reasons and any new real property purchased would be assessed at the current market value (purchase price). The exclusion from reassessment available for sale of a principal residence between parents and children provides a benefit to such a buyer that other buyers are not able to obtain. Such benefits result in similar taxpayers not being treated similarly.	0
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Owners of real property are aware of property taxes and can easily find out the amount of property taxes that will be assessed on new property. Businesses are generally aware of business personal property taxes on equipment. When real property changes hands during the tax year, the new owner will receive "supplemental" property tax bill(s) which can be confusing in determining how much property tax has been paid and/or is owed.	+

Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Payment dates and the amount due are provided by the tax collector. The Prop 13 formula provides certainty as to the amount of property tax owed. Owners of real property subject to Prop 13 can also project their property tax change from year to year. Generally, certainty exists for business personal property as well in that owners already keep tax records of what they purchase and sell. Uncertainty can arise regarding the proper depreciation schedule to use to determine the value of business personal property though.	+
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Secured property taxes are due twice a year and real property owners receive a billing statement well in advance of the payment due date. Unsecured property taxes are due in a single payment. Unlike sales tax and income tax, where the amount owed is closely associated with one's income, property taxes are not tied to income. Thus, they are still owed when the owner's income drops to zero. If the owner has no other sources of funds, he or she might be forced to sell the property or borrow against it. But, this is the nature of the property tax. Since passage of Proposition 13, few usable properties have been seized for failure to pay property taxes. As secured property taxes are paid in 6-month installments and unsecured property taxes are paid in a single payment, some taxpayers may find this to be inconvenient due to the size or manageability of these payments as opposed to monthly payments. Moreover, most counties do not permit payment by credit or debit card.	0
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Generally, property owners pay the bill sent to them by the local tax collector. There is no need for the owner to do any calculations. While appeals as to valuation may be filed, it is not an appreciable number, although the number is likely to increase in economic downturns when property values drop, especially for property owned by businesses.	+
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	At a fixed rate and a base that changes by a stated formula, the property tax is generally simple with respect to real property. Businesses may face valuation issues and identification issues, but they are unlikely to be significant relative to the complexities that exist for income taxes.	+
Minimum Tax Gap A tax should be structured to minimize non-compliance."	The tax gap is likely to be quite small for real property taxes because it is difficult to hide real property and government records frequently identify the property owner. Some gap will exist for business personal property due to the volume and difficulties in businesses providing accurate records to the Assessor upon request for audit. It is likely to be small though relative to the gap for other types of taxes.	+
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	The amount of property tax collected is not tied to government spending needs. For example, in an economic downturn that leads to a drop in property values, less property tax will be collected because the tax rate is constitutionally fixed. Also, if the economy is strong and owners are buying and selling properties, assessed values will go up and more property tax revenues will be collected. There is no correlation between either of these situations and a change in the demand for government services.	0

Operability		
Appropriate Government Revenues (continued) The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Because local jurisdictions do not control the allocation of property tax dollars, it is not always viewed as an ideal tax source. This is an odd result for a property tax because it is generally viewed as a good local tax because people believe and understand that taxes on property go to the local jurisdictions that provide services to that property. Also, the allocation of the property tax among cities, counties, schools and other districts within a county varies from county to county without much rationale for the differences. Economic development activities are challenged under the existing property tax allocation scheme because it is difficult, if not impossible, to determine how much property taxes paid by a business come back to the local jurisdictions. If the property is in an RDA (Redevelopment Agency area), better information may be available, however. Unlike the sales and use tax, the property tax is deductible for individuals who itemize their deductions on their federal income tax return. For some taxpayers, this deduction is reduced due to the federal alternative minimum tax. Thus, the state is able to shift some of this tax burden to the federal government. (Because property taxes are also deductible on the California personal income tax return, itemizers are able to shift part of the cost to the state as well.)	
Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	The certainty of the tax base and rate for real property lessens the impact – positive or negative, on decisions to buy and sell property. Businesses and individuals who have owned real property long enough to have significant benefit of lower property taxes relative to new owners of similar property, will often find that property taxes do affect their decision-making regarding ownership of the property. The tax savings from continuing to own their present property rather than selling it to buy a property that may be more suitable for them now is easily affected by the reality that property taxes will be higher on the new property. One offset is that transfers within the same county by homeowners age 55 or older retain the old valuation, and some counties allow the same for inter-county transfers (R&T §69.5). Many states and their local jurisdictions offer property tax incentives to businesses to entice them to locate or remain in the area. California is basically unable to do the same due to constitutional constraints.	0
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	The Prop 13 valuation system has prevented property taxes from proportionally increasing with property values. While without Prop 13, the tax rate could have been reduced or the value could have been reduced by some percentage amount to prevent escalation, taxpayers would still likely want some type of constitutional mechanism to assure them that that would happen. To the extent that businesses, such as manufacturers, can find more favorable property tax systems in other states, businesses can be enticed to move or expand outside California. For example, if another state caps the value per site, rather than tax a chip manufacturing plant at a greater amount than a retail store sitting on the same- size parcel of land, that state may be more attractive to the company. Of course, many other factors are relevant in any business decision as to where to locate operations.	+

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY

UTILITY USER TAXES (UUT) IN CALIFORNIA

Scoring

+ works well
o needs improvement

Principle	Application and Analysis	Rating
	Fairness	
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	Generally, residents within a city or county imposing a UUT are taxed similarly to others in the same city or county. Some cities have exemptions for low-income residents, which should help to achieve vertical equity. Technological advances, such as Internet telephony, have led to unfairness in that such usage would not be subject to a UUT (as it is not part of the phone charges for a resident).	0
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Many consumers likely do not know of the UUT because they don't look at their utility bills with enough scrutiny. Most utility bills have the UUT separately stated. However, it is not clear from most bills how the tax was computed and why it was assessed.	0
	Operability	
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Payers of the UUT (telecom, water, gas, and electricity and cable providers) can generally find the municipal code and tax forms needed for every city and county where they have customers. While there are over 150 taxing jurisdictions for the UUT, for each city, certainty mostly exists. One administrative relief provision was added to California law in 1995. AB 1575 passed in 1995 (Chapter 280) added §495.6 to the Public Utilities Code. This provision requires all cities and counties that levy a telephone user's tax to provide information to the PUC on the tax rate, how the tax is collected and the frequency of collection. The PUC is to determine how often such information is to be reported. The purpose of the reporting is to provide one source from which telephone service providers, particularly long distance providers with operations in most of the taxing jurisdictions, can obtain information on the applicable UUT. The PUC is allowed to charge a fee for providing the information provided it does not exceed the direct expenses of preparing and providing the information. The PUC is not responsible for the accuracy of the information.	+

Operability		
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Generally not an issue.	+
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Collection costs are minimized by having the service provider collect and remit the tax rather than each consumer.	+
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	Within each city or county, the tax is fairly simple. However, where a service provider has customers on several taxing jurisdictions, the multitude of bases, rates and administrative procedures adds complexity for providers. Moreover, most cities do not impose an UUT: only about 160 cities out of the more than 450 cities in California impose an UUT.	0
Minimum Tax Gap A tax should be structured to minimize non-compliance."	There is unlikely to be much of a tax gap for the UUT because the relatively small number of utility providers are aware of the rules and follow them.	+
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Except where changes in utility prices changes usage in unknown ways, local governments are likely to be able to estimate UUT collections with reasonable accuracy.	+
Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	For the approximately 160 cities and four counties in CA that impose a UUT, the rates range from one percent to 11 percent, with five percent being the average rate. Some of the services subject to UUT, such as telephone and cable services, are also subject to other taxes and fees as well. Given the small cost of the UUT to consumers (relative to other taxes, such as income and sales taxes) it is unlikely that the UUT would cause a consumer to choose to live in one city versus another. However, it might cause a manufacturer to choose one city over another or to negotiate a tax break with a particular city. While the UUT might cause a consumer to use Internet telephony rather than regular phone services, savings derived from avoiding long distance phone charges is most likely the bigger incentive to engage in Internet telephony.	0

Appropriate Purpose and Goals		
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	If energy costs go up, such as they did in recent years in CA, a UUT on electricity or gas might cause a hardship to a business leading to a decrease in use and a decline in collections for local governments. Given that higher income individuals do not use a significantly greater amount of utilities than lower income individuals, the UUT is regressive which adversely impacts lower income households (unless there is a low-income exemption). The tax is an added burden for utilities to deal with because of lack of conformity among jurisdictions that impose the tax. In addition, other industries are not burdened with a similar tax compliance obligation.	0

APPENDIX I: BACKGROUND FOR SELECTED TAXES

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA PERSONAL INCOME TAX (PIT)

BACKGROUND: PERSONAL INCOME TAX

- The California income tax was first enacted in 1935. The state income tax was set at about 25% of the federal income tax owed. The rates ranged from one percent on the first $5,000 of income to 15% on income over $250,000. The definition of taxable income was similar to that at the federal level and the returns were due on April 15.[*]
- The high level of conformity to federal law did not last. In 1982, AB 36 removed about 300 differences between the state and federal system.[†] Not all federal income tax changes are adopted by the California legislature, primarily due to revenue effects. Thus, individuals must make adjustments from their federal taxable income to compute California taxable income.
- Tax rates today range from one percent to 9.3 percent. The 1935 top rate of 15 percent was reduced to six percent in 1943. The top rate was raised to 10 percent in 1967 and then to 11 percent in 1971. The top rate was lowered to 9.3% in 1987. In 1991, temporary rates at the top of 10 percent and 11 percent were enacted.[‡]
- Tax brackets began to be indexed for the effects of inflation (to prevent "bracket creep") in 1978.[§]
- The rate structure in 2002 for a married couple with two dependent children (see 2002 tax rate schedule for details of tax calculation):

Taxable income range	Marginal Rate	Tax after personal and dependency exemptions, if income is at top of this bracket	Average tax rate for prior column
$1 - $11,668	1.0%	$0	0%
$11,668 - $27,658	2.0%	$0	0%
$27,658 - $43,652	4.0%	$414	0.9%
$43,652 - $60,596	6.0%	$1,431	2.4%
$60,596 - $76,582	8.0%	$3,372	4.4%
Over $76,582	9.3%	$5,550 (assumes taxable income of $100,000)	5.5%

- In 2000, 13.4 million full-year resident individual income tax forms were filed. These consisted of 1.6 million Forms 540EZ, 3.4 million Forms 540A and 8.4 million Forms 540.[**]
- In 1998, individuals with annual income of $200,000 or more represented less than three percent of returns filed, but about 50 percent of PIT collected. Individuals with adjusted gross income under $50,000 represented over 70 percent of returns filed and less than 10 percent of PIT collected.[††] "Taxpayers with annual income of $500,000 or more constitute about one percent of returns but

[*] Doerr, David R., *California's Tax Machine*, California Taxpayers' Association, 2000, pages 37, 437 - 445.
[†] *Ibid*, page 191.
[‡] *Ibid*, pages243, 437 – 445.
[§] *Ibid*, page 156.
[**] Franchise Tax Board, 2001 Annual Report, page 11; available at http://www.ftb.ca.gov/other/annrpt/2001/2001ar.pdf.
[††] LAO, *California's Tax System – A Primer*, January 21, page 20.

roughly 40 percent of revenue."[*] See Franchise Tax Board (FTB) data for further breakdown (http://www.ftb.ca.gov/other/annrpt/2000/append.html).

A January 2003 article in the *Sacramento Bee* summarizes the picture well: In 2000, about 44,000 individuals reported income of $1 million or more. These 44,000 people represented one-third of one percent of all taxpayers, earned 21 percent of the income and paid 37 percent of the total personal income tax. In 2001, only about 29,000 individuals reported income of $1 million or more, which was just one-fourth of one percent of the population, about 12 percent of the income and 25 percent of the tax paid. "What that means is that the decline in income on 15,000 tax returns – out of 13.5 million taxpayers and 35 million Californians – was responsible for about 80 percent of the state's historic revenue loss."[†]

- The PIT does not apply to individuals until their income exceeds twice the poverty line.[‡] In 2001, a married family of four did not owe income tax until income reached $38,800.[§]
- The PIT does not include an equivalent of the federal earned income tax credit (EITC).
- PIT revenues declined 26 percent from 2000-01 to 2001-02.[**] A significant part of this is due to the decline in capital gains and stock option revenue. "[T]ax revenues [from stock options and capital gains] peaked at $17 billion in 2000-01, but fell abruptly following the stock market decline—to under $6 billion in 2001-02. This unprecedented 66 percent decline is the key factor behind the $10-plus billion annual mismatch between revenues and expenditures that began in 2001-02."[††]

- Comparison to other states:
  - Only seven states do not have a personal income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming). Two others, New Hampshire and Tennessee, tax only dividend and interest income.
  - 2001 PIT collection as a percentage of total tax collections – selected states:[‡‡]

Arizona	27.2%
California	49.3%
Colorado	51.5%
Massachusetts	57.5%
Michigan	30.5%
New York	59.0%
Oregon	74.4%
Virginia	55.2%
All States Average	37.1%

  - State income tax thresholds for a married family of four in 2001 – selected states:[§§]

Arizona	$23,600

[*] LAO, *Governor's Tax Increase Proposal*, 1/29/03; available at http://www.lao.ca.gov/handouts\revtax\2003\030089_HO.pdf.
[†] Daniel Weintraub, "As a few rich guys go, so goes state budget," Sacramento Bee, January 5, 2003.
[‡] Based on an estimated poverty line of $18,104.
[§] Center for Budget and Policy Priorities, *State Income Tax Burdens on Low-Income Families In 2001*, California fact sheet; available at http://www.cbpp.org/2-26-02sfp-ca.pdf.
[**] LAO, *The 2003-04 Budget Bill: Perspectives and Issues*; available at http://www.lao.ca.gov/analysis_2003/2003_pandi/pi_part_3_anl03.html.
[††] LAO, *California's Fiscal Outlook LAO Projections, 2002-03 Through 2007-08*; available at http://www.lao.ca.gov/2002/fiscal_outlook/fiscal_outlook_2002.html.
[‡‡] Federation of Tax Administrators; table at http://www.taxadmin.org/fta/rate/01taxdis.html.
[§§] Center for Budget and Policy Priorities, *State Income Tax Burdens on Low-Income Families In 2001*, available at http://www.cbpp.org/2-26-02sfp.htm.

California	$38,800
Colorado	$28,700
Massachusetts	$22,700
Michigan	$12,800
New York	$24,900
Oregon	$15,100
Virginia	$17,700
Average 41 states + District of Columbia	$19,000

California had the highest threshold among the 42 taxing jurisdictions.

- Per capita comparisons, total state revenues for 2000:[*]

State	Per capita	Rank
Arizona	$3,180	50
California	$5,092	15
Colorado	$3,966	35
Massachusetts	$5,042	16
Michigan	$4,982	18
Nevada	$3,646	42
New York	$5,870	6
Oregon	$6,142	4
Virginia	$4,154	30
All state summary	$4,489	--

- Individual income tax rate range for 2002 – selected states:[†]

State	Tax rate range	# brackets
Arizona	2.87 – 5.04	5
California	1.0 – 9.3	6
Colorado	4.63	1
Massachusetts	5.3	1
Michigan	4.1	1
New York	4.0 – 6.85	5
Oregon	5.0 – 9.0	3
Virginia	2.0 – 5.75	4

States with a top individual tax rate equal to or greater than California's:

Montana	11.0%
District of Columbia	9.3%

[*] U.S. Census Bureau, information available at http://www.census.gov/govs/www/state00.html.
[†] Federation of Tax Administrators; table at http://www.taxadmin.org/fta/rate/ind_inc.html. Also see information at http://www.taxpolicycenter.org/taxfacts/state/rates.cfm.

- 15 states and the District of Columbia offer some version of an EITC based on the federal EITC.*

- Contribution of PIT to California revenues:†

Year	PIT as % of Total Tax Collections	PIT as % of Corporation Tax Collections	PIT as % of SUT Collections
1971	22.8%	237.6%	69.9%
1980	34.1%	259.2%	98.2%
1985	37.2%	295.0%	110.3%
1990	39.3%	340.5%	121.5%
1995	36.7%	327.3%	114.3%
2000	48.4%	596.1%	168.8%
2002	45.1%	620.0%	138.8%

- As currently structured, the personal income tax base has grown faster than taxable sales and at about the same rate as assessed valuation. "Since 1990, personal income and assessed valuation have grown at roughly the same rate while taxable sales grew more slowly. Between 1990 and 2002, personal income increased by 76.7 percent or 4.9 percent per year while assessed valuation rose by 74.6 percent or 4.8 percent per year. Taxable sales increased by 55.4 percent or 3.7 percent per year while the California Consumer Price Index rose by 2.7 percent annually."‡

- PIT is deductible on the individual federal income tax return for those who itemize their deductions, but is subject to the alternative minimum tax (AMT).

- City Income Tax Information – no city within California imposes an income tax. However, several states have cities that impose an income tax. Such states include Alabama, Delaware, Michigan, Missouri, New York, Ohio, and Pennsylvania. In Arizona, cities are prohibited from assessing an income tax. Instead, the state shares 15 percent of its income tax collections with cities based on population (*Urban Revenue Sharing*).§

- Further analysis from the Legislative Analyst's Office:**

  "Some key PIT-related policy issues facing policymakers include:

  - Marginal Rate Structure. Should California's PIT marginal tax rates be reduced, and the cost be financed through base broadening?
  - Federal Conformity. Should California more fully conform to federal PIT law in areas where it currently differs, such as capital gains tax rates, depreciation, certain credits, and net operating losses?
  - Broad-Based Simplification. Should California move towards a more simplified PIT system with fewer special provisions for particular groups/businesses?

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* Center for Budget and Policy Priorities, *A HAND UP: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2001*, 12/27/01, page 6; available at http://www.cbpp.org/12-27-01sfp.pdf.

† Governor's Budget Summary 2003-2004, Revenue Estimates, page 74; available at http://www.dof.ca.gov/HTML/Budgt03-04/BudgetSum03/08_Rev_Est.pdf.

‡ Memo of July 8, 2003 by Stephen Levy of the Institute of Regional and Urban Studies to Budget Project Friends.

§ For further information see http://www.strongcities.org/04d_total_shared.htm and http://www.azleg.state.az.us/ars/43/00206.htm.

** Legislative Analyst's Office, *California's Tax System – A Primer*, January 2001; available at http://www.lao.ca.gov/2001/tax_primer/0101_taxprimer_chapter2.html.

- Targeted Simplification. Alternatively, should California leave its basic system intact, but focus on simplifications in those PIT areas where the greatest complexities for taxpayers lie, such as the AMT?
- Tax Expenditure Programs (TEP). Are there certain PIT-related TEPs that are ineffective and inefficient, and therefore in need of elimination or modification?
- Reliance on the PIT. Has California become overly dependent on the PIT, given that it is a somewhat volatile revenue source and now accounts for over half of the state's General Fund total?"

As with corporate taxes, the personal income tax is administered by the Franchise Tax Board (FTB). The mission of the FTB is "to collect the proper amount of tax revenue, and operate other programs entrusted to us, at the least cost; serve the public by continually improving the quality of our products and service; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness." The FTB began in 1929 as the Office of the Franchise Tax Commissioner (OFTC) to administer the new bank and corporate tax act. This was somewhat unusual because prior to that, administration of new taxes was assigned to the State Board of Equalization (SBE) and State Controller. The OFTC was abolished in 1950 and the FTB was created. The FTB members are: the chair of the SBE, the Director of Finance, and the State Controller. An administrative executive serves as executive officer. The FTB processes over 14 million personal income tax returns annually.[*]

Appeals of FTB decisions are heard by the State Board of Equalization (SBE). If the taxpayer's appeal is denied and the taxpayer has paid the tax and exhausted all administrative remedies, an action against the FTB may be filed in California Superior Court. There is no procedure for the FTB to file an action when it loses an appeal before the SBE. The Superior Court decisions are not officially published. The members of the SBE are elected officials and are not required to have any particular tax experience or knowledge. Judges of the Superior Court are not required to be tax experts.[†]

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[*] See FTB, *California Franchise Tax Board At a Glance*, Pub. 1041; available at http://www.ftb.ca.gov/forms/misc/1041_021402.pdf. Also see R & T §19501 and §19084.

[†] For more information on the appeal and decision process, see the 9/23/03 letter from Professor Daniel Simmons to the California Commission on Tax Policy in the New Economy. The letter supports testimony of the author before the Commission on 9/9/03 and suggests that California should have a tax court.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA SALES & USE TAX (SUT)

BACKGROUND: SALES AND USE TAX

- *History*: The California sales tax was created by the legislature when it enacted the Retail Sales Act of 1933. It was imposed on retailers for the privilege of selling tangible personal property. The impetus behind the new tax was the need to raise revenue to cover a budget deficit. The sales tax rate was 2.5 percent and the base was most tangible personal property. The use tax was enacted in 1935 to complement the sales tax. It was imposed on the storage, use or other consumption in California of tangible personal property purchased from any retailer on or after July 1, 1935. The use tax rate was 3 percent, dropping to 2.5 percent after June 30, 1943.

  A 1963 California Appellate Court decision provided the following explanation of the use tax: "One of the chief purposes of the use tax is to help retailers in this state, who are subject to sales tax, to compete on an equal footing with their out of state competitors who are exempt from the sales tax. Thus it is intended to reach property purchased for use and storage in this state from retailers who, being outside of the territorial boundaries of California, are not subject to its laws at all. It also seeks to reach such property where the taxable event of a sales tax, i.e., the sale, occurs outside of this state or where such property is immune from the sales tax because of the Commerce Clause. ... The use tax is complemental to the sales tax, and as such is intended to supplement the latter by imposing upon those subject to it a tax burden equivalent to the sales tax in order that tangible personal property sold or utilized in this state would be taxable once for the support of the state government. ... It is not intended to apply to property subject to the sales tax. ... This does not mean, however, that all property which is subject to the sales tax is exempt from the use tax, 'but, rather, that all property not actually covered by the sales tax is subject to the use tax.' ... 'The use tax applies to property purchased for use in this state wherever purchased, unless the gross receipts from the sale have been included in the measure of the California sales tax (Rev. & Tax.Code, sec. 6401), or unless the transaction is otherwise exempted by the statute or by the state or federal Constitution.' ... The use tax is imposed upon the purchaser rather than seller and the former is primarily liable therefor. ...

  It should be pointed out, moreover, that while the California sales tax and use tax are complemental to each other, they are not interdependent. Each is a separate tax. The sales tax is imposed upon the retailer for the privilege of selling tangible personal property (§6051), while the use tax ... is upon the purchaser who stores, uses or consumes property in this state. ... The definitions contained in the 'Sales and Use Tax Law' (§§6002 to 6019 incl.), however, apply to both taxes, except where the contract specifically limits the particular definition to one and not the other. (§6002.)" [*Bank of America National Trust and Savings Association v. State Board of Equalization,* 209 Cal App 2d 780, 26 Cal Rptr 348 (First App Dist 1963).]

- As noted earlier, there are constitutional limitations on a state imposing the sales tax on vendors outside of the territorial boundaries of the state. This position was reaffirmed by the U.S. Supreme Court in 1992 in *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992). In that decision, the Court ruled that to be within the Commerce Clause,* a vendor must have a physical presence in the state before the state can impose sales tax collection obligations upon the vendor. Litigation continues in

* "The Congress shall have power ... to regulate commerce with foreign nations, and among the several States, and with the Indian tribes." [Article I, Section 8, clause 3] Courts often refer to the "dormant Commerce Clause" because the Commerce Clause does not specifically limit state activities—it just grants power to Congress to regulate commerce. In applying the dormant Commerce Clause, the courts consider the purpose served by the Commerce Clause and "whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve." *Wardair Canada v. Florida Dept. of Revenue*, 477 U.S. 1 (1986).

the states as to how much physical presence is required for a vendor to have nexus* (taxable presence) in the state. For example, would ten hours of employee time be sufficient or a leased computer or use of a trademark? These questions are not always resolved similarly among state courts.

- In the 1940's, in addition to the state sales tax, some cities began to assess a local sales tax. By 1954, about half of California cities were imposing a sales tax which was producing significant revenue for them. Each city administered its sales tax on its own. In response to complexity concerns raised by businesses, the legislature enacted the Bradley-Burns Uniform Local Sales Tax Act in 1955. The Act allowed counties and cities to impose a sales tax with a base similar to that of the state and administered at the state level. Regulation 1802 provides that for retailers with one place of business, the sale is deemed to occur at that place of business. Thus, cities are incentivized to get businesses to locate a sales office or large retail outlets within the city borders. In contrast, district taxes (those imposed by special districts) go to the district where the delivery was made.†

- Not all-tangible personal property is subject to the sales and use tax. There are many exemptions, such as for food and prescription medicine. Other states also tend to have a variety of exemptions. Over half of the states exempt food from sales tax. Most states exempt equipment purchased by manufacturers.

- The combined state and local sales tax rate in California is 7.25 percent (January 2003). Some areas also have district sales tax(es), with the result that the rate varies among counties from 7.25 percent to 8.50 percent. The 7.25 percent California sales tax rate is composed of the following elements:

Rate	Jurisdiction
5.00%	State (General Fund)
0.50%	State (Local Revenue Fund)
0.50%	State (Local Public Safety Fund)
1.25%	Local (County/City) *(City and county operations + County transportation funds)*
7.25%	**Total Statewide Base Sales/Use Tax**

District taxes range from 0.125 percent to 0.50 percent per district. A county may have more than one district within it or it may have no districts. For example, the tax rate in Santa Clara County is 8.25 percent, comprised of the standard 7.25 percent and two district taxes of 0.50 percent each.

- The combined state and local sales tax rates in the other 45 states that impose such a tax range from four percent to nine percent.

- In 2000/2001, $35.4 billion of sales and use taxes were collected in California. The sales tax represents about 10 percent of a city's total revenues.

- California taxes almost no services while many states tax a variety of services (for example, Hawaii and South Dakota).

* Nexus may be thought of as a connection between the vendor and state such that subjecting the vendor to the state's sales tax rules is neither unfair to the vendor nor harmful to interstate commerce. These two requirements of fairness to the vendor and no impediment to interstate commerce stem from the U.S. Constitution—respectively, from the Due Process Clause and the Commerce Clause. Both of these requirements must be satisfied before a state may impose sales and use tax collection responsibilities on a vendor.

† For further information on local sales and use taxes and district taxes, see SBE publications 28, 44 and 105, available at http://www.boe.ca.gov/sutax/staxpubsa.htm.

- In all states, compliance with the use tax is low, particularly when taxable items are sold to consumers by remote (non-present) sellers. Some states, such as Maine, Michigan and North Carolina, attempt to simplify collection by allowing consumers to report the use tax on their personal income tax returns. In 2003, the legislature passed SB 1009 that calls for the Franchise Tax Board to add a line to personal income tax forms for reporting and remitting use tax, with the FTB charged to submit the amount collected to the State Board of Equalization.

  A June 2000 report from the GAO estimated that use tax compliance by individual consumers was no higher than five percent, except on auto purchases. Because cars must be registered, the use tax can be collected easily and use tax compliance is about 100 percent. The GAO also found that business compliance with the use tax is probably only between 65 percent and 80 percent.[*]

  The GAO estimated that for 2000, state and local governments may lose between $1.6 and $9.1 billion due to use tax non-compliance. The range in estimates is due to varying assumptions about collection rates and quantity of remote sales. The GAO also estimates that between $0.3 and $3.8 billion of this loss is due to Internet sales.[†] For California, the estimates of uncollected use tax on all remote sales for 2000 was between $298 million and $1.4 billion, and for Internet sales, between $23 million and $533 million.[‡]

- While sales taxes are paid by customers, the vendor generally has the tax compliance and collection duties.[§] In addition, in most states, errors are the liability of the vendor, rather than the buyer. The costs of complying with the tax rules of multiple state and local taxing jurisdictions can be quite high in terms of labor costs, training, computer systems, need for continual updates (due to changes in laws and regulations), audits, and error. A recent study by the State of Washington on sales tax compliance costs reached the following conclusions:[**]

  Costs as a percent of total state and local sales tax collections:

Small business	6.47%	(gross sales between $150,000 and $400,000)
Medium business	3.35%	(gross sales between $400,000 and $1,500,000)
Large business	0.97%	(gross sales over $1,500,000)
Total cost weighted by number	4.23%	
Total cost weighted by dollars	1.42%	

  A 1999 study by Ernst & Young LLP concluded that the costs of administering state and local sales taxes were primarily borne by vendors. The report notes that a large multistate vendor in 15 states would have compliance costs equal to approximately 8.3 percent of the sales and use taxes paid. Added compliance costs for multistate vendors include variations across states as to what is taxable and dealing with numerous tax base and tax rate changes enacted by the states each year. The report also noted that e-commerce vendors face additional costs over traditional vendors. For example, there would be added costs of collecting information about the buyer's location, particularly for the sale of digitized products.[††]

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[*] GAO, *Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000, page 17.

[†] *Supra*, page 19.

[‡] *Supra*, page 59.

[§] Some large businesses may file a "direct pay" permit with a state and self-assess any sales and use tax owed on its purchases.

[**] Washington State Department of Revenue, *Retailers' Cost of Collecting and Remitting Sales Tax*, December 1998; http://www.wa.gov/dor/reports/retail/retailsum.htm. The report also notes that the costs of collection can be offset somewhat by the float that retailers enjoy due to the lag between collection and remittance of the tax, and the ability to deduct these costs on their income tax returns.

[††] Robert J. Cline and Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Vendors*, September 1999.

The costs of compliance can also be complicated and costly due to the frequent changes that are made to tax rules and forms. While many companies rely on software systems for compliance, such systems can be expensive to both obtain and maintain. Also, many large companies find that they need to create their own software systems rather than purchase "canned" programs. In addition, the software is not a replacement for personnel who are needed in sufficient number to meet the filing obligations of the vendor. One large U.S. company with over $40 billion of revenues has stated that it has twice as many employees involved with sales and use tax compliance than with federal and state income tax compliance, planning, and audit activities.[*]

- The Streamlined Sales Tax Project (SSTP) stems from the simplification suggestions made in the minority report of the federal Advisory Commission on E-Commerce (formed by the Internet Tax Freedom Act) and suggestions of the National Governors Association (NGA) in 1999. A group of representatives from over 35 states met throughout 2000 to create a Model Act and Agreement for a uniform and simplified sales and use tax act. California was not involved in this effort. The language was approved by the participating states in December 2000. Additional work was done and a final agreement was reached in November 2002. The mission of the SSTP: "The Streamlined Sales Tax Project will develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes."[†]

  SB 1949, introduced in February 2000, would have directed the Governor to enter into discussions with other states "regarding the development of a multistate, voluntary, streamlined system for sales and use tax collection and administration." SB 1949 was passed in both the California Assembly and Senate, but was vetoed by Governor Davis in September 2000 because he deemed it unnecessary. He noted that California already participates in such forums as the Multistate Tax Commission and National Governor's Association that work on tax simplification activities.

  SB 157 (Chapter 702) enacted in October 2003, creates the "Streamlined Sales Tax Project," a governance board to represent California in meetings related to the Streamlined Sales and Use Tax Agreement (SSUTA). The Board will consist of 2 members of the Senate, 2 from the Assembly, one member from the SBE, one from the FTB and one person from the Governor's Department of Finance.

  Diverse views exist among vendors and state and local governments as to whether the SSTP will be a better system. Some vendors see benefits of having a more uniform sales and use tax system across jurisdictions and more fair competition should the project be successful in enabling states to collect use tax from remote vendors. On the other hand, some vendors are concerned that the number of jurisdictions in which they have filing obligations will increase (such as when the taxing point of a pizza delivery business is changed from vendor's location (origin) to point of delivery). Some cities that currently collect significant sales tax from a business base that sells within the city's borders to other cities in the state are concerned that they will lose sales tax revenue when the sales tax shifts to point of delivery (other cities). The House Judiciary's Subcommittee on Commercial and Administrative Law held a hearing on the SSTP on October 1, 2003, where some of these pro and con arguments were raised. See testimony for this hearing at http://www.house.gov/judiciary/commercial.htm, as well as various sites of business and city/county organizations.

- From 1980 – 1990 and 1990 – 2002, taxable sales grew at a slower rate than personal income or assessed valuation. "Between 1990 and 2002, personal income increased by 76.7 percent or 4.9 percent per year while assessed valuation rose by 74.6 percent or 4.8 percent per year. Taxable sales

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[*] Testimony of Dan Kostenbauder, General Tax Counsel, Hewlett Packard Company, before the Advisory Commission on Electronic Commerce, December 15, 1999, available at www.ecommercecommission.org/sanFran/tr1215.htm.

[†] See http://www.geocities.com/streamlined2000/.

increased by 55.4 percent or 3.7 percent per year while the California Consumer Price Index rose by 2.7 percent annually."

"The volatility of taxable sales is explained by the close link between business and consumer spending and the business cycle. In all recent recessions, spending has fallen by more than income. It is reasonable to expect that taxable sales will continue to be the most volatile of the three major tax bases."*

- The sales and use tax is administered by the State Board of Equalization (SBE). The SBE consists of five elected members. The state is split into four districts with each one electing a board member. The fifth board member is the State Controller, serving in an ex officio role. The SBE serves administrative functions as well as some quasi-judicial ones. It is an appellate body for appeals on certain business tax assessments, Franchise Tax Board actions, and public utility assessments. The three general tax areas the SBE oversees are (1) sales and use taxes, (2) property taxes (but it does not assess local properties), and (3) special taxes, such as those on cigarettes and fuel.

  The Final Report of the California Constitution Revision Commission of 1996 included a recommendation to abolish the SBE. This recommendation also included merging the functions of the SBE, Franchise Tax Board, and other major revenue agencies into a combined Department of Revenue. The Commission also recommended creating a tax appeals board that would be appointed by the Governor and confirmed by the Senate. In addition to the problems of an elected tax board, the Report notes the fragmentation of tax administration under the present system and the lack of accountability. In addition, economies of scale would be realized by consolidation of the administrative and audit functions of the current tax agencies. The Report notes that since 1929, there have been several studies that have called for the SBE to be eliminated.†

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* Memo of July 8, 2003 by Stephen Levy of the Institute of Regional and Urban Studies to Budget Project Friends.

† California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, 1996, pages 2 and 20 – 22.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA PROPERTY TAX*

BACKGROUND: PROPERTY TAX

Nature of the tax: The property tax is best described as an *ad valorem* tax based on a percentage of value of property; it is not tied to the property owner's income or consumption. That is, the amount of property tax owed is not dependent on income, but on the value (as measured under the state's property tax valuation laws) of the property. Real property is taxed by the jurisdiction in which it is located (rather than where the owner is located). Personal property subject to the California property tax is taxed based on where it has obtained a permanent situs (rather than on where the owner is located).

History: The property tax has existed in California since 1849.† The property tax is a local tax. Since 1933, the only property tax that the state assesses, collects and keeps is one on privately-owned public utilities and railroad cars ($6.5 million of assessed value and $171 in local property tax revenues in 2002-2003‡).

What is subject to tax: The California property tax is generally assessed on all real property and tangible personal property unless an exemption applies. Significant exemptions for tangible personal property include personal effects and business inventories. Significant exemptions for real property include the homeowner's exemption which reduces the assessed valuation of an owner-occupied home by $7,000; property used exclusively for non-profit organizations, public schools, community colleges, state colleges and state universities; and exemptions for church property and growing crops.

Proposition 13: For real property, the valuation for property tax purposes is based on the 1975-1976 valuation amount ("Prop 13" system). If the property has transferred ownership, is purchased new, or was constructed (including additional new construction) after 1976, it is reassessed at market value (frequently, the purchase price). Valuations may only increase annually at no greater than the inflation rate or 2%, whichever is lower. Pursuant to Proposition 8, if the market value decreases below the original assessed value (the factored base year value), the assessed value is temporarily decreased until the market value exceeds original assessed value plus the inflation rate. This valuation system, commonly referred to as an acquisition-based property tax system as opposed to market-based, has led to "dramatic disparities" [U.S. Supreme Court in Nordlinger] of the property taxes assessed on properties that are similar but were purchased at different times. The valuation system was upheld in 1992 under the Equal Protection clause of the 14th Amendment by the U.S. Supreme Court in a case involving residential property (Nordlinger v. Hahn, 505 U.S. 1 (1992)).

Prop 13 generally limits the tax rate to 1one percent.
The Prop 13 valuation method does not apply to locally assessed business personal property or utilities, railroads and other properties assessed by the State Board of Equalization (that is, not assessed by counties).

Property Tax Relief Measures: In addition to the homeowner's exemption, which a majority of states provide, California also provides limited relief to low-income homeowners and renters age 62 and over. Property tax assistance of a few hundred dollars is administered by the Franchise Tax Board for low-income homeowners or renters age 62 and over, blind or disabled. Homeowners file Form 9000 to claim relief and renters file Form 9000R. Homeowners who are age 62 or older, blind or disabled may also obtain postponement of all or a portion of their property taxes. Basically, the state pays the taxes and a lien

* Additional Reference: SBE Publication 29 - California Property Tax, An Overview (9/02) available at http://www.boe.ca.gov/proptaxes/pdf/pub29.pdf.

† Legislative Analyst's Office, *California's Tax System – A Primer,* Chapter 6, January 2001, available at http://www.lao.ca.gov/2001/tax%5Fprimer/0101_taxprimer_chapter6.html.

‡ State Board of Equalization's 2001-2002 Annual Report, Property Tax section – page 14, available at http://www.boe.ca.gov/annual/.

is placed on the property; thus, it is a postponement of payment. These types of relief and postponement provisions are provided by many states.

Exclusion from normal reassessment is also available for seniors and certain intrafamily transfers. Homeowners who are at least age 55 or disabled may transfer the taxable value of their home to a replacement home of equal or lesser value within the same county and maintain the equivalent prior assessed value. Certain counties allow such relief for intercounty transfers. In addition, the purchase or transfer of a principal residence and the first $1 million of other real property between parents and children will not be reassessed if a claim is filed within specified time limits. This relief also applies to transfers between grandparents and grandchildren if both qualifying parents are deceased.

Allocation of property tax dollars: In 2001-2002, over $27.1 billion of property tax dollars were raised. On average, this amount was allocated 19 percent to counties, 11 percent to cities, 52 percent to schools and 18 percent to special districts.[*] Allocation of property taxes to cities, counties, schools, and other districts is not consistent among counties, however. See Table 14 and Table 15 from the State Board of Equalization's 2001-2002 Annual Report. [http://www.boe.ca.gov/annual/statindex0102.htm#pt]

Local or State Tax? Many people likely believe that the property tax is a local tax. The amount owed is determined by a county collector (for most property) and payment is made to a local tax collector, rather than to the state. However, after Proposition 13, most *control* over property tax allocations rests with the state. The 1996 report of the California Constitution Revision Commission noted that the property tax, "once a local tax for local purposes, is now treated as a tax for state purposes."[†] A 2000 report by the Legislative Analyst's Office noted that one of the problems with the allocation of the property tax is the lack of local control. The report explains that the distribution of property tax revenues among local jurisdictions is mostly the same as it was in the 1970s. For example, a water district may receive the same property tax allocation today as it did 25 years ago even thought its services today may be funded with user charges. Also, local residents who seek a higher level of service from their city or county are powerless to reallocate the property tax among the local jurisdictions to cover the service. The only solution is to approve an assessment or special tax. Finally, local governments are vulnerable to the state shifting property tax dollars to the state, as was done with the Educational Revenue Augmentation Fund (ERAF).[‡]

Tax Stats:

Valuations[§] (net exemptions)	**2001-2002**	**2002-2003**
State assessed property values	$63.3 billion	$65.17 billion
County-assessed property values	$2.5 trillion	$2.69 trillion

The assessed value of property grew by 10.5 percent per year between 1980 and 1990, but only 4.8 percent since 1990. In comparison, between 1980 and 1990, there was 7.5 percent annual growth in population and inflation, and 4.2 percent since 1990.[**]

[*] SBE, *California Property Tax – An Overview*, Publication 29, 9/02, page 1.
[†] California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, 1996, page 64.
[‡] LAO, *Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes,* February 2000, pages 4 – 5.
[§] State Board of Equalization's 2001-2002 Annual Report, Table 4, available at http://www.boe.ca.gov/annual/.
[**] Memo of July 8, 2003 by Stephen Levy of the Institute of Regional and Urban Studies to Budget Project Friends.

Issues per the Legislative Analyst's Office:[*]

"The property tax has numerous issues associated with it.

- *Basic Fairness of the Tax.* Under current assessment methods, owners of identical properties can pay vastly different taxes solely based on when the property was purchased.
- *Property Tax Allocations.* The most appropriate way of allocating the property tax among local governments continues to be a topic of discussion and debate.
- *Personal Property Assessment.* Issues have been raised regarding the appropriate methodologies used for assessing the value of personal property, which largely affects businesses."

Further Information on California Property Taxes: See SBE Publication 29 - California Property Tax, An Overview (9/02) available at http://www.boe.ca.gov/proptaxes/pdf/pub29.pdf, and SBE Annual Reports available at http://www.boe.ca.gov/annual/annualrpts.htm.

Comparison Among States:

A. Local Property Taxes as a Percent of Local Taxes, FY 1999[†]

Local property taxes are a significant revenue source for U.S. local governments as indicated below. California is below the national average in its dependence on property taxes at the local level. This is likely due to the one percent rate cap and assessed value cap, as well as the importance of the sales tax to local governments.

State	Percent	Rank
Arizona	70.6	32
California	66.2	34
Colorado	61.5	40
Massachusetts	96.9	6
Michigan	89.8	14
Nevada	63.3	38
New York	57.0	44
Oregon	80.1	20
Virginia	71.7	31
All states	72.3	--

B. Property Taxes as a Percent of Total State and Local Revenue FY 1999[‡]]

State	Percent	Rank
Arizona	13.94	20
California	10.49	36
Colorado	13.43	21
Massachusetts	17.62	8
Michigan	13.33	22
Nevada	10.76	35
New York	14.37	17
Oregon	11.10	33
Virginia	14.42	16
All states	13.38	--

[*] *Primer, supra.*
[†] National Conference of State Legislatures, *A Guide to Property Taxes: An Overview*, May 2002, page 12.
[‡] National Conference of State Legislatures, *A Guide to Property Taxes: An Overview*, May 2002, page 30.

C. Property Taxes Per Capita and as a Percentage of Personal Income, FY 1999*

State	Collections in thousands	Per Capita		Per $100 Income	
		Amount	Rank	Amount	Rank
Arizona	$3,584,155	$750.1	32	$3.2	24
California	25,424,960	767.1	31	2.8	33
Colorado	3,413,607	841.6	23	2.9	31
Massachusetts	7,300,559	1,182.3	8	3.6	16
Michigan	8,810,590	893.2	19	3.3	22
Nevada	1,261,135	697.1	33	2.4	39
New York	24,758,694	1,360.6	4	4.2	9
Oregon	2,558,189	771.5	30	3.0	28
Virginia	5.757,546	837.7	24	3.0	29
All states	$239.427,272	879.7	--	3.3	--

D. Other Measures of Assessed Value

Some states have different valuation and assessment ratios for different classes of property. Some states, such as Oregon, have a constitutionally set maximum assessed value for each property. Some may allow for property tax reductions for purposes of economic development.

* National Conference of State Legislatures, *A Guide to Property Taxes: An Overview*, May 2002, page 15.

TABLE 14 – 2000-01 GENERAL PROPERTY TAX LEVIES AS COMPILED FOR COMPUTATION OF THE AVERAGE TAX RATE (Levies and assessed values in thousands of dollars)

County	Net taxable[a] assessed value	Property tax allocations and levies[b]					Average tax rate	
		City	County[c]	School[c]	Other[d] districts	Total[d]	2000-01	1999-00
1	2	3	4	5	6	7	8	9
Alameda	$110,060,850	$251,707	$184,030	$560,604	$246,682	$1,243,023	1.129%	1.134%
Alpine	285,745	–	1,807	753	297	2,857	1.000	1.000
Amador	2,419,457	984	7,971	14,809	431	24,195	1.000	1.000
Butte	10,401,153	5,962	13,702	70,169	18,344	108,177	1.040	1.040
Calaveras	3,262,168	239	6,407	22,676	4,763	34,085	1.045	1.044
Colusa	1,733,974	879	4,899	10,191	1,353	17,322	0.999	0.999
Contra Costa	83,102,679	76,832	111,499	437,809	251,936	878,076	1.057	1.063
Del Norte	1,047,189	95	1,918	6,841	1,628	10,482	1.001	1.001
El Dorado	12,424,735	3,670	29,582	63,539	31,612	128,403	1.033	1.039
Fresno	34,106,100	51,697	44,772	247,719	45,286	389,474	1.142	1.131
Glenn	1,572,002	1,011	3,237	11,027	701	15,976	1.016	1.013
Humboldt	6,348,653	1,857	12,772	40,624	8,995	64,248	1.012	1.013
Imperial	6,293,900	5,139	11,447	43,487	11,135	71,208	1.131	1.099
Inyo	2,435,523	298	7,434	15,566	1,626	24,924	1.023	1.001
Kern	42,209,013	23,294	121,677	263,741	50,075	458,787	1.087	1.095
Kings	4,442,430	2,994	11,377	26,718	6,139	47,228	1.063	1.059
Lake	3,495,752	908	8,508	20,367	5,750	35,533	1.016	1.014
Lassen	1,447,186	599	2,860	10,716	754	14,929	1.032	1.027
Los Angeles	581,226,946	997,654	1,542,409	2,532,770	1,163,358	6,236,191	1.073	1.068
Madera	6,211,635	1,771	9,673	46,775	5,808	64,027	1.031	1.025
Marin	30,958,871	36,059	58,047	180,752	45,389	320,247	1.034	1.023
Mariposa	1,189,731	–	3,070	8,240	626	11,936	1.003	1.001
Mendocino	5,716,567	948	16,516	36,448	6,466	60,378	1.056	1.053
Merced	9,590,787	6,163	22,211	61,462	9,047	98,883	1.031	1.018
Modoc	711,467	230	1,965	4,527	393	7,115	1.000	1.000
Mono	2,243,923	727	6,742	9,103	6,346	22,918	1.021	1.020
Monterey	27,617,259	18,863	46,006	175,584	41,727	282,180	1.022	1.020
Napa	12,582,819	12,215	28,640	84,332	4,345	129,532	1.029	1.033
Nevada	8,011,172	5,360	12,247	47,946	15,910	81,463	1.017	1.011
Orange	225,391,305	248,009	243,253	1,432,372	409,114	2,332,748	1.035	1.035
Placer	24,231,322	16,333	49,331	160,707	29,297	255,668	1.055	1.045
Plumas	2,217,021	153	4,812	14,653	2,554	22,172	1.000	1.000
Riverside	88,025,025	56,718	115,654	453,339	314,766	940,477	1.068	1.079
Sacramento	63,669,662	62,728	126,054	338,453	138,855	666,090	1.046	1.037
San Benito	3,805,950	994	5,884	23,759	9,396	40,033	1.052	1.082
San Bernardino	81,981,706	64,659	108,342	411,499	314,696	899,196	1.097	1.095
San Diego	192,488,886	258,673	287,804	1,285,516	214,652	2,046,645	1.063	1.062
San Francisco	77,649,539	–	566,050	249,270	64,743	880,063	1.133	1.132
San Joaquin	28,940,756	32,282	64,204	162,228	31,131	289,845	1.002	1.002
San Luis Obispo	21,758,815	15,572	55,295	157,562	12,361	240,790	1.107	1.103
San Mateo	80,120,297	86,719	122,169	509,420	111,374	829,682	1.036	1.035
Santa Barbara	32,566,457	15,905	65,386	200,546	52,902	334,739	1.028	1.035
Santa Clara	173,399,110	157,236	271,286	1,155,838	327,582	1,911,942	1.103	1.091
Santa Cruz	19,432,444	11,527	30,177	122,242	41,959	205,905	1.060	1.038
Shasta	8,873,806	6,187	12,879	64,891	12,055	96,012	1.082	1.081
Sierra	406,786	26	2,228	1,396	579	4,229	1.040	1.034
Siskiyou	2,570,930	1,618	5,940	17,427	1,044	26,029	1.012	1.014
Solano	22,708,182	32,438	40,200	107,606	64,496	244,740	1.078	1.086
Sonoma	35,732,663	23,356	81,470	238,088	45,850	388,764	1.088	1.089
Stanislaus	20,427,521	13,129	24,171	164,533	15,493	217,326	1.064	1.073
Sutter	4,458,105	3,092	8,299	29,135	4,964	45,490	1.020	1.000
Tehama	2,698,361	1,183	6,858	18,144	926	27,111	1.005	1.006
Trinity	713,730	–	2,171	4,619	368	7,158	1.003	1.003
Tulare	15,380,658	8,846	32,838	98,613	18,790	159,087	1.034	1.033
Tuolumne	3,629,657	261	10,970	23,562	2,027	36,820	1.014	1.015
Ventura	56,223,638	47,312	97,437	320,955	136,536	602,240	1.071	1.069
Yolo	10,486,358	17,674	10,624	62,578	17,401	108,277	1.033	1.006
Yuba	2,367,330	897	5,182	15,792	2,195	24,066	1.017	1.016
TOTAL	$2,315,505,706	$2,691,682	$4,790,393	$12,900,038	$4,385,028	$24,767,141	1.070%	1.067%

a. These are the assessed values on which general property taxes were actually levied in 2000-01. Excluded are exemptions totaling $99,271,272,000 as follows: homeowners', $36,396,322,000; all other, $62,874,950,000.

b. The county levies at a rate of 1 percent of assessed value have been allocated among the jurisdictions receiving a portion of those levies. Excluded are the state reimbursements to local governments of $398,362,000 for the homeowners' exemption described in footnote a.

c. County levies for school purposes such as junior college tuition and countywide school levies are included with school levies.

d. Includes debt levies on land and/or improvements only. Also includes the portion of the 1 percent levy allocated to jurisdictions previously taxing less than total property.

TABLE 15 – 2000-01 GENERAL PROPERTY TAX DOLLAR[a], BY COUNTY

County	Property tax dollars				
	City	County[b]	School[b]	Other districts	Total
1	2	3	4	5	6
Alameda	$.20	$.15	$.45	$.20	$1.00
Alpine	–	.63	.26	.11	1.00
Amador	.04	.33	.61	.02	1.00
Butte	.05	.13	.65	.17	1.00
Calaveras	.01	.19	.66	.14	1.00
Colusa	.05	.28	.59	.08	1.00
Contra Costa	.09	.13	.50	.28	1.00
Del Norte	.01	.18	.65	.16	1.00
El Dorado	.03	.23	.49	.25	1.00
Fresno	.13	.11	.64	.12	1.00
Glenn	.06	.20	.69	.05	1.00
Humboldt	.03	.20	.63	.14	1.00
Imperial	.07	.16	.61	.16	1.00
Inyo	.01	.30	.62	.07	1.00
Kern	.05	.27	.57	.11	1.00
Kings	.06	.24	.57	.13	1.00
Lake	.03	.24	.57	.16	1.00
Lassen	.04	.19	.72	.05	1.00
Los Angeles	.16	.25	.40	.19	1.00
Madera	.03	.15	.73	.09	1.00
Marin	.11	.18	.57	.14	1.00
Mariposa	–	.26	.69	.05	1.00
Mendocino	.02	.27	.60	.11	1.00
Merced	.06	.23	.62	.09	1.00
Modoc	.03	.28	.64	.05	1.00
Mono	.03	.29	.40	.28	1.00
Monterey	.07	.16	.62	.15	1.00
Napa	.10	.22	.65	.03	1.00
Nevada	.07	.15	.59	.19	1.00
Orange	.11	.10	.61	.18	1.00
Placer	.06	.19	.63	.12	1.00
Plumas	.01	.22	.66	.11	1.00
Riverside	.06	.12	.48	.34	1.00
Sacramento	.09	.19	.51	.21	1.00
San Benito	.03	.15	.59	.23	1.00
San Bernardino	.07	.12	.46	.35	1.00
San Diego	.13	.14	.63	.10	1.00
San Francisco	–	.64	.28	.08	1.00
San Joaquin	.11	.22	.56	.11	1.00
San Luis Obispo	.07	.23	.65	.05	1.00
San Mateo	.11	.15	.61	.13	1.00
Santa Barbara	.05	.19	.60	.16	1.00
Santa Clara	.08	.14	.61	.17	1.00
Santa Cruz	.06	.15	.59	.20	1.00
Shasta	.06	.13	.68	.13	1.00
Sierra	.01	.52	.33	.14	1.00
Siskiyou	.06	.23	.67	.04	1.00
Solano	.13	.17	.44	.26	1.00
Sonoma	.06	.21	.61	.12	1.00
Stanislaus	.06	.11	.76	.07	1.00
Sutter	.07	.18	.64	.11	1.00
Tehama	.04	.25	.67	.04	1.00
Trinity	–	.30	.65	.05	1.00
Tulare	.05	.21	.62	.12	1.00
Tuolumne	.01	.30	.64	.05	1.00
Ventura	.08	.16	.53	.23	1.00
Yolo	.16	.10	.58	.16	1.00
Yuba	.04	.21	.66	.09	1.00
TOTAL	$.11	$.19	$.52	$.18	$1.00

a. Includes ad valorem levies for debt service on land and/or improvements only, but excludes special assessments levied on other than an ad valorem basis (e.g. per parcel).

b. County levies for school purposes such as junior college tuition and countywide school levies are included with school levies.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA TELECOMMUNICATIONS TAXES AND FEES

BACKGROUND: TELECOMMUNICATIONS TAXES AND FEES

- There are a variety of assessments on telecommunications services. These assessments include both taxes and fees and are imposed at both the state and local levels. Thus, there is no single "telecom tax" in California. In addition to specific taxes and fees pertinent to companies providing various telecommunications services, special rules and issues exist under the other key taxes. For example, significant assets for some telecom companies are FCC licenses. Yet, as an intangible, the licenses are not included in apportionment factors for income tax purposes. Also, property of regulated telephone companies is assessed by the state rather than by the county, and the Prop 13 valuation system does not apply. Because telecommunications services are not tangible personal property, they are not subject to sales and use taxes.

- Cities and Counties charge franchise fees for the right of companies to lay cable lines, with the fee representing fair rental for using the property. Unlike most states, local governments in California may impose franchise fees only upon cable and energy companies and not upon telephone companies. The difference in treatment in California comes from a law passed in 1850 to promote the establishment of telegraph, and later telephone service in the State. In 1959 the California Supreme Court ruled in *The Pacific Telephone and Telegraph Company v. City and County of San Francisco*, that "construction and maintenance of telephone lines in the streets and other public places within the city is today a matter of state concern and not a municipal affair."[*] The court noted that since 1850, state statute authorized the construction and maintenance of telegraph lines along roads and other public places in the state. In 1905, the statute was expanded to also cover telephone corporations and telephone lines.[†] Federal law prohibits jurisdictions from imposing a franchise fee on cable companies greater than five percent of the operator's 12-month gross receipts. Franchise fees must represent "fair and reasonable compensation" for the jurisdiction's management and maintenance of public rights of way (rent), rather than serve as a source of general revenues. In some cases, a portion of these fees is also used to help pay for the cost of educational, government and public access (PEG) programming that is broadcast on the cable system.

- The state imposes a variety of taxes and surcharges. "The majority of statewide taxes and surcharges provide funding for telecommunications public programs established by the California Public Utilities Commission (CPUC) to achieve the state's universal service goals of affordability and availability of basic telephone service to all Californians."

  "The CPUC has created five public programs to achieve its universal service goals:
  - The Deaf and Disabled Telecommunications Program (DDTP) and Telecommunications Device for the Deaf Placement Program (TDPP), which provide relay service and communications devices to deaf and disabled consumers;
  - The Universal Lifeline Telephone Service (ULTS) program, which provides discounted basic telephone services to low-income consumers;
  - The California High Cost Fund-A (CHCF-A), which subsidizes the 17 incumbent small local exchange companies (LECs) to reduce any disparity in the rates charged by these companies;

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[*] *The Pacific Telephone and Telegraph Company v. City and County of San Francisco*, 51 Cal.2d 766, 768, 336 F.2d 514 (CA Sup Ct. 1959). Also see *The Pacific Telephone and Telegraph Company v. City and County of San Francisco*, 197 Cal.App.2d 133 (1st App 1961).

[†] The current statute is California Public Utilities Code §7901, formerly Civil Code §536. CPUC §7901 provides: "Telegraph or telephone corporations may construct lines of telegraph or telephone lines along and upon any public road or highway, along or across any of the waters or lands within this State, and may erect poles, posts, piers, or abutments for supporting the insulators, wires, and other necessary fixtures of their lines, in such manner and at such points as not to incommode the public use of the road or highway or interrupt the navigation of the waters."

- The California High Cost Fund-B (CHCF-B), which subsidizes the few largest incumbent LECs in their high-cost areas, to reduce any disparity in their rates; and
- The California Teleconnect Fund (CTF), which provides discounted services to schools, libraries, municipal and county government-owned hospitals and health clinics, and community-based organizations."

"Other state-imposed fees include the California 911 surcharge, the state regulatory fee, and fees to fund payphone programs." *

- "In 2001 California was tied with Colorado, Illinois, and Louisiana for the second highest number of state taxes on telecommunications sales: seven.ˣ Only New Mexico, New York, and Texas had more, each with eight. The national average is four. Arizona, Florida, and Washington each have five, Oregon has four, and Nevada has three."†
- In recent years, some states, such as Florida and Illinois have consolidated their multiple telecom taxes into a single tax.

Utility User Taxes

Over 150 California cities and counties impose a UUT on use within their borders of telephone service, water, gas, electricity and/or cable service. The tax rate is applied to the charges for the particular utility service. The base varies from city to city, as does the rate (from 0 percent to 11 percent). For example, some cities tax all telephone services while others only tax intrastate calls. Also, some cities tax cable service while others do not.

For more information, see *The Taxation of Telecommunications in California in the Information Age*, James E. Prieger, Terri A. Sexton, and Annette Nellen, Report , April 2003, 172 pp.; *Brief*,Vol. 15, No. 4, April 2003, 4 pp.; available at http://www.ucop.edu/cprc/publist.html#ECONOMIC.

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* *The Taxation of Telecommunications in California in the Information Age*, James E. Prieger, Terri A. Sexton, and Annette Nellen, April 2003; available at http://www.ucop.edu/cprc/publist.html#ECONOMIC

† *Supra.*

ENDNOTES

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[i] "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals," New York: Tax Division of the American Institute of Certified Public Accountants, 2001.
[ii] Testimony to the California Commission on Tax Policy in the New Economy, Matt Stolte, Price WaterhouseCoopers LLP March 20 2002.
[iii] California Board of Equalization (BOE) Electronic Commerce And Mail Order Sales Revenue Estimate, released April 12, 2002. For further information, contact Joe Fitz, Economist, jfitz@boe.ca.gov
[iv] California Legislative Analyst's Office. *California Tax Policy and the Internet*, Supplement D-3, January 31, 2000. These estimates do not account for taxes that would have been collected on the sale of a tangible good that was instead purchased in intangible form using the Internet, or (2) purchases by (non-registered seller) businesses that would otherwise have resulted in the payment of the sales and use tax.
[v] Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," Knoxville, Tennessee: Center for Business and Economic Research, September 2001.
[vi] In tax year 1999, the top 9.6 percent of State taxpayers (those with adjusted gross incomes of over $100,000) reported 48.6 percent of total income and paid 75.1 percent of the personal income tax. Lower-income taxpayers (those with adjusted gross incomes of less than $20,000) reported 6.1 percent of total income and paid only 0.5 percent of the personal income tax. Source: Governor's Budget Summary, 2002-03, p. 102-3
[vii] Legislative Analyst's Office, *Tax Policy and the Internet*, January 31, 2000.
[viii] Governor's Budget Summary, 2002-03, p. 100.
[ix] Legislative Analyst's Office, *California's Tax System: A Primer*, January 2001, p. 37.