

Reevaluating the California Sales Tax: Exemptions, Equity, Effectiveness, and the Need for a Broader Base*

TABLE OF CONTENTS

I. INTRODUCTION	1682
II. THE RISE OF CALIFORNIA'S SALES TAX	1691
III. THE SALES TAX SYSTEM IN CALIFORNIA TODAY	1699
A. <i>Revenue, Rate, and Expenses</i>	1699
B. <i>Rulemaking and Compliance</i>	1700
C. <i>Exemptions and Exclusions</i>	1702
IV. AN ANALYSIS OF THE CURRENT SYSTEM AGAINST ITS ORIGINAL GOALS	1708
A. <i>Revenue Generation</i>	1708
B. <i>Fairness I: Equity</i>	1714
1. <i>The Historical Debate</i>	1714
2. <i>Vertical Equity</i>	1717
3. <i>Horizontal Equity</i>	1721
C. <i>Administration, Reporting, and Collection</i>	1723
1. <i>Costs</i>	1723
2. <i>Compliance</i>	1729
3. <i>Confusion</i>	1735
4. <i>Consequences</i>	1746
D. <i>Fairness II: Neutrality</i>	1751
V. A LOOK AT SOME ALTERNATIVES	1756
A. <i>Broadening the Tax Base</i>	1756
1. <i>Taxing Services</i>	1758
2. <i>Eliminating Exemptions</i>	1765
3. <i>Sales Tax Credits</i>	1767
B. <i>Revising the Tax Structure</i>	1769
VI. CONCLUSION	1777

* The author wishes to express his gratitude to Prof. Adrienne P. Jeffrey for her thought-provoking discussions and practical guidance, to Prof. Lester B. Snyder for his insightful and challenging comments, and to Marc Matys for living through it all.

If the sales tax is to continue as a successful revenue measure, *it must be kept on as broad a base as possible. Its principal value as a source of public funds is the universality of its application. . . .*

One additional exemption will undoubtedly lead to another. Soon others will follow, supported by the argument that they are fully as meritorious as those allowed previously. *Exemptions, reasonable enough when considered individually, will form a vicious cycle destroying the usefulness of the measure, and will plunge the State back into the "tax crisis" from which it was rescued through the adoption of the Sales Tax Act.*¹

I. INTRODUCTION

A bit dramatic, yes, but those words are still every bit as true today as when they were written sixty years ago. This is a time of economic turmoil at all levels of government. Rising costs and declining revenues have led to budgetary shortfalls at the national, state, and local levels. Calls for tax reform have come from all directions and in many forms. Proposals range from modifying existing tax structures (reducing or eliminating the capital gains tax² or modifying the rate of personal and

1. 1935-36 CAL. ST. BD. OF EQUALIZATION BIENNIAL REP. 3 [hereinafter 1935-36 BD. REPORT] (emphasis added). The California State Board of Equalization, the body charged with administering the State's retail sales tax, was addressing additional exemptions expected to be advocated in the wake of a recently-enacted exemption for food. This will be discussed in greater detail *infra* in the text. The Board's admonition that such exemptions would "tend to impair materially the effectiveness of the tax" has proved to be prescient and is the major focus of this Article. *Id.*

2. See H.R. 2491, 104th Cong., 1st Sess. (1995) (Balanced Budget Act of 1995) (proposing, among other things, reducing the tax rate on capital gains for individuals and corporations); see also S. 959, 104th Cong., 1st Sess. (1995) (Senator Hatch's proposal to reduce the capital gains tax); S. 924, 104th Cong., 1st Sess. (1995) (Senator Gregg's proposal to reduce capital gains taxes for assets held more than two years and to create a surcharge for short-term capital gains); H.R. 1042, 104th Cong., 1st Sess. (1995) (Representative Crane's proposal to abolish the capital gains tax for individuals); H.R. 593, 104th Cong., 1st Sess. (1995) (Representative Rohrabacher's proposal to reduce the capital gains tax and increase the dollar limitation on the one-time exclusion of gain from the sale of a principal residence for persons over 55); H.R. 512, 104th Cong., 1st Sess. (1995) (Representative Meehan's proposal to reduce the capital gains tax on the stock of domestic corporations engaged in manufacturing and to index the basis of such stock for inflation); Richard Lacayo, *Tax Cuts: Who Will Get the Breaks?*, TIME, Jan. 8, 1996, at 30, 32-33. The Omnibus Reconciliation Act of 1995 was the subject of extensive debate both in the House of Representatives and in the Senate (where portions were introduced as S. 1357, 104th Cong., 1st Sess. (1995)). It was presented to President Clinton on November 30, 1995 and vetoed on December 6, 1995.

During Bob Dole's Presidential campaign, he called for a 50% reduction in the tax rate on capital gains. *E.g.*, *A Transcript of the First Presidential Debate Between Clinton and Dole*, N.Y. TIMES, Oct. 7, 1996, at B8 [hereinafter *Transcript*]; Edwin Chen & Jonathan Peterson, *Dole Proposes to Slash Taxes, Balance Budget*, L.A. TIMES, Aug. 6, 1996, at A1, A21; George E. Condon Jr., *Dole Ready to Propose Large Tax Reductions*, SAN DIEGO UNION-TRIB., Aug. 5, 1996, at A-1, A-11. This pledge was eventually incorporated into the Republican platform. See *Actions by GOP Platform Subcommit-*

corporate taxes³) to broad structural changes (such as a flat personal

tees, SAN DIEGO UNION-TRIB., Aug. 6, 1996, at A-14 [hereinafter *Platform Actions*]; David E. Rosenbaum, *Platform Ban on Abortion Veers to Right of Dole's Stand*, N.Y. TIMES, Aug. 12, 1996, at B5 ("this year's Republican platform . . . places more emphasis on the economy, endorsing Mr. Dole's call for deep tax cuts.").

Similar proposals are being considered on the state level in California. See, e.g., S. 345, 1995-96 Reg. Sess. (Cal.) (proposal to provide a smaller alternative tax for taxpayers over 65 disposing of certain assets); A. 2200, 1995-96 Reg. Sess. (Cal.) (proposal that, under current tax laws, gross income shall not include any gain from the sale or exchange of capital assets); A. 1673, 1995-96 Reg. Sess. (Cal.) (proposal to index the basis of capital assets purchased in 1978 or later by the CPI for the purposes of determining the taxable gain).

3. Bob Dole's proposal for an across-the-board income tax cut of 15% was the cornerstone of his failed presidential campaign. See Chen & Peterson, *supra* note 2, at A1 ("Dole . . . is gambling that voters will flock to his hopeful, Ronald Reagan-style promise of prosperity without worrying too much about the budgetary arithmetic."); Condon, *supra* note 2, at A-1 ("Bob Dole has decided to propose a bold 15 percent across-the-board tax cut in an effort to shake up the presidential race and revive his struggling campaign."); see also *Transcript*, *supra* note 2, at B8 (during the debate, Dole called his proposal "a family tax cut[,] . . . a Main Street tax cut"). This aspect of Dole's plan was also incorporated into the Republican platform. *The 1996 Platform*, SAN DIEGO UNION-TRIB., Aug. 12, 1996, at GOP-1; see also *Platform Actions*, *supra* note 2, at A-14; Rosenbaum, *supra* note 2, at B5.

For a similar proposal on the state level, see 1995-96 GOVERNOR'S BUDGET SUMMARY 4 [hereinafter 1995-96 BUDGET]. Governor Wilson's 1995 proposal to reduce the rate of corporate and personal taxes by 15% was rejected by the State Senate after passing in the Assembly. He reaffirmed his commitment to fight for such a tax cut in his most recent budget proposal. 1996-97 GOVERNOR'S BUDGET SUMMARY 4-5 [hereinafter 1996-97 BUDGET]. With the State appearing to be in recovery mode, however, this tax cut is now termed a "recovery dividend." Ed Mendel, *Wilson Budget Calls for 15% Tax Cut*, SAN DIEGO UNION-TRIB., Jan. 11, 1996, at A-1, A-17; see also Dave Leshner, *Wilson Makes Renewed Call for Moral Values*, L.A. TIMES, Jan. 9, 1996, at A1, A13. On March 20, 1996, the Assembly Committee for Revenue and Taxation passed the Governor's proposed tax cut for the second year in a row. *Assembly Committee Backs 15% Tax Cut*, SAN DIEGO UNION-TRIB., Mar. 21, 1996, at A-3. In the end, the Legislature passed a 5% tax cut for corporations and banks effective January 1, 1997. Dan Morian, *Wilson Signs Budget into Law*, L.A. TIMES, July 16, 1996, at A3.

income tax,⁴ some variant of a value added tax for businesses,⁵ or a

4. *E.g.*, S. 1050, 104th Cong., 1st Sess. (1995) (The Freedom and Fairness Restoration Act sponsored by Rep. Dick Armey of Texas and Sen. Richard Shelby of Alabama, this is the truest flat tax proposal; it would create a flat income tax rate of 17% on wages and pensions, a 17% cash flow tax on businesses, and a single standard deduction for all filers plus a supplemental deduction for each dependent; it was submitted simultaneously to the House as H.R. 2060, 104th Cong., 1st Sess. (1995)); S. 722, 104th Cong., 1st Sess. (1995) (the USA Tax of 1995, sponsored by Sen. Domenici and Sen. Nunn, this plan would simplify the tax structure, but still provide numerous exemptions such as home mortgage interest, charitable contributions, and education expenses and would keep the progressive rate structure in place; it was submitted simultaneously to the House as H.R. 2600, 104th Cong., 1st Sess. (1995)); S. 488, 104th Cong., 1st Sess. (1995) (proposal by Sen. Specter to impose a flat tax on the earned income of individuals and the business taxable income of corporations); see NATIONAL COMM'N ON ECONOMIC GROWTH AND TAX REFORM, UNLEASHING AMERICA'S POTENTIAL (1996), reprinted in *Special Report*, 70 TAX NOTES 413 (1996) [hereinafter KEMP COMMISSION REPORT] (convened by Senate Majority Leader Bob Dole and Speaker of the House Newt Gingrich and chaired by Jack Kemp, this so-called "Kemp Commission" was charged with broadly studying the tax system on a national level); see generally Jeffrey H. Birnbaum, *Secrets of the Kemp Commission*, TIME, Jan. 8, 1996, at 34 (outlining other proposals being made at the national level and noting that the flat tax received so much attention in the Republican Presidential primary race that the issue seemed to be not whether to create such a tax, but rather what its particular attributes should be). For a comparison of the various federal proposals, see JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX, 104th Cong., 1st Sess. (1995), reprinted in 95 TAX NOTES TODAY 109-38 (June 6, 1995), available in LEXIS, Taxana Library, TNT File [hereinafter JCT, PROPOSALS TO REPLACE THE INCOME TAX].

For a typical proposal made on the state level, see Victor A. Canto & Arthur B. Laffer, *The California Flat Tax Proposal* (October 20, 1995) (unpublished manuscript, available from A.B. Laffer, V.A. Canto & Associates, 5405 Morehouse Drive, Suite 340, San Diego, CA 92121).

5. See, e.g., MICH. COMP. LAWS ANN. § 208 (West 1986 & Supp. 1995) (Single Business Tax Act). This was the first value-added tax (VAT) enacted in the country and will be discussed more in the text *infra* Subpart V.B. The VAT has been considered off and on as an alternative by many taxing authorities. Like the flat tax, proposals are being made with increasing frequency not only on the state level, but at the national level as well. See, e.g., H.R. 4050, 104th Cong., 2nd Sess. (1996) (Revenue Restructuring Act of 1996); S. 237, 104th Cong., 1st Sess. (1995) (Deficit and Debt Reduction and Health Care Financing Act of 1995); S. 2143, 103d Cong., 2nd Sess. (1994) (Deficit and Debt Reduction and Health Care Financing Act of 1994); S. 169, 102d Cong., 1st Sess. (1991) (The Deficit and Debt Reduction Act of 1991); H.R. 16, 102d Cong., 1st Sess. (1991); see also JCT, PROPOSALS TO REPLACE THE INCOME TAX, *supra* note 4; William H. Morris, *A "National Debate" on VAT: The Gibbons Proposal*, 60 TAX NOTES 1259 (1993); Gilbert E. Metcalf, *Value-Added Taxation: A Tax Whose Time Has Come?*, J. ECON. PERSP., Winter 1995, at 121 [hereinafter Metcalf, VAT].

The foremost authority on the VAT is Professor Alan Schenk, who has written extensively on the subject, both from a theoretical and practical perspective. See ALAN SCHENK, AMERICAN BAR ASS'N, VALUE ADDED TAX: A MODEL STATUTE AND COMMENTARY (1989) [hereinafter SCHENK, VAT MODEL STATUTE]; ALAN SCHENK, VALUE ADDED TAX IN THE UNITED KINGDOM (1976) [hereinafter SCHENK, VAT/U.K.]; Alan Schenk, *The Plethora of Consumption Tax Proposals: Putting the Value Added Tax, Flat Tax, Retail Sales Tax, and USA Tax into Perspective*, 33 SAN DIEGO L. REV. 1281 (1996) [hereinafter Schenk, *Consumption Tax Proposals*]; Alan Schenk, *Japanese*

national retail sales tax⁶).

This Article will examine the tax base and administrative aspects of the sales tax in California and will argue the need for reform.⁷ After years of tinkering, the current tax system is confusing at best and at times unintelligible. For example, what is the policy distinction among sodas (taxable), carbonated fruit juice (non-taxable), and that same carbonated fruit drink after the addition of a preservative (taxable)?⁸

Consumption Tax After Six Years: A Unique VAT Matures, 69 TAX NOTES 899 (1995) [hereinafter Schenk, *Japanese Consumption Tax*]; Oliver Oldman & Alan Schenk, *Have Senators Danforth & Boren Created a Better Value Added Tax?*, 65 TAX NOTES 1547 (1994); Alan Schenk, *Choosing the Form of a Federal Value-Added Tax*, 22 CAP. U.L. REV. 291 (1993) [hereinafter Schenk, *Federal VAT*].

For a background discussion of the basic economic ramifications of a VAT, both macroeconomic and microeconomic, see generally RICHARD W. LINDHOLM, *THE ECONOMICS OF VAT* (1980); M. Jeff Hamond, *The Economics and Politics of a Value-Added Tax*, in 4 ENTERPRISE ECONOMICS AND TAX REFORM: THE CASE FOR AND AGAINST VALUE-ADDED TAXATION (Robert J. Shapiro ed., 1995), reprinted in 95 TAX NOTES TODAY 146-74 (July 27, 1995) available in LEXIS, Taxana Library, TNT File.

6. See, e.g., H.R. 3039, 104th Cong., 2nd Sess. (1996) (proposal by Rep. Shaeffer to replace the current income tax with such a system in an effort "to promote freedom, fairness, and economic opportunity for families"); JCT, PROPOSALS TO REPLACE THE INCOME TAX, *supra* note 4, at n.4 (discussing a similar proposal by Sen. Lugar).

For an excellent overview of the competing proposals for reform, see Schenk, *Consumption Tax Proposals*, *supra* note 5. In an effort to make sense of the proposals, not to mention their tax policy implications and administrative ramifications, one Representative has suggested forming a Creative Revenues Commission to study the issue. H.R. 2526, 104th Cong., 1st Sess. (1995) (Creative Revenues Act of 1995).

7. There are several different taxes usually included under the common heading of "sales tax." A *general sales tax* is "a levy imposed upon the sales, or elements incidental to the sales, such as receipts from them, of all or a wide range of commodities." JOHN F. DUE, *SALES TAXATION* 3 (1957). This includes sales both at retail and for resale. A *retail sales tax*, by contrast, is imposed only on sales of tangible personal property at retail. CAL. REV. & TAX. CODE § 6051 (West 1987); JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE AND LOCAL TAXATION* 551 (1978) [hereinafter *STATE AND LOCAL TAXATION*]. This is the tax system in place in most American states. The *use tax* is "[a]n excise tax . . . imposed on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer." CAL. REV. & TAX. CODE § 6201 (West 1987). This applies whether or not the retailer is in the State. The use tax is used by most states in conjunction with and as a backstop for its retail sales tax. Throughout this Article, the term "sales tax" will be used to refer to both taxes.

8. CAL. REV. & TAX. CODE § 6359(b)(3) (West Supp. 1996) (sodas are not included in the definition of "food products for human consumption" exempted from the tax); Cal. Sales & Use Tax Annotation 245.0285, 2 BUS. TAXES L. GUIDE 3256 (1996) (100% natural fruit juice drinks qualify as exempt even though carbonated, but the incorporation of any additive violates the exemption and causes tax to apply); cf. Cal. Sales & Use Tax Annotation 245.0260, 2 BUS. TAXES L. GUIDE 3256 (Cal. State Bd.

How about the rationale differentiating among the sale of ice cream at a stand without tables and chairs (generally non-taxable), the same stand when providing tables and chairs (taxable), and the sale of that same ice cream at a stadium for consumption in one's seat (non-taxable)?⁹ And don't forget that separate sales of coffee and a pastry from an espresso cart not providing seating (non-taxable) are different than the sale of that same coffee and pastry together for one price (taxable).¹⁰

of Equalization) (1996) (the addition of *any* amount of carbonation to any non-juice drink makes that drink "carbonated" and, therefore, taxable).

9. CAL. CODE REGS. tit. 18, § 1603(f) (1996). As a general rule, but subject to many restrictions, tax does not apply to the sale of cold food products sold on a "to go" basis at a location where sales are principally of cold food products. A principal exception is that "[t]ax applies to sales of sandwiches, ice cream, and other foods sold in a form for consumption at tables, chairs, or counters or from trays, glasses, dishes, or other tableware provided by the retailer." *Id.* The regulation notes that it is generally the *form* of the item sold that controls.

As usual, however, there are exceptions to that rule. First, in certain cases, it is the *location* of the sale that controls, regardless of the type of product sold. This is the case with the stadium exception noted in the text (which includes "a passenger's seat aboard a train, or a spectator's seat at a game, show, or similar event"). *Id.* Tax also applies to all "sales of food products when sold within, and for consumption within, a place the entrance to which is subject to an admission charge," unless the retailer can prove that the food products were not sold for consumption within the place. CAL. CODE REGS. tit. 18, § 1603(d)(1), (3) (1996). An item sold at a "drive-in" establishment is also generally subject to tax, regardless of its character ("cold food product") and the form in which it is sold (in a "to go" container). CAL. CODE REGS. tit. 18, § 1603(b) (1996).

Second, even if the form is proper (i.e., the sale is of a "cold food product," it is not for consumption at tables, chairs, or counters, and it is sold in a "to go" container) and the location is proper (i.e., not at a "drive-in" or a place that charges admission or other automatically taxable site), the sale may still be subject to tax under two scenarios. In one case, the seller may "qualify" to pay tax under the "80/80 rule." If more than 80% of the seller's gross receipts are from the sale of food products *and* more than 80% of such sales are otherwise subject to tax (e.g., because they are "hot prepared food products" as discussed in the next note), then "tax applies to sales of cold food products (including sales for a separate price of hot bakery goods and hot beverages such as coffee) in a form suitable for consumption on the seller's premises even though such food products are sold on a 'take-out' or 'to go' order." CAL. CODE REGS. tit. 18, § 1603(c)(1), (3) (1996). In another situation, sales of coffee sold separately in a "to go" container from an independently-owned kiosk are still taxed to the extent they are consumed at tables and chairs provided not by the seller, but by the building manager. Cal. Sales & Use Tax Annotation 550.0126, 2 BUS. TAXES L. GUIDE 4000 (Cal. State Bd. of Equalization) (1996).

10. Cal. Sales & Use Tax Annotation 550.0090, 2 BUS. TAXES L. GUIDE 3999 (Cal. State Bd. of Equalization) (1996). As a general rule, sales of "hot prepared food products" are always taxable. It is the mere act of heating the food, even by heat lamps, that renders it taxable. However, an item meant to be served hot, such as a fried ham sandwich, is a "hot food product" even if cold when sold. CAL. CODE REGS. tit. 18, § 1603(e)(1) (1996).

Although hot bakery goods and hot beverages are defined as "hot prepared food products," they are nevertheless exempt from tax. *Id.* But beware, there are two exceptions to this exception. First, if the otherwise non-taxable bakery good and hot beverage are sold in combination, sales tax applies to the entire transaction. *Id.* Second,

In the face of economic adversity, state and local governments have made a two-stage assault on revenues. First, many have raised existing tax rates and/or created new sources of revenue.¹¹ In 1994, the national average combined sales tax rate at the state, county, and city levels rose to a record high of 8.25 percent,¹² an increase of twenty-five percent over the 1981 average of 6.52 percent.¹³ Besides the 838 jurisdictions raising sales tax rates in 1993 and 1994, another 317 added new sales taxes.¹⁴ Second, many jurisdictions are working harder to ensure compliance with existing tax laws, especially sales taxes, by becoming increasingly aggressive in auditing taxpayers and by more narrowly interpreting existing statutes and regulations.¹⁵ However, much of the

not all "hot bakery goods" are created equal. For example, a hot croissant filled with fruit or cream is a non-taxable "bakery good," but that same croissant filled with meat and cheese and heated is taxable. Cal. Sales & Use Tax Annotation 550.1712, 2 BUS. TAXES L. GUIDE 4024 (Cal. State Bd. of Equalization) (1996).

By the way, hot soup, bouillon, or consommé, even though they may seem like a non-taxable hot beverage, are considered regular "hot prepared food products" and are, therefore, taxable. § 1603(3)(1).

11. At the federal level, for example, payroll taxes have increased in recent years. The Federal Insurance Contributions Act (FICA) consists of two separate taxes, the Social Security tax and the Medicare tax. They are collected at a single rate based on wages and are levied in equal amounts on both employees and their employers. Since 1980, the share of total federal tax collections from these payroll taxes has increased from 27.7% to 35.1%. Hamond, *supra* note 5. The Social Security tax for both employers and employees increased from 6.02% of wages to 6.20% in 1990. INTERNAL REVENUE SERVICE, PUBLICATION 15: CIRCULAR E, EMPLOYER'S TAX GUIDE (1990) [hereinafter, I.R.S. 1990]. The Social Security portion is subject to a maximum withholding. For 1996, this tax is collected only on the first \$62,700 in wages. INTERNAL REVENUE SERVICE, PUBLICATION 15: CIRCULAR E, EMPLOYER'S TAX GUIDE (1996) [hereinafter I.R.S. 1996]. The absolute rate of the Medicare portion of the tax (1.45% for both employers and employees) has remained constant. However, the maximum wage base against which this tax is applied has increased substantially from \$48,000 in 1989 to an unlimited amount in 1996. Compare I.R.S. 1990, *supra* with I.R.S. 1996, *supra*.

In California, the tax rate for State Disability Insurance (SDI) has increased steadily. Compare EMPLOYMENT DEVELOPMENT DEPARTMENT, STATE OF CALIFORNIA, CALIFORNIA EMPLOYER'S GUIDE (1990) (SDI rate of 0.9%) with EMPLOYMENT DEVELOPMENT DEPARTMENT, STATE OF CALIFORNIA, CALIFORNIA EMPLOYER'S GUIDE (1996) (SDI rate of 1.3%).

12. *Sales Tax on a Steady Course: Upward*, J. ACCT., Apr. 1995, at 24 (graph).

13. *Tax Report*, WALL ST. J., Jan. 18, 1995, at A1.

14. *Id.* at A1.

15. Brian D. Clark, *States Get Tough on Sales Tax Compliance*, J. ACCT., Apr. 1993, at 29, 29-30; see also Richard W. Preston, *Working With Sales and Use Taxes—Some Problem Areas*, 24 TAX ADVISER 650 (1993). A recent survey of tax directors at *Fortune* 100 companies and the top 10 accounting firms found it ironic that

recent interest in sales tax has been driven primarily by fiscal necessity, rather than by a genuine interest in tax reform or tax policy.¹⁶

California, far from being isolated from these recent events, faced one of the worst state fiscal crises in the nation during the early 1990's. The loss of more than 700,000 jobs¹⁷ through military base closures, cutbacks in the aerospace industry, and loss of business to other western states¹⁸ combined with an "unprecedented string of disasters—drought, civil unrest, wildfires, and earthquakes" to create California's "deepest recession in a half-century."¹⁹ During the height of this crisis, the State faced a 1992-93 fiscal year²⁰ budgetary shortfall originally estimated at \$10.7 billion.²¹ At the start of the 1995-96 budget process, a plan adopted in 1994 to pay off the 1993-94 budget deficit over a two-year period and achieve a balanced budget by the end of 1995-96 was \$2 billion out of balance.²²

Although the situation has improved somewhat recently, the State is by no means out of the woods.²³ The recovering State economy

"while state politicians and economic development officials bend over backwards to retain and attract employers, revenue commissioners are tracking down and squeezing corporate taxpayers for every available cent." Ian Springsteel, *State Taxes: A Guide for the Besieged*, CFO, Aug. 1996, at 26, 29. One respondent stated that "[a]uditors are asking more questions, requesting more documentation, taking inconsistent approaches, [and] creating aggressive interpretations of statutes and rules." *Id.* at 34. In fact, the article noted that some auditors are "playing fast and loose with the rules" and basically "challenging companies to take them to court." *Id.* at 33.

For a discussion of recent sales tax audit results in California specifically, see *infra* notes 291-95 and accompanying text.

16. William Duncombe, *Economic Change and the Evolving State Tax Structure: The Case of the Sales Tax*, 45 NAT'L TAX J. 299, 306 (1992). One article has predicted that state legislatures will likely be focusing on the sales tax to meet new revenue demands, but that the policy issues of the immediate future are likely to be the "bread and butter" issues of tax base and tax rate and not genuine tax reform. Billy Hamilton & John L. Mikesell, *Sales Tax Policy During the Next Decade*, in SALES TAXATION 28, 28 (William F. Fox ed., 1992).

17. 1995-96 BUDGET, *supra* note 3, at 1.

18. *California's Budget: A Time to Cut, a Time to Vote*, THE ECONOMIST, Feb. 25, 1995, at 30, 31.

19. 1995-96 BUDGET, *supra* note 3, at 1.

20. The State of California fiscal year runs from July 1 to June 30. CAL. GOV'T CODE § 13290 (West 1992).

21. *State of Suspense*, TIME, July 13, 1992, at 16; *But Don't Call It Deficit*, THE ECONOMIST, May 23, 1992, at 27. When the Legislature and Governor Wilson were unable to agree on the means for erasing the estimated deficit, the State issued nearly \$2 billion in IOU's known as "registered warrants" in lieu of checks. *Insufficient Funds*, TIME, Aug. 3, 1992, at 21.

22. CALIFORNIA LEGISLATIVE ANALYST, THE 1995-96 BUDGET: PERSPECTIVES AND ISSUES 1 (1995) [hereinafter 1995-96 BUDGET ANALYSIS].

23. By the middle of 1996, the Department of Finance expected State employment to be back to its 1990 high of 12.7 million jobs. Mendel, *supra* note 3, at A-1. This was due in large part, however, to the fact that the Department of Finance has long

“differ[s] significantly from the economy of the late 1980s” because of such factors as “slower population growth, reduced home building activity, and lower home prices.”²⁴ Additionally, other unexpected events “dampened California’s economic expansion in early 1995,” most notably the devaluation of the Mexican peso and severe winter storms.²⁵ Despite all this, Governor Wilson estimated a \$402 million surplus at the end of fiscal 1995-96, while the State Legislative Analyst’s Office estimated the year would end roughly in balance.²⁶ Fiscal 1996-97 is also expected to end “with virtually no reserve.”²⁷ In addition, the State’s budget pressures are expected to build in future

contended that job growth in California is stronger than otherwise believed because U.S. Labor Department statistics exclude most hires at small companies and all jobs created at start-up firms. Uri Berliner, *State Foresees Solid '96 Economy*, SAN DIEGO UNION-TRIB., Jan. 11, 1996, at C-1, C-3. In fact, the Department of Finance contends that the difference between California Employment Development Department and U.S. Bureau of Labor Statistics estimates suggests that 60% of job gains are occurring in firms outside the older, larger businesses surveyed monthly by the federal government. 1996-97 BUDGET, *supra* note 3, at 63-64.

24. 1994-95 CAL. ST. BD. OF EQUALIZATION ANN. REP. 56-57 [hereinafter 1994-95 BD. REPORT]. The same source notes that the economy is less dependent on defense spending and more dependent on business services and exports. *Id.* at 57.

25. *Id.* at 57-58. The decline in the peso led to a 4.2% decrease in California exports to Mexico during the first half of 1995. Additionally, sales to Mexican visitors along the border dropped significantly. *Id.* at 57. The storms of January and March 1995 were the costliest in the State’s history, causing an estimated \$2 billion in damage due to flooding and mudslides. *Id.* at 58.

26. Mendel, *supra* note 3, at A-17 (Governor’s figure); CALIFORNIA LEGISLATIVE ANALYST’S OFFICE, HIGHLIGHTS OF THE 1996-97 ANALYSIS 1 (1996) [hereinafter 1996-97 BUDGET ANALYSIS]. In early 1996, the Governor’s projected reserve from fiscal 1996-97 was \$731 million. Mendel, *supra*, at A-17. The Legislative Analyst’s estimate was slightly higher, approximately \$900 million. 1996-97 BUDGET ANALYSIS, *supra*, at 2. It is important to note that the economic success of both the current fiscal year and future years is dependent on significant savings expected to be achieved through federal actions, most of which have not occurred. *Id.*

The budget submitted by the executive branch (the Governor and Department of Finance) often differs significantly in its projections from those of the Legislature (through the Legislative Analyst). Compare 1995-96 BUDGET, *supra* note 3, at 2 (Governor’s budget noting that the State has learned to “live within its means” because spending has been at or below revenues for each of the three fiscal years from 1992-93 to 1994-95) with 1995-96 BUDGET ANALYSIS, *supra* note 22, at 13-15 (Legislative Analyst’s report noting that this was actually achieved by a combination of “paper” savings realized through off-budget spending, one-time accounting gains, loans, and spending deferrals).

27. Brad Hayward, *School Outlays Threaten Deficits, State Warned*, SACRAMENTO BEE, Nov. 22, 1996, at A1 (quoting a report issued by the Legislative Analyst).

years, especially in light of a recently-passed tax cut and repeated proposals for additional cuts.²⁸

In its search for new sources of revenue and efforts to reform the State's tax structure,²⁹ California must also evaluate its existing tax structure, especially the tax base.³⁰ This Article analyzes the State's sales tax system against its original goals and attempts to measure its success. As a background, Part II will explore the historical events that gave rise to the State sales tax and Part III will summarize the current structure of the system. Part IV will then explore the current tax in terms of its revenue-generating capability, the equity of its application, the effectiveness of its administration from both a reporting and collection perspective, and the impact of exemptions on its fairness in terms of tax neutrality. This analysis will point up the proliferation of exclusions and exemptions that reduce the efficacy and equity of the tax and clearly demonstrate a need to expand its base if it is to remain true to its original goals and remain a strong source of revenue for the State. Part V discusses the tax systems instituted in several other states to overcome shortcomings similar to those of the current California system. It will also discuss alternative taxation schemes, focusing both on simplifying the tax structure through the taxation of selected services and decreasing the number of exemptions as well as exploring the possibility of a wholesale structural revision of the taxing system.

28. 1996-97 BUDGET ANALYSIS, *supra* note 26, at 2. The recent 5% tax reduction for corporations and banks will cost California an estimated \$230 million annually. Morian, *supra* note 3, at A3. If the Governor's proposed 15% tax cuts were enacted, overall State revenue would be decreased \$4.7 billion annually by fiscal 1999-2000 when they are fully phased-in. 1996-97 BUDGET ANALYSIS, *supra* note 26, at 3.

Even assuming no further change in revenue structures, the State will face deficits of \$260 million in fiscal 1997-98 and \$1 billion in 1998-99 if existing expenditure patterns remain as currently set forth in State law. Hayward, *supra* note 27, at A1.

29. *Cf.* 1996-97 BUDGET, *supra* note 3, at 4-5 (noting that a "failure to further reform the state's tax structure threatens further growth and puts California at a competitive disadvantage").

30. It is this issue of tax base (i.e., what exactly does the tax tax?) that is central to the issue of reforming any tax, including the sales tax. It is the scope of this base, much more than the means of taxation, that creates the effects noted in this Article *infra* Part IV.

II. THE RISE OF CALIFORNIA'S SALES TAX³¹

Taxes upon the transfer of commodities are among the oldest known taxes, dating back to the Roman Empire.³² Despite this fact, they were not widely used in European nations or the United States until the early part of this century.³³ Although some mercantile license taxes were imposed in the United States as early as 1821,³⁴ the first general tax measured by sales was adopted in 1921 in West Virginia.³⁵ Macroeconomic forces, however, came into play at state and local levels as the Depression led to a brutal combination of declining revenues from traditional sources, especially property taxes, and increasing financial demands on the states.³⁶ This pressure forced state legislators to look to new sources of revenue. The first true retail sales tax was enacted in Mississippi in 1932.³⁷ The popularity of this new tax from a legislative perspective was evident by its swift adoption in jurisdiction after jurisdiction. When state legislatures met for their 1933 biennial sessions,

31. For a comprehensive explanation of the factors giving rise to the California sales tax and a blow-by-blow description of events surrounding its birth and implementation, see MARVEL M. STOCKWELL, *STUDIES IN CALIFORNIA STATE TAXATION* 163-228 (1939).

32. DUE, *supra* note 7, at 2.

33. *Id.*

34. James W. Martin & William A. Tolman, *Recent State Gross Sales Tax Legislation*, *TAXES*, Dec. 1933, at 450-51. This Pennsylvania law, like a 1906 Delaware statute and a 1914 Virginia statute, imposed license taxes upon merchants based on their volume of business or gross receipts. *Id.* Unlike a general sales tax, a gross receipts tax is regarded as a charge for the privilege of carrying on business activity and is generally intended to be a burden on the business itself, not the consumer. These types of taxes are further differentiated from sales taxes by their rate, which is generally a fraction of one percent. DUE, *supra* note 7, at 3-4. The tax base under a gross receipts tax can include sales of personal and professional services and, in some cases, intangibles. *STATE AND LOCAL TAXATION*, *supra* note 7, at 551.

35. Martin & Tolman, *supra* note 34, at 450-51; see also JAMES D. KITCHEN, *UNIV. CAL. L.A., ADMINISTRATION OF MUNICIPAL SALES TAXES IN CALIFORNIA* 1 (1949). This tax, however, was still essentially a multiple stage business occupation levy that taxed all levels of production at a very low rate. JOHN F. DUE & JOHN L. MIKESELL, *SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION* 2 (1983).

36. KITCHEN, *supra* note 35, at 2; see also Martin & Tolman, *supra* note 34, at 452; STOCKWELL, *supra* note 31, at 201 (noting that "[t]wo facts were plain: increased taxation was necessary, and this taxation could not fall upon land").

37. DUE & MIKESELL, *supra* note 35, at 2.

only five states had a general sales tax; by November of that year, nineteen states had approved such a tax.³⁸

The California Legislature, at the close of its 1931-33 session, was facing an estimated deficit for the ensuing biennium of over fifty million dollars.³⁹ The Joint Legislative Tax Committee formed for the purpose of evaluating the situation⁴⁰ noted that it “hesitate[d] to suggest additional taxes at this time and would not do so except for the urgent necessity of balancing the state budget.”⁴¹ The Committee, among other things, proposed a retail sales tax of two percent and the drafting of a state constitutional amendment necessary for its implementation.⁴² The so-called Riley-Stewart tax plan was presented to the voters as Senate Constitutional Amendment Number 30 and was approved on June 27, 1933.⁴³ Although subsequently amended in form, the constitutional

38. Rodney L. Mott, *General Sales Tax Laws*, at 1, *microformed on* ALA BX-62 (Council of St. Gov't). The states were: Arizona, California, Delaware, Illinois, Indiana, Kentucky, Michigan, Mississippi, New Mexico, New York, North Carolina, Oklahoma, Pennsylvania, South Dakota, Vermont, Virginia, Utah, Washington, and West Virginia. *Id.*

39. REP. OF JOINT LEGIS. TAX COMM., 1933 CAL. ASSEMBLY J. 2967 [hereinafter 1933 TAX REPORT]. This total included both the estimated 1931-33 deficit of \$10 million and the estimated shortfall of revenues to “necessary expenditures” for 1933-35 of \$41.5 million. *Id.*

40. *See* MESSAGE FROM THE LIEUTENANT GOVERNOR, 1933 CAL. ASSEMBLY J. 2561.

41. 1933 TAX REPORT, *supra* note 39, at 2966.

42. *Id.* at 2967-68; REP. OF SELECT COMM., 1933 CAL. ASSEMBLY J. 3057. This Amendment also provided for state assumption of public school expenditures, return of the property of public utilities to local tax rolls, a prohibition on raising more than 25% of state funds through the property tax, and a restriction on the annual increase in the cost of running state and local governments. Senate Constitutional Amendment No. 30, ch. 63, 1933 Cal. Stat. 3072; *see also* KITCHEN, *supra* note 35, at 2-3; CALIFORNIA STATE BD. OF EQUALIZATION, HISTORY CALIFORNIA STATE BOARD OF EQUALIZATION: THE FIRST HUNDRED YEARS 39 (1980) [hereinafter BD. OF EQUALIZATION HISTORY].

43. BD. OF EQUALIZATION HISTORY, *supra* note 42, at 39. This special election approved the amendment by a wide margin, with voters in all but three counties voting in its favor. STOCKWELL, *supra* note 31, at 163.

Section 14 of Article XIII of the California State Constitution was amended to include the following enabling language:

The Legislature shall have the power to provide for the assessment, levy and collection of taxes upon all forms of tangible personal property, all notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, mortgages, and any legal or equitable interest therein, not exempt from taxation under the provisions of this Constitution, in such manner, and at such rates, as may be provided by law, and in pursuance of the exercise of such power the Legislature, two-thirds of all of the members elected to each of the two houses voting in favor thereof, may classify any and all kinds of personal property for the purposes of assessment and taxation in a manner and at a rate or rates in proportion to value different from any other property in this State subject to taxation and may exempt entirely from taxation any or all forms, types or classes of personal property.

enabling language for the State sales tax has remained virtually unchanged in substance.⁴⁴

Armed with voter approval of a sales tax in concept, the Senate began the task of solving the State's "tax problems of unusual complexity" in specific form immediately upon the resumption of its session in July

CAL. CONST. art. XIII, § 14 (amended 1974).

44. The section quoted in the preceding note was repealed on November 5, 1974 and replaced with a simpler, but substantially similar, provision. The equivalent section now reads:

The Legislature may provide for property taxation of all forms of tangible personal property, shares of capital stock, evidences of indebtedness, and any legal or equitable interest therein not exempt under any other provision of this article. The Legislature, two-thirds of the membership of each house concurring, may classify such personal property for differential taxation or for exemption. The tax on any interest in notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, or mortgages shall not exceed four-tenths of one percent of full value, and the tax per dollar of full value shall not be higher on personal property than on real property in the same taxing jurisdiction.

CAL. CONST. art. XIII, § 2.

Proposition 13, passed by voter initiative in 1978, has impacted the taxing autonomy of the state and local governments. The basic structure of the initiative provides that property taxes be based on assessed value at the time of construction or sale, subject to a small increase each year, but not subject to reassessment. CAL. CONST. art. XIII, § 2. This basic structure withstood challenge in *Nordlinger v. Lynch*, 225 Cal. App. 3d 1259, 275 Cal. Rptr. 684 (1990). The court in *Nordlinger* held (1) acquisition value assessment was constitutional as long as it was not arbitrarily enforced, (2) Proposition 13 did not violate equal protection absent an explicit constitutional requirement to tax property of equal current value equally, and (3) it did not violate the right to travel because the acquisition value system applied equally to residents and non-residents. *Id.* at 1265, 1273-74, 275 Cal. Rptr. at 686, 692.

In addition, the initiative further stipulates that local governments cannot "make up" the loss of property tax revenues with other taxes. This is enforced by requiring a two-thirds majority for passage of any "special taxes" sought to be imposed by cities, counties, and special districts. CAL. CONST. art. XIII, § 4. The creation of such a special district, the San Diego County Regional Justice Facility Financing Agency, and its plan to raise the sales tax by one-half cent to finance jail and court construction and approve such a plan by a simple voter majority was successfully challenged in *Rider v. County of San Diego*, 1 Cal. 4th 1, 820 P.2d 1000, 2 Cal. Rptr. 2d 490 (1991). In holding the new tax unconstitutional, the California Supreme Court noted:

Proposition 13 was intended to restrict the ability of local governments to impose new taxes to replace property tax revenues lost under the other provisions of that measure. [Citations omitted.] This intent would be frustrated if cities and counties were nonetheless permitted to arrange for the formation of local taxing districts to finance municipal functions without securing the requisite two-thirds voter approval.

Id. at 11, 820 P.2d at 1006, 2 Cal. Rptr. 2d at 496.

1933.⁴⁵ The result was the Retail Sales Act of 1933, modeled largely after the New York sales tax law.⁴⁶ To set forth the purpose of the new tax and to establish clearly the burden of the tax on sellers, not consumers, the Act was subtitled “[a]n act for the privilege of selling tangible personal property and for the privilege of furnishing, preparing or serving tangible personal property”⁴⁷ As Senate Bill 1211, the Retail Sales Act was submitted on July 18, 1933, quickly approved by both houses of the Legislature, and signed into law by the Governor on July 25, 1933.⁴⁸

In drafting the sales tax statute, the Senate was concerned from the beginning with the policy implications of both the absolute rate of such a tax and its exemptions. It sought a report from the State Board of Equalization⁴⁹ setting forth the tax rates and exemptions adopted in

45. S. Con. Res. 39, ch. 115, 1933 Cal. Stat. 3184.

46. KITCHEN, *supra* note 35, at 3.

47. Retail Sales Act of 1933, ch. 1020, 1933 Cal. Stat. 2599. The term “tangible personal property” was not originally defined in the Retail Sales Act, but was later defined as “personal property which may be seen, weighed, measured, felt, or touched, or is in any other manner perceptible to the senses.” Act of June 25, 1935, ch. 357, 1935 Cal. Stat. 1256, 1258 (codified as amended at CAL. REV. & TAX. CODE § 6016 (West 1987)).

Unlike the initial proposal, the sales tax rate began at two and one-half percent, but was scheduled to decrease to two percent on July 1, 1935. Retail Sales Act of 1933, ch. 1020, § 3, 1933 Cal. Stat. 2600. Despite initial opposition, this increased rate met with the approval of the state retail associations when it was determined that the tax could be passed on to the consumer in the form of a “reimbursement” to the retailer. COMMUNICATION, 1933 CAL. SENATE J. 3247. The groups agreeing to the tax were the California Retail Merchants Association, the California Merchants Federation, San Francisco Retail Merchants Association, the Alliance of Retail Trade Associations of Northern California, the California Retail Grocers and Merchants Association, California Real Estate Association, California Manufacturers Association, Progressive Merchants Association, and over 1,000 retail lumber associations. *Id.* For a discussion of the sales tax reimbursement, see discussion *infra* text Section IV.C.1.

48. STOCKWELL, *supra* note 31, at 203; BD. OF EQUALIZATION HISTORY, *supra* note 42, at 42. There was little opposition to this Act, in part because “[t]he very speed with which the law was passed disarmed its natural opponents.” STOCKWELL, *supra*, at 203; see also BD. OF EQUALIZATION HISTORY, *supra*, at 42.

49. Under the Retail Sales Act of 1933, the State Board of Equalization was given the authority to enforce the Act and “empowered to prescribe, adopt and enforce rules and regulations relating to the administration and enforcement” of the Act. Retail Sales Act of 1933, ch. 1020, § 27, 1933 Cal. Stat. 2609 (codified as amended at CAL. REV. & TAX. CODE § 7051 (West 1987)). The Board was first established in 1870 and given its current form by amendment of the California State Constitution in 1879, its purpose being to regulate property tax procedures throughout the State by “equaliz[ing] the valuation of the taxable property in the several counties of the State for the purposes of taxation.” CAL. CONST. art. XIII, § 9 (amended 1884, repealed 1974) (original role of Board); see also 1993-94 CAL. ST. BD. OF EQUALIZATION ANN. REP. 73 [hereinafter 1993-94 BD. REPORT]. The Board itself consists of four elected members, each representing a discrete region of the State and the State Controller. CAL. CONST. art. XIII, § 9 (amended 1884, repealed 1974). In addition to the property tax and sales and

other states, proclaiming that “[t]he *proper and equitable rate* of taxation on retail sales, and the *propriety of exemptions*, are matters of grave interest and concern to the taxpayers of this State, and to this Legislature in the enactment of *fair, sound, and equitable tax measures*.”⁵⁰ This attention to exemptions was tied not only to the neutrality of the proposed sales tax across various industries, but to concerns about the burdensomeness of its administration as well.⁵¹ As a result of these concerns, the Retail Sales Act of 1933 as originally passed provided for only four exemptions: sales to the United States; gas, electricity, and water service; sales of gold bullion; and public works contracts executed prior to the effective date of the Act.⁵²

The relatively simple structure of the tax, however, was to change almost immediately. With the return of utility property to the local tax rolls on January 1, 1935, the State faced continuing shortfalls and could ill afford the revenue loss that would accompany the scheduled decrease in the sales tax rate to two percent on July 1, 1935.⁵³ Therefore, in his 1935-36 budget, the Governor proposed an increase in the rate to three percent.⁵⁴ The Joint Legislative Committee on Revenue and Taxation concurred with the Governor’s recommendation. At the same time, however, it narrowed the scope of the tax by recommending an

use taxes, the Board oversees sixteen special tax programs such as the alcoholic beverage tax, cigarette and tobacco products tax, insurance tax, and fuel tax as well as the tax appeal programs for the State personal income tax and bank and corporation tax. 1994-95 BD. REPORT, *supra* note 24, at 1-2. For the full scope of the Board’s powers and duties, see CAL. GOV’T CODE § 15606 (West 1992 & Supp. 1996).

50. S.J. RES., 1933 CAL. SENATE J. 3199 (emphasis added). The responding report listed 16 states with some variation of a sales or gross receipts tax in place and was presented on July 18, 1933. COMMUNICATION, 1933 CAL. SENATE J. 3244.

51. *Cf.* COMMUNICATION, 1933 CAL. SENATE J. 3200. This letter from Robert M. Haig of the Columbia University School of Business noted that the tax measure’s “alleged administrative simplicity is greatly exaggerated, *particularly if there are any exemptions whatsoever*.” *Id.* at 3201 (emphasis added).

52. Retail Sales Act of 1933, ch. 1020, § 5, 1933 Cal. Stat. 2599, 2601. The exemption for sales to the United States is constitutionally prohibited and the exemption for contracts already executed is an issue of reliance. In addition, the sale of gold bullion is thought to be outside the definition of “tangible personal property.” *See* discussion *infra* note 352. Thus, the only real exemption from a policy standpoint is that for utilities.

53. BD. OF EQUALIZATION HISTORY, *supra* note 42, at 44.

54. *Id.*

exemption for food for home consumption.⁵⁵ The Joint Committee also recommended measures to stop evasion of the sales tax by applying it to some leases and rentals made in lieu of sales⁵⁶ and by creating a use and storage tax for purchases made out of the State and brought in to

55. REP. OF THE SPECIAL JOINT LEGIS. COMM. ON REVENUE AND TAX'N, 1935 CAL. SENATE J. 2026 [hereinafter 1935 REVENUE & TAXATION REPORT]. It was this exemption for foodstuffs, coupled with proposals for additional exemptions being considered by the Legislature, that engendered the rather emotional statement at the beginning of this Article. See discussion *supra* note 1; see also 1935-36 BD. REPORT, *supra* note 1, at 3. It was the Board's strong feeling that "the wisdom of allowing [additional exemptions] is subject to serious question. Individually many of the proposals may appear to have merit, but their enactment would tend to impair materially the effectiveness of the tax." *Id.* at 3.

It was generally believed that exempting food for home consumption would assist lower-income families because such food comprised a larger portion of their budgets than those of higher-income families. ASSEMBLY REVENUE AND TAXATION COMM., THE CALIFORNIA SALES AND USE TAX: AN OVERVIEW, A LOOK AT EXEMPTIONS, AND AN ANALYSIS OF THE TAXATION OF SERVICES 40 (1983) [hereinafter 1983 REVENUE & TAXATION REPORT]. The argument for such an exemption rests largely on the theory that an exemption of so basic a necessity as food will make the sales tax less regressive. *Id.* at 41. This will be discussed more fully in Subpart IV.B. of the text.

56. 1935 REVENUE & TAXATION REPORT, *supra* note 55, at 2026. The current statute includes under its definition of a taxable sale "any lease of tangible personal property in any manner or by any means whatsoever, for a consideration." CAL. REV. & TAX. CODE § 6006(g) (West Supp. 1996). There are only a few types of leases exempted from this definition, the most notable being where the property is leased in "substantially the same form as acquired" and the lessor or transferor has already paid sales or use tax for the property based on its initial purchase price. § 6006(g)(5); CAL. CODE REGS. tit. 18, § 1660(c)(2) (1996). A "lease" is later broadly defined to include "rental, hire and license." There are only a few non-taxable exceptions. First, the use of tangible personal property for a period of less than one day for a charge of less than \$20 when the use thereof is restricted to the premises of the grantor of the privilege is not a lease. CAL. REV. & TAX. CODE § 6006.3 (West 1987); CAL. CODE REGS. tit. 18, § 1660(e). Second, capital leases where the lessee is to obtain title at the completion of a fixed term upon completion of payments or may purchase the property for a nominal amount are regarded as sales under a security agreement and not as leases. CAL. REV. & TAX. CODE § 6006.3; CAL. CODE REGS. tit. 18, § 1660(a)(2). Third, sale/leaseback transactions are considered financing transactions and, therefore, are not subject to sales tax. CAL. CODE REGS. tit. 18, § 1660(a)(3).

California.⁵⁷ These recommendations were passed under three separate bills, all effective July 1, 1935.⁵⁸

Food for home consumption had initially accounted for one-quarter of all sales tax receipts.⁵⁹ Its exemption, along with the other structural changes in the tax, led to a forty percent increase in the cost of administering the sales tax in absolute dollars.⁶⁰ While the combination of new programs did raise more revenue,⁶¹ the percentage cost of administration increased from 1.98 percent to 2.28 percent, a relative increase of fifteen percent.⁶² In response to some of the same economic pressures faced by the State during the early 1930's, many municipalities began enacting their own sales tax provisions during and immediate-

57. 1935 REVENUE & TAXATION REPORT, *supra* note 55, at 2026. The use tax generally applies either to purchases made out-of-state for use in-state or in situations where the retailer initially purchases a good for resale, but later self-consumes it. This differs from the sales tax because the use tax is measured by the sales price of the property (as opposed to the gross receipts from retail sales) and, most significantly, because the obligation to pay use tax is on the consumer of the item, not the retailer. CALIFORNIA STATE BD. OF EQUALIZATION, CALIFORNIA SALES AND USE TAX LAW 7 (1996). See note 7, *supra*, for the statutory distinction between the sales tax and the use tax. See also the discussion in the text *infra* Section IV.C.3. concerning the difficulties faced by retailers in making the resale/not-for-resale election at the time of purchasing production components.

58. Act of June 25, 1935, ch. 355, 1935 Cal. Stat. 1252 (increasing sales tax rate to three percent and exempting "food products for home consumption"); Act of June 25, 1935, ch. 357, 1935 Cal. Stat. 1256 (expanding the definition of a taxable "sale" to include "any transfer of title or possession, or both, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property, for a consideration"); Use Tax Act of 1935, ch. 361, 1935 Cal. Stat. 1297 ("imposing an excise tax on the storage, use or other consumption in this State of tangible personal property"). In its search for additional revenues, earlier that same month the Legislature also imposed a personal income tax for the first time. The Personal Income Tax Act of 1935, ch. 329, 1935 Cal. Stat. 1090.

59. STOCKWELL, *supra* note 31, at 206; see also BD. OF EQUALIZATION HISTORY, *supra* note 42, at 45. Subsequent studies have shown that states taxing food can expect between 10% and 25% of their total sales tax collections to come from that source. SCOTT R. MACKEY, NATIONAL CONF. OF ST. LEGISLATURES, STATE TAX ACTIONS 1996 6 (1996).

60. 1935-36 BD. REPORT, *supra* note 1, at 29. The Board's costs jumped from \$1,198,263 for the 1934-35 fiscal year to \$1,671,657 for 1935-36. *Id.*

61. Retail sales tax collections for 1934-35 were \$60,605,256. For 1935-36, collections grew to \$73,287,837. *Id.*

62. *Id.* These figures represent the total cost of administration as a percentage of the total revenue collected by the taxes.

ly after World War II.⁶³ By 1954, 173 of California's 316 cities were taxing sales.⁶⁴ The cities enacting such ordinances tended to be in larger, more metropolitan areas. Thus, although they represented only fifty-five percent of all cities numerically, these areas accounted for seventy-three percent of State-taxed retail sales.⁶⁵ In response to problems arising out of the competitive advantage offered to untaxed merchants outside the cities taxing sales,⁶⁶ the diversity of exemptions among municipalities, and the possibility of duplicate taxation of a single sale,⁶⁷ the State Legislature passed the Bradley-Burns Uniform Local Sales and Use Tax Law in 1955.⁶⁸ This statute allowed counties and cities to levy and share a maximum one-percent⁶⁹ sales tax (in addition to the tax levied by the State) to be collected and remitted to the municipalities by the State.⁷⁰ By the end of 1961, all of the State's fifty-eight counties and 375 cities had adopted conforming local sales tax ordinances.⁷¹

These California taxes, like those of many other states, were passed during a period of unusual fiscal crisis. As a general rule, most state

63. KITCHEN, *supra* note 35, at 6. The first such tax was a San Bernardino levy effective January 1, 1945. *Id.* The authority for cities and counties to adopt such taxes was granted by sections of the California State Constitution allowing for creation of home rule charters. CAL. CONST. art. XI, §§ 6, 8 (amended 1914, repealed 1970); see *Hunt v. Mayor of Riverside*, 31 Cal. 2d 619, 191 P.2d 426 (1948) (City ordinance levying sales tax for usual and current expenses is within City's authority and thus not required to be submitted to a referendum vote); see also *City of Grass Valley v. Walkinshaw*, 34 Cal. 2d 595, 212 P.2d 894 (1949) (the levy of taxes for "city purposes," in this case special levy property taxes to discharge bonded indebtedness, is constitutionally permitted; the powers enumerated in the City's charter are not exhaustive and do not limit the City's powers); *West Coast Advertising Co. v. City and County of San Francisco*, 14 Cal. 2d 516, 95 P.2d 138 (1939) (source of local power of taxation is grant by the State; issue is not whether a specific tax, in this case a general business license tax, is authorized under the municipality's charter, but rather whether the charter prohibits it); cf. *Redwood Theatres v. City of Modesto*, 86 Cal. App. 2d 907, 196 P.2d 119 (1948) (upholding City's ability to tax movie theatre admissions); *Hill v. City of Eureka*, 35 Cal. App. 2d 154, 94 P.2d 1025 (1939) (upholding City's authority to apply a general business license fee to the practice of law).

64. 1953-54 CAL. ST. BD. OF EQUALIZATION ANN. REP. 3.

65. *Id.* at 4.

66. BD. OF EQUALIZATION HISTORY, *supra* note 42, at 65.

67. KITCHEN, *supra* note 35, at 11-14.

68. Bradley-Burns Uniform Local Sales and Use Tax Law, ch. 1311, 1955 Cal. Stat. 2381 (codified as amended at CAL. REV. & TAX. CODE §§ 7200-7212 (West 1987 & Supp. 1996)).

69. The amount of the local tax was later increased to 1.25% and remains at that amount today. Act of Feb. 28, 1979, ch. 5, § 3.2, 1979 Cal. Stat. 8, 9.

70. CAL. REV. & TAX. CODE § 7202 (West Supp. 1996). In exchange for its services, the Board charges cities and counties a proportionate share of its expenses based on collected revenue. CAL. REV. & TAX. CODE § 7204.3 (West Supp. 1996).

71. 1960-61 CAL. ST. BD. OF EQUALIZATION ANN. REP. 28 [hereinafter 1960-61 BD. REPORT].

sales taxes were originally passed as “emergency measures,” but have rarely been revoked, even after the original reason for their passage has long ceased to exist.⁷² Over time, this “tax which essentially crept in by the back door in periods of crisis, and was apologetically justified by governments as a temporary measure has gained a high degree of respectability” and has been rapidly accepted (although not universally admired) as a part of state and local tax structures.⁷³ Currently, forty-five states and the District of Columbia impose some combination of sales, use, and(or) gross receipts taxes.⁷⁴

III. THE SALES TAX SYSTEM IN CALIFORNIA TODAY

A. Revenue, Rate, and Expenses

For the 1996-97 fiscal year, sales and use taxes are expected to raise \$16.275 billion for the State general fund, up from an estimated \$15.545 billion for 1995-96, \$14.630 billion for 1994-95,⁷⁵ and \$13.880 billion for 1993-94.⁷⁶ This total represents approximately 35.7 percent of the anticipated \$45.6 billion general fund revenues for the 1996-97 fiscal year,⁷⁷ up slightly from 35.1 percent of the estimated \$42.5 billion general fund for 1995-96.⁷⁸

72. Martin & Tolman, *supra* note 34, at 1. For example, the New York City sales tax was enacted in 1934 under temporary authority granted by the state. That tax has now been in effect for over sixty years. Jerome R. Hellerstein, *Significant Sales and Use Tax Developments During the Past Half Century*, 39 Vand. L. Rev. 961, 962 (1986) (hereinafter Hellerstein, *Significant Developments*).

73. DUE, *supra* note 7, at 2-3.

74. Only Alaska, Delaware, Montana, New Hampshire, and Oregon do not impose a state sales tax. 2 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶ 12.01 (1992); see also *Sales Tax on a Steady Course: Upward*, *supra* note 12, at 24. Notwithstanding the lack of a state sales tax, however, many Alaskan municipalities levy sales taxes. By 1992, 96 Alaskan cities had taxes on goods and services ranging from 1% to 6%, with this tax generally applying to the first \$500 or \$1000 of the transaction. FEDERATION OF TAX ADMINISTRATORS, *SALES TAXATION OF SERVICES: AN UPDATE* 44 (1994) [hereinafter *TAXATION OF SERVICES*]. Additionally, despite its lack of a retail sales tax, Delaware does levy a combination of license fees, gross receipts taxes, and business and occupations taxes on 141 services, an unusually high number. *Id.* at 2, 14-20, 49.

75. 1996-97 BUDGET, *supra* note 3, at 68.

76. 1993-94 CAL. CONTROLLER ANN. REP. A-38.

77. 1996-97 BUDGET, *supra* note 3, at 59, 61.

78. 1995-96 BUDGET, *supra* note 3, at 105.

The current State sales tax rate is six percent.⁷⁹ Local sales taxes account for an additional one and one-quarter percent; of this amount, incorporated cities generally receive one percent of the tax collected for sales within their jurisdictions, with the remaining one-quarter percent going to the county in which the city is located.⁸⁰ This seven and one-quarter percent tax, however, is just a minimum. Because of the addition of special districts in certain areas of the State, the overall sales tax rate varies from area to area and can reach a maximum of eight and one-half percent.⁸¹

In the 1994-95 fiscal year (the most current period for which such information is available), the total cost of performing all Board of Equalization functions related to sales and use taxes was \$228 million, by far the majority of the Board's overall operational cost of \$274 million.⁸² The ratio of total administrative costs to total sales and use tax revenues rose to 0.97 percent in 1994-95.⁸³ Previous cost ratios were 0.96 percent for 1993-94 and 0.89 percent for 1992-93.⁸⁴

B. Rulemaking and Compliance

There is no simple, comprehensive sales tax "law" governing the entire system. Rather, there are many separate statutory sources plus administrative regulations and interpretations⁸⁵ plus applicable case law, all of which must be consulted to determine the tax treatment of a

79. CAL. REV. & TAX. CODE §§ 6051, 6051.1 to .4 (West Supp. 1996).

80. CAL. REV. & TAX. CODE § 7202(a) (West Supp. 1996); *see also* 1994-95 BD. REPORT, *supra* note 24, at 28.

81. These special districts are usually created to fund transportation projects, some are used to finance hospitals, schools, and even open space protection. 1994-95 BD. REPORT, *supra* note 24, at 28. As of June 30, 1995, there were thirty such districts, with tax rates of 0.10% (one district), 0.25% (two districts), or, most commonly, 0.50% (the remaining twenty-seven districts). *Id.* at A-30. During the fiscal year from July 1, 1993 to June 30, 1994, four new districts were added: Del Norte County (landfill), Fresno County (scientific programs and cultural facilities), San Benito County (general fund augmentation), and San Francisco County (general public financing, replacing a recently-expired special district for education at the same rate). 1993-94 BD. REPORT, *supra* note 49, at 8. On March 31, 1995, the special district for the Santa Clara County Transportation Authority expired. 1994-95 BD. REPORT, *supra* note 24, at 10. The highest rate in California is for the City and County of San Francisco, where three special districts account for an additional 1.25% over the base 7.25%, for a total tax rate of 8.50%. *Id.* at A-30.

82. 1994-95 BD. REPORT, *supra* note 24, at A-3.

83. *Id.*

84. 1993-94 BD. REPORT, *supra* note 49, at A-3. This will be discussed in more detail in the text *infra* Section IV.C.1.

85. Recall that the Board of Equalization has the authority to "prescribe, adopt and enforce rules and regulations relating to the administration and enforcement" of the sales tax. CAL. REV. & TAX. CODE § 7051 (West 1987).

particular transaction. To compound the problems created by this web of rules, the statutes governing the sales tax have evolved over time, with sections added on a piecemeal basis nearly every year.

To begin researching the situation, there are 415 sections (and countless subsections) in the California Revenue and Taxation Code related to just the State sales and use taxes.⁸⁶ These are augmented by over 100 Regulations (most of which, again, consist of several sections and subsections),⁸⁷ almost 100 explanatory publications compiled by the Board,⁸⁸ and over 600 pages of Annotations.⁸⁹ In some cases, information in these various sources will appear contradictory.⁹⁰ In many others, the only relevant material available covers the general topic and does not offer the specific guidance desired. In still others, the topic is only partially addressed or addressed in only one of the sources, leaving the taxpayer with the sense that the answer is incomplete and the suggested tax treatment of the transaction is open to potential contrary interpretation at a later date or, worse yet, during a subsequent audit.⁹¹

86. See CAL. REV. & TAX. CODE §§ 6001-7176 (West 1987 & Supp. 1996).

87. See CAL. CODE REGS. tit. 18, §§ 1500-1704 (1996). These Regulations are promulgated by the Board and authorized under CAL. REV. & TAX. CODE § 7051 (West 1987).

88. 1994-95 BD. REPORT, *supra* note 24, at 75-76.

89. See Cal. Sales & Use Tax Annotations 100.0000-610.0750, 2 BUS. TAXES L. GUIDE 3001-4107 (Cal. State Bd. of Equalization) (1996). These Annotations are the Board's written interpretation of the sales and use tax statutes and/or regulations. They cover either a particular factual situation or compare two or more situations and discuss the taxation ramifications of each. 1994-95 BD. REPORT, *supra* note 24, at 12. They usually consist of short rulings issued in response to actual inquiries or cases. The Board claims these are "synopses of selected Board legal opinions, judicial opinions, Letters to Assessors, and attorney general opinions." *Id.* However, an individual Annotation may be issued in advance of formal Board action in the particular case upon which it is based. See *infra* text accompanying notes 281-84.

90. Compare Cal. Sales & Use Tax Annotation 245.0340, 2 BUS. TAXES L. GUIDE 3257 (Cal. State Bd. of Equalization) (1996) (salt used to cure meat is exempt from tax because the purpose of its use is to incorporate it into the meat even though the process entails a large amount of waste) with Cal. Sales & Use Tax Annotation 245.1000, 2 BUS. TAXES L. GUIDE 3261 (Cal. State Bd. of Equalization) (1996) (salt sold for use in preserving or processing food products but not becoming part thereof is not exempt as a food product).

91. This argument will be developed more fully in the text *infra* parts IV.C.3-4.

C. Exemptions and Exclusions

In perhaps no other area has the sales tax system of California changed in the sixty-two years since its inception than in the field of exemptions and exclusions.⁹² From the original four exemptions in the Retail Sales Tax Act of 1933,⁹³ the total number of exemptions and exclusions grew to 139 by the end of 1994.⁹⁴ It is these exemptions that narrow the tax base and, more than any other factor, create the systemic distortions that are the primary focus of Part IV of this Article.

Exemptions and exclusions are both in the category known as "tax expenditures" because the revenues lost by such exemptions are similar to direct expenditures made by the government, the only difference being that they are made through the tax system and not the legislative appropriations process.⁹⁵ These tax expenditure programs (TEP's) are

92. The State Board of Equalization has explained the difference between exemptions and exclusions as follows:

Since the 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 and organizations. In addition to complete exemptions, provisions have been enacted that reduce the tax base by defining certain persons to be consumers of property sold, or provide a partial exemption or credit. 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.

CALIFORNIA STATE BD. OF EQUALIZATION, SALES AND USE TAXES: EXEMPTIONS AND EXCLUSIONS 1 (1993) [hereinafter EXEMPTIONS & EXCLUSIONS] (emphasis added). Exclusions include items specifically not included in the definition of a "sale," such as motion picture production and exhibition. CAL. REV. & TAX. CODE § 6010.6 (West Supp. 1996). Exemptions are sales otherwise taxable, but given special dispensation for policy reasons, such as intermittent sales by nonprofit youth groups (e.g., sales of Girl Scout cookies). CAL. REV. & TAX CODE § 6361 (West Supp. 1996).

This distinction is only especially meaningful in the context of proving the non-taxable status of a transaction. The burden of showing that a transaction is not *excluded* from the imposition of tax is on the state whereas the burden of showing that a transaction is *exempt* is on the person claiming such an exemption. EXEMPTIONS & EXCLUSIONS, *supra*, at 1.

93. Retail Sales Tax Act of 1933, ch. 1020, § 5, 1933 Cal. Stat. 2601.

94. EXEMPTIONS AND EXCLUSIONS, *supra* note 92, at 4-25 (cataloging 135 exemptions and exclusions through January, 1993); CALIFORNIA DEP'T OF FINANCE, 1995-96 TAX EXPENDITURE REPORT 9 [hereinafter 1995-96 TAX EXPENDITURE REPORT] (listing four additional exemptions enacted in 1993 and 1994).

95. 1985-86 GOVERNOR'S BUDGET SUMMARY 70 [hereinafter 1985-86 BUDGET]. For a general discussion of tax incentives provided by the federal tax system, see Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) [hereinafter Surrey, *Tax Incentives*], Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352 (1970), and Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969).

sometimes defined as “subsidies provided through the taxation systems,”⁹⁶ but the broadest definition includes all categories of “deductions, credits, exclusions, exemptions, preferential tax rates and tax deferrals.”⁹⁷

There are several unique attributes of TEP’s that warrant further review. First, they weaken the Legislature’s control over the budget because, once passed, they are no longer part of the normal annual appropriations process.⁹⁸ Second, because they are not passed as part

In his earlier article, Professor Surrey argues that almost all tax expenditures are really *tax incentives* and relief provisions designed to further social policies. Surrey, *Tax Incentives*, *supra*, at 711-12 (noting the only exceptions are those tax expenditures over which the taxpayer has no control, such as being blind or being a certain age). He goes on to argue quite persuasively that a tax incentive is generally inferior to a direct subsidy as a means of achieving social goals. *Id.* at 734-38.

In his article, Professor Bittker refers to such tax expenditures as *tax subsidies* and calls for a “full accounting” in order to expose the true cost and extent of such subsidies to lawmakers and the public. Bittker, *supra*.

96. 1995-96 BUDGET, *supra* note 3, at A-6.

97. 1985-86 BUDGET, *supra* note 95, at 70. The federal government defines tax expenditures as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” 2 U.S.C. § 622(a)(3) (1994).

98. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 1; 1985-86 BUDGET, *supra* note 95, at 70; CALIFORNIA LEGISLATIVE ANALYST, THE 1983-84 BUDGET: PERSPECTIVES AND ISSUES 117 [hereinafter 1983-84 BUDGET ANALYSIS]; CALIFORNIA LEGISLATIVE ANALYST, ANALYSIS OF THE BUDGET BILL B-2 to B-3 (1982) [hereinafter 1982-83 BUDGET ANALYSIS]. This is exacerbated by the fact that fewer than 15% of all existing tax expenditures have “sunset” provisions. 1985-86 BUDGET, *supra* note 95, at 70.

As for the argument that this mechanism involves less government interference, Professor Surrey notes:

A government that decides it is wise to pay out tax credit money via a simple tax schedule would be highly irrational if it also decided that it would be unwise to pay the same amount directly on the same basis. A dollar is a dollar—both for the person who receives it and the government that pays it, whether the dollar comes with a tax credit label or a direct expenditure label. Surrey, *Tax Incentives*, *supra* note 95, at 717. He goes on to say that, at least on a national level, the avoidance of repeated attention to the tax incentive may be deliberate:

It may be that the legislator and the beneficiaries of tax incentive programs . . . fear that once the public is fully aware of the amounts involved and can weigh expenditure costs against benefits received by the nation, the tax incentives will be found wanting in many respects. In this view, the deeper the incentive is buried in tax technicalities and tax terminology, the more it looks like any other technical tax provision, the more it partakes of the protective coloration of the tax law that can be obtained by such outward similarity to ordinary tax provisions, then the more desirable the tax incentive

of the State budget, they are not subject to the two-thirds vote required for appropriations, but rather require only a simple majority for passage.⁹⁹ Third, like entitlements, there is no limit on the number of people claiming the benefit, thus there is no way to measure accurately the expected loss prior to its enactment. Moreover, there is no cap on the amount of foregone revenue created by enactment or continuance of the TEP.¹⁰⁰ Finally, tax incentives are wasteful because some of the benefits go to taxpayers for activities that they would have performed absent the incentive.¹⁰¹

For decades, TEP's got little recognition from the Legislature. Although many TEP's were enacted after implementation of the Retail Sales Tax Act, not a single one was deleted until 1963.¹⁰² In 1971, the Legislature began requiring the State Department of Finance (part of the executive branch) to prepare a biennial report outlining current tax expenditures as "a step toward the eventual inclusion in the annual state budget of tax expenditures through the tax structure."¹⁰³ In 1984, this

becomes.
Id. at 733-34.

Professor Bittker quotes Walter Heller in observing that tax subsidies might be politically more palatable than direct expenditures and, moreover, that such subsidies, once granted, are difficult to remove:

The back door to government subsidies marked "tax relief" is easier to push open than the front door marked "expenditures" or the side door marked "loans, guarantees, and insurance." . . . [H]ere is a whole catacombs of Government benefits which are largely hidden from public view, let alone, periodic review. Once imbedded in the tax structure, the preferential provisions are treated as inalienable vested rights, impervious to changes in tax rates, economic policy, and technology.

Bittker, *supra* note 95, at 244-45.

99. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 1; 1985-86 BUDGET, *supra* note 95, at 70.

100. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 1; 1985-86 BUDGET, *supra* note 95, at 70-71; 1983-84 BUDGET ANALYSIS, *supra* note 98, at 117; 1982-83 BUDGET ANALYSIS, *supra* note 98, at B-3; Surrey, *Tax Incentives*, *supra* note 95, at 726; *cf.* Bittker, *supra* note 95, at 244 (noting that this problem is especially true for the federal income tax, or any graduated tax, because the amount of a given subsidy varies directly with the tax bracket of the taxpayer utilizing it).

101. Surrey, *Tax Incentives*, *supra* note 95, at 719. The converse is also true. Tax incentives will create misallocations of resources due to the economically distorting effects of people changing their behavior in response to the incentive. *Id.* at 725; Bittker, *supra* note 95, at 247 (noting that any estimate of the cost of tax subsidies "would have to take account of the fact that tax concessions influence behavior").

102. HAROLD M. SOMERS, ASSEMBLY INTERIM COMM. ON REVENUE & TAXATION, THE SALES TAX, pt. 4, at 11 (1964). That year, the Legislature repealed exemptions for sales of meals by employers to employees, food products sold by "drive-ins," and sales by some non-profit organizations of certain classes of merchandise. *Id.*

103. An Act Relating to Exemptions from Taxation, ch. 1762, §§ 1, 3, 1971 Cal. Stat. 3810, 3810-11. While the report is being prepared on an annual basis, tax expenditures are still not part of the annual budget process. During 1984, the Legislature

directive was expanded to require annual reports, including a comprehensive and detailed list of tax expenditures as well as historical information on their enactment and repeal.¹⁰⁴

went so far as to enact legislation requiring the Governor to submit an annual "Tax Expenditure Budget." This bill (Cal. A.B. 1894), however, was vetoed by Governor Deukmejian. CALIFORNIA LEGISLATIVE ANALYST, THE 1985-86 BUDGET: PERSPECTIVES AND ISSUES 141 [hereinafter 1985-86 BUDGET ANALYSIS].

The idea behind mandating a tax expenditure budget is based on the premise that: [M]any tax incentives look, and are, highly irrational when phrased as direct expenditure programs structured in the same way. Indeed, it is doubtful that most of our existing tax incentives would ever have been introduced, let alone accepted, if so structured, and many would be laughed out of Congress. . . .

. . . .
 . . . Just why is it that in many cases legislators appear willing, with hardly any thought, to accept an expensive tax incentive program when they would just as quickly reject a similar direct expenditure program, even a much smaller one?

Surrey, *Tax Incentives*, *supra* note 95, at 721-22, 735.

The federal government has taken the California requirements a step further. The Congressional Budget Act of 1974 requires the President to submit, as part of the proposed budget, "the level of tax expenditures under existing law in the tax expenditures budget . . . for the fiscal year for which the budget is submitted, considering projected economic factors and changes in the existing levels based on proposals in the budget." 31 U.S.C. § 1105(a)(16) (1994). The Committees on the Budget in each house of Congress are to receive a report incorporating this information. 2 U.S.C. § 602(f)(1) (1994). Additionally, Congress has subjected itself to this same mandate by requiring the submittal of the same information when considering tax expenditure programs as part of regular direct expenditure bills or programs. 2 U.S.C. § 639(a)(1) (1994).

104. Act of June 29, 1984, ch. 268, § 23.5, 1984 Cal. Stat. 1335, 1335-36 (codified as CAL. GOV'T CODE § 13305). Meeting this requirement has been the responsibility of the Department of Finance. The information has, however, been given different treatment over the years by the sitting Governor. During the late 1980s, under Governor George Deukmejian, the *Tax Expenditure Report* was included in the *Governor's Budget Summary*, thus allowing the report increased visibility and at least the appearance of deliberation over the issue of TEP's in connection with preparation of the State budget. See 1988-89 GOVERNOR'S BUDGET SUMMARY 130-37 [hereinafter 1988-89 BUDGET]; 1987-88 GOVERNOR'S BUDGET SUMMARY 105-11 [hereinafter 1987-88 BUDGET]; 1986-87 GOVERNOR'S BUDGET SUMMARY 83-88 [hereinafter 1986-87 BUDGET]; 1985-86 BUDGET, *supra* note 95, at 70-80. Since then, however, during the tenure of Governor Pete Wilson, the *Tax Expenditure Report* has been prepared and presented separately from the *Governor's Budget Summary*. See, e.g., 1995-96 BUDGET, *supra* note 3 (*Tax Expenditure Report* not included); 1995-96 TAX EXPENDITURE REPORT, *supra* note 94 (published separately in pamphlet form).

During this same period, the Legislature also required the Legislative Analyst to prepare an annual report including, for each exemption, the following: (1) a fiscal analysis taking into account the original social and economic purpose of the exemption, (2) an examination of the minimal level necessary to meet the State's objective, (3) an evaluation of the income groups impacted by the exemption and its effect on the overall

Since the commencement of the reports in 1972, the Legislature has eliminated ten sales and use tax exemptions, creating an estimated first year savings of \$288 million.¹⁰⁵ During that same period, however, forty-eight new tax expenditures were enacted, with an estimated first year cost of \$196 million.¹⁰⁶ In 1993, the State Board of Equalization

distribution of the tax burden, and (4) the extent to which federal and state exemptions overlap. A. Con. Res. 17, res. ch. 70, 1985 Cal. Stat. 6123.

105. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 4-5 (listing repeals from 1985 through 1994); 1985-86 BUDGET, *supra* note 95, at 73 (listing repeals from 1972 through 1984). This total of 10 does not include one program eliminated twice (diesel fuel used in commercial fishing) or three programs later reinstated (exemptions for snack foods, candy, and bottled water), but does include three programs that have been subsequently partially reinstated (sales from vending machines, newspapers, and periodicals). 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 4-6, 8 (listing repeals from 1985 through 1994 and partial reenactment of vending machine, newspaper, and periodical exemptions); Prop. 163, § 2 (1992) (codified as part of CAL. REV. & TAX. CODE § 6359) (reexemption of snack foods, candy, and bottled water); 1985-86 BUDGET, *supra* note 95, at 73 (listing repeals from 1972 through 1984). These eliminated programs are all tax incentives under Professor Surrey's definition—any advantageous provision of the tax code except those expenditures related to "involuntary activities of taxpayers." Surrey, *Tax Incentives*, *supra* note 95, at 712.

There have, of course, been proposals for additional repeals made by both the executive and legislative branches of State government, but concurrence of both is necessary for passage. In 1983, for example, Governor Deukmejian recommended the repeal of exemptions totalling \$168 million in annual State savings for candy, commercial motion picture rentals, home video rentals, master tapes and recordings, custom computer software, vending machine sales, bottled water, gasohol, and monetized bullion. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 117. This proposal was incorporated into Cal. A.B. 1428, authored by Speaker Willie Brown, and passed the Assembly only to die in the Senate. *Id.* at 118. The bill was defeated despite the prediction of Senate President Pro Tem David Roberti who noted that the Senate would "move swiftly" to approve the measure. Alan Ashby, *Senate Expected to Pass Loophole Tax Law*, L.A. DAILY J., May 18, 1983, at 2. The only portions of the proposal to survive were a repeal of the exemption for home video rentals and a partial exemption for items sold through vending machines, both of which were passed as part of the 1983-84 Budget Trailer Bill. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 118.

106. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 6-9 (listing enactments from 1985 through 1994); 1985-86 BUDGET, *supra* note 95, at 74-76 (listing enactments from 1972 through 1984). Added tax expenditures from 1972 to 1984 include those for factory built housing, institutional meals, artificial limbs, monetized bullion, trailers and semitrailers, camp trailers, master tapes, prosthetic and ambulatory devices, vitamins sold by chiropractors, sales by PTA's, mobile homes (partial), food served in senior citizens' homes, mobile transportation equipment, bottled water, gasohol, certain cargo containers, custom computer programs, oxygen and oxygen delivery systems, x-ray film, mass commuting vehicles, diesel fuel for commercial fishing, and auditory devices. 1985-86 BUDGET, *supra* note 95, at 74-76. Later exemptions include waterborne vessels, special order printing, food stamp purchases, motion picture services, fuel for common carriers in foreign commerce, newspapers and periodicals distributed free of charge, fuel for watercraft common carriers, subscription periodicals, manufacturing equipment for start-up firms, mailing lists, and intangible rights. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 6-9.

A few of these tax expenditures are designed to "provide tax reduction in order to relieve misfortune or hardship—situations involving 'personal hardships,' as contrasted

calculated the annual revenue loss from all exclusions and exemptions from these TEP's to be at least \$4.29 billion for the State's portion of the sales tax alone.¹⁰⁷

with the 'tax hardships' that have brought about other special tax provisions, chiefly for business activities." Surrey, *Tax Incentives*, *supra* note 95, at 712. This list includes exemptions for prosthetic and auditory devices. Under Professor Surrey's definition, these items cannot properly be categorized as tax incentives.

107. EXEMPTIONS AND EXCLUSIONS, *supra* note 92, at 21-25 (listing exemptions as of January 1993); 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 9 (listing four additional exemptions enacted in 1993 and 1994). These two publications include actual revenue loss estimates for only 25 of the 139 programs and it is only these 25 programs that are included in the \$4.29 billion figure. The remaining 114 programs are classified as follows: three as "major" (annual cost over \$10 million), 13 as "minor" (annual cost less than \$100,000), 96 as unknown because information is not available, and only two as having no fiscal impact. EXEMPTIONS AND EXCLUSIONS, *supra* note 92, at 1, 21-25 (listing exemptions as of January 1993 and definitions of categories); 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 9 (listing four additional exemptions enacted in 1993 and 1994).

The Board of Equalization's figure, however, does not coincide with the annual estimate provided by the Department of Finance, which calculated the annual State loss at \$1.05 billion for 1995-96. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 11. The reason is simple. In its 1986-87 *Tax Expenditure Report* (included in the *Governor's Budget Summary*), the Department of Finance for the first time distinguished between "general" and "special" tax expenditures. 1986-87 BUDGET, *supra* note 104, at 83; *see also* Bittker, *supra* note 95, at 252 (setting forth this two-part classification system). This change was brought about by the belief that the definition of tax expenditures ("any special provisions which deviate from the 'basic tax structure' and which result in a revenue loss") was too broad, hence the refinement. 1986-87 BUDGET, *supra* note 104, at 83. General tax expenditures are those deductions or exclusions that "apply to the vast majority of taxpayers or are determined to be a part of the basic tax structure" and special tax expenditures are "narrowly focused deductions or exclusions that are only available to a select group of taxpayers." *Id.*; *accord* Bittker, *supra* note 95, at 252 (defining a "general" exemption as one that applies to all taxpayers and a "special" exemption as one "for which the taxpayer qualifies only by virtue of the type, location, or other characteristics of his[her] activities").

At least in the Department of Finance's view, only the general exemption category is properly the "main focus of legislative review." 1986-87 BUDGET, *supra* note 104, at 83. This was a significant policy shift because, according to the Department, included in general exemptions are food, utilities (gas, electricity, and water), agricultural inputs (feed, seed, and fertilizer), prescription medicine, and medical supplies such as wheelchairs. *Id.* at 87. Therefore, beginning with its 1987-88 report, these general tax expenditures were no longer included in the Department of Finance's annual *Tax Expenditure Report*. *See* 1987-88 BUDGET, *supra* note 104, at 110. This treatment has continued to the present day. *See, e.g.*, 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 11. The report lists the only "major identifiable state tax expenditures of \$10 million or more" as vessels and aircraft (\$523 million), cargo and returnable containers (\$278 million), custom computer programs (\$67 million), leases of motion pictures (\$56 million), motion picture production services (\$37 million), printed advertising (\$26

IV. AN ANALYSIS OF THE CURRENT SYSTEM AGAINST ITS ORIGINAL GOALS

A. Revenue Generation

California expects to earn a little over one-third of its general fund revenues from sales and use taxes for the 1996-97 fiscal year.¹⁰⁸ This percentage has been steadily declining over the past fifty years. In 1949-50, sales tax accounted for fifty percent of State general fund tax collections.¹⁰⁹ That number fell to forty-six percent by 1959-60,¹¹⁰ forty-three percent by 1969-70, thirty-nine percent by 1979-80, and thirty-seven percent by 1989-90.¹¹¹

For this reason alone, the California sales tax is clearly not living up to the expectations of its creators in terms of revenue-generating capability.¹¹² There are several factors causing this phenomenon.

million), watercraft common carrier fuel (\$22 million), student meals (\$18 million), subscription periodicals (\$11 million), and manufacturing equipment for start-up firms (\$10 million). *Id.* The total of these special tax expenditures is \$1.048 billion, approximately one-quarter the Board of Equalization's estimate of \$4.29 billion for general and special tax expenditures combined.

Professor Bittker, however, was quite adamant that any "full accounting" of tax subsidies must include the full "cost of influencing . . . [the] tax structure, a function that can be served interchangeably by rate reductions (whether "general" or "special"), deductions, credits, exclusions, or other allowances." Bittker, *supra* note 95, at 252-53. Any comprehensive evaluation of the effectiveness of the sales tax system must therefore include *all* tax expenditures, whether general or special.

108. 1996-97 BUDGET, *supra* note 3, at 57. The sales tax is expected to contribute 35.7% of the State's general fund revenues. *Id.*

109. 1965-66 SUPPORT AND ASSISTANCE BUDGET A-21 to A-22.

110. *Id.*

111. 1991-92 GOVERNOR'S BUDGET SUMMARY 33, 35. In addition to the falling *proportion* of sales tax revenues to total revenue, the *growth rate* of sales tax revenues is also declining. State revenues grew at an average rate of five and one-half percent from the early 1980s through the mid-1990s. 1995-96 BUDGET ANALYSIS, *supra* note 22, at 44. On the other hand, the projected increase general fund sales tax revenues from the 1994-95 fiscal year to 1995-96 is only one percent. *Id.* at 46.

More importantly, collections from sales tax, as an *ad valorem* tax that applies a percentage tax rate to the tax base, tend to fluctuate with the economy because they capture the effects of real economic growth and inflation. *Id.* at 47-48. Thus, when the economy is healthy, tax revenues increase. Conversely, when the economy enters a recession, tax collections decline. See 1996-97 BUDGET, *supra* note 3, at 72 (graph showing the growth rate of taxable sales in California from 1968 to the present which clearly demonstrates the cyclical nature of sales tax collections).

The cyclical coincidence of economic performance and revenue generation is one of the weakest features of any consumption-based tax. For a suggestion on dampening this effect, see the discussion in the text *infra* Section V.A.2.

112. Sales taxes are the most lucrative revenue source for state governments. In a recent survey, the average percentage of state tax collections from the sales tax was

First, and most importantly, exemptions and exclusions account for over \$4.29 billion in revenue losses annually (as measured in 1993 dollars).¹¹³ This amount represents twenty-one percent of all potentially-collectible sales and use tax.¹¹⁴

Second, changes in the basic demographic structure of the State impact sales tax revenues by affecting consumption patterns. At least part of the declining growth rate can be attributed to the gradual aging of the population. Between 1970 and 1990, the percentage of the national population between the ages of forty-five and sixty-four decreased from 20.6 percent to 18.6 percent while the percentage age sixty-five and older grew from 9.8 percent to 12.5 percent.¹¹⁵ Since 1990, the percentage of the population age sixty-five and older has increased over ten percent, compared to only six percent for the population from eighteen to sixty-four.¹¹⁶ The increase in older households will tend to decrease sales tax collections because these persons are greater relative consumers of such non-taxable items as medical care, food for home consumption, and utilities.¹¹⁷ This will tend to dampen the growth rate of sales tax revenues, although this may be somewhat offset by the expected growth during the latter 1990's and first part of the next century in the portion of the population between forty-five and sixty-

found to be approximately one-third. Four receive over half their revenue from the sales tax, but, of these, three do not have a state income tax. In 1991, sales tax accounted for \$102.4 billion in combined state revenues and another \$6 billion in revenue for local governments. HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 12.01.

113. EXEMPTIONS AND EXCLUSIONS, *supra* note 92, at 21-25 (listing exemptions as of January 1993); 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 9 (listing four additional exemptions enacted in 1993 and 1994). See *supra* note 107 for the calculation and methodology used to arrive at this figure.

114. The Board of Equalization estimates were made in early 1993. As discussed *supra* note 111, taxable sales tend to rise and fall with the economy in general. Therefore, the most appropriate period of comparison for the cost of exemptions relative to realized tax revenue is fiscal 1992-93. Total tax collections for that year were \$16,598,863,000. 1996-97 BUDGET, *supra* note 3, at 83. Thus, the total potential tax revenue from all sales taxes, ignoring exclusions and exemptions, would be \$20,888,863,000, measured in 1993 dollars ($\$4.29 \div \$20.89 = 21\%$).

115. Duncombe, *supra* note 16, at 300.

116. 1996-97 BUDGET, *supra* note 3, at 86.

117. Duncombe, *supra* note 16, at 309. For example, in households where the head was over 65, an average of 10.05% of household income was spent on food at home compared to 8.08% for households with heads under 35. This also holds true for utility spending (8.93% versus 6.13%) and especially for health care (11.26% versus 3.42%). *Id.* at 310.

four, a segment which includes the prime working years and households that are heavy consumers of taxable goods.¹¹⁸

Third, and perhaps most significantly, spending on services has increased substantially. Because most such transactions are non-taxable, this has had a profound impact on sales tax revenues. In 1929, expenditures on services totaled thirty-nine percent of all spending; by 1990, this total had risen to fifty-four percent, a relative increase of almost forty percent.¹¹⁹ This increased demand has fueled sustained growth in the service sector of the economy, whose earnings as a percentage of all nonagricultural earnings rose from sixty-five percent in 1970 to seventy-four percent by 1990.¹²⁰ Additionally, in 1952, services accounted for forty-three percent of the gross domestic product (GDP), goods forty-five percent, and construction twelve percent. By 1992, however, the share of the service sector of the economy grew to fifty-one percent of GDP, while goods shrank to forty percent and construction to nine percent.¹²¹ This sector has continued to grow in California, with business services employment increasing 6.4 percent in 1994 alone.¹²²

Intertwined with this expanding “pure” service sector of the economy is the hybridization of what were traditionally either goods or services. This concept is evidenced by the increasing difficulty of dividing businesses into clearly-delineated categories such as capital-intensive manufacturing or labor-intensive services.¹²³ This “new economy” is

118. *Id.* at 309. Besides buying more non-taxable commodities, older persons generally have overall less expensive lifestyles. This translates into the purchase of fewer taxable commodities and, therefore, into lower tax collections. For example, a 1980 study showed that married households with annual incomes between \$20,000 and \$30,000 spent 36% of their income on taxable commodities where the household head was under 45, 33% where the head was 45 to 61, and 28% where the head was 62 or over. This decline is even more pronounced for single households. There, the percentages dropped from 37% for persons under 45 to 27% for persons 45 to 61 and finally to 19% for persons 62 and over. JAMES PATTERSON, CALIFORNIA ASSEMBLY OFFICE OF RESEARCH, *THE ESTIMATED IMPACT OF CALIFORNIA'S STATE AND LOCAL SALES TAX ON HOUSEHOLDS* 13 (1980).

119. 2 ANN DUBAY, CALIFORNIA SENATE OFFICE OF RESEARCH, *CALIFORNIA'S TAX BURDEN: WHO PAYS?* 3-4 (1991).

120. Duncombe, *supra* note 16, at 302. At the same time, the proportion of all nonagricultural earnings attributable to manufacturing dropped from almost 30% in 1970 to less than 20% by 1990. *Id.*

121. Laura M. Litvan, *More Sales Taxes on Services?*, *NATION'S BUS.*, Jan. 1994, at 28R; cf. Hellerstein, *Significant Developments*, *supra* note 72; Robert A. Pierce & Carol D. Peacock, *Broadening the Sales Tax Base: Answering One Question Leads to Others*, 14 FLA. ST. U. L. REV. 463 (1986).

122. 1994-95 BD. REPORT, *supra* note 24, at 58.

123. Cf. John Huey, *A New Era Dawns*, *FORTUNE*, May 15, 1995, at 8. In 1995, for the first time in its 40 year history, *FORTUNE* expanded its list of the 500 biggest companies in the United States beyond industrial corporations. The list now includes,

quickly “obliterat[ing] once valid distinctions between industrial and services businesses.”¹²⁴ In fact, these distinctions have become “as meaningless as battlefield lines in a guerrilla war.”¹²⁵ For example, Nike, the shoe “manufacturer,” no longer makes shoes; it provides only services (research and development, design, marketing, and distribution) surrounding a product “made” by others. Conversely, software “creators” such as Microsoft were originally considered service companies. Today, the “service” they provide (computer programming) is indisputably mass-produced and sold in discrete units—in other words, manufactured.¹²⁶

Of the 164 services tracked by the Federation of Tax Administrators (FTA),¹²⁷ as of 1992 California taxed only nineteen, compared to the national state average of fifty-three.¹²⁸ On the other hand, six states tax over 100 of the listed services.¹²⁹ Most of the services that California does tax are the result either of the definition of “tangible personal property” itself in that particular situation or the fact that an otherwise exempt component of the transaction is not or cannot be stated separately and is therefore taxed. For example, tuxedo rentals, included as a service in the FTA chart, are considered taxable as lease payments by the Board of Equalization.¹³⁰ Similarly, prewritten or “canned”

inter alia, manufacturers, retailers, financial services companies, and software vendors. *Id.*

124. Thomas A. Stewart, *A New 500 for the New Economy*, FORTUNE, May 15, 1995, at 166.

125. *Id.* at 170.

126. *Id.*

127. TAXATION OF SERVICES, *supra* note 74, at 2. These are broken down into eight categories: utilities (16 services), personal services such as hair salons and dry cleaning (20), business services such as photocopying and marketing/public relations (34), computer services (6), admissions/amusement such as sporting events (14), professional services such as attorneys and doctors (8), fabrication/repair/installation (19), and other services (47). *Id.* at 2, 14-20.

128. *Id.* at 2. Only eight states tax the same or a fewer number of services than California. These states are Alaska (1), Colorado (15), Illinois (16), Montana (19), Nevada (11), New Hampshire (11), Oregon (0), and Virginia (18). *Id.*

129. *Id.* These states are Delaware (141), Hawaii (155), New Mexico (155), South Dakota (130), Washington (152), and West Virginia (110). *Id.* It is interesting to note that Delaware, despite its lack of a general sales tax, significantly taxes services through alternative schemes such as a gross receipts tax. *Id.* at 14-20, 49.

130. Cal. Sales & Use Tax Annotation 330.3015, 2 BUS. TAXES L. GUIDE 3487 (Cal. State Bd. of Equalization) (1996). The ongoing lease payments can be exempt from tax if the lessor of the garment makes a timely election to pay sales tax reimbursement or use tax as measured by the purchase price of the garment. *Id.*

computer programs are taxable, despite the fact that a large percentage of the amount charged represents license fees or labor costs which are otherwise non-taxable, because they are transferred on storage media (e.g., computer disks or magnetic tapes) and these storage media are considered tangible personal property.¹³¹

The State Legislative Analyst, in a report on the administration of the sales tax, noted that disputes over interpretation of the law were most likely to arise in transactions involving businesses providing tangible personal property in the context of a service.¹³² Sales tax generally does not apply to the labor component of the repair or installation of tangible personal property.¹³³ If, however, charges for such services are combined with the charges for the parts and materials necessary for

131. See CAL. REV. & TAX. CODE § 6010.9 (West 1987); CAL. CODE REGS. tit. 18, § 1502(f) (1996). The fact that this is viewed as a tax on tangible personal property and not a service is further illuminated by the fact that there is no sales tax for canned programs if they are transferred by remote telecommunications (modem) and the purchaser does not obtain title to any storage media as a result of the transaction. CAL. CODE REGS. tit. 18, § 1502(f)(1)(D) (1996). Note that sales tax does not apply to custom computer programs in any case or to the modification of prewritten programs if the labor charges for the modifications are stated separately. § 1502(f)(2).

132. CALIFORNIA LEGISLATIVE ANALYST, ADMINISTERING THE SALES AND USE TAX: IMPROVED INFORMATION MANAGEMENT SHOULD IMPROVE COMPLIANCE 3 (1987) [hereinafter ADMINISTERING THE SALES TAX]; cf. MCI Airsignal, Inc. v. State Bd. of Equalization, 1 Cal. App. 4th 1527, 2 Cal. Rptr. 2d 746 (1991). In MCI, the company sought a refund of taxes paid for that portion of its receipts attributable to the rental of paging devices. The court held in the taxpayer's favor, noting:

If the business is providing purely a service and the property is incidental, then the business entity is the consumer, not the retailer, of the tangible property and must pay sales tax when *acquiring* the property; the transfer of the tangible property to the service customer is not subject to tax.

MCI, 1 Cal. App. 4th at 1530, 2 Cal. Rptr. 2d at 747. The proper test for determining whether a business activity is a service (non-taxable) or a sale of tangible property (taxable) depends on the "true object" of the transaction. *Id.* This test is contained in Sales and Use Tax Regulation 1501, which states in pertinent part:

The basic distinction . . . is one of the true objects of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred.

CAL. CODE REGS. tit. 18, § 1501 (1996). For example, the transfer to a publisher of an original manuscript by its author for the purpose of publication is not subject to tax even though the method of transfer involves tangible personal property (the paper). *Id.* But see discussion *supra* note 131 and accompanying text for a seemingly opposite result as regards "canned" computer software.

133. Sales tax does apply, however, to fabrication labor. CAL. REV. & TAX. CODE § 6006(b) (West Supp. 1996) (definition of sale includes "[t]he producing, fabricating, processing, printing, or imprinting of tangible personal property for a consideration for consumers who furnish either directly or indirectly the materials used in the producing, fabricating, processing, printing, or imprinting").

the repair or installation, then the repairperson is the retailer and tax applies to the entire transaction.¹³⁴

Because the service sector of the economy is growing at such a tremendous pace and because California taxes so few services, taxable sales as a percentage of personal income has been steadily declining for over fifteen years. This ratio is currently estimated at approximately forty percent, down from almost fifty-five percent in the late 1970's, meaning that a larger and larger portion of consumption expenditures are exempt from taxation.¹³⁵

California is clearly behind most other states in the country not only in terms of total services taxed, but also the rate of adding new services to the list of those subject to tax. Many states are at least "inching their way, in a very incremental fashion, toward taxing service industries."¹³⁶ Others are whole-heartedly reevaluating their taxing structure and systematically adding services to their tax bases. During the period from 1990 to 1992, twenty-eight states added some business services (including maintenance and janitorial services, personnel supply services, and marketing/public relations services) to their tax base and twenty-seven added some personal services (including beauty salons, laundry/dry cleaning, and personal instruction).¹³⁷ There has traditionally been a reluctance to tax labor-intensive services, yet several of these newly-taxed services fall in that category. This may signal an increased willingness to tax services in general.¹³⁸

By contrast, there has been no concerted effort in California to extend the sales tax to services in over twenty-five years.¹³⁹ However, given

134. CAL. CODE REGS. tit. 18, § 1546(b)(1) (1996). Tax also applies if the value of the parts and materials are more than ten percent of the total charge. § 1546(b)(1). If, however, the total for parts and materials is less than ten percent and no separate charge is made for such property, then (1) the repair transaction is exempt from tax and (2) the repairperson is the consumer of the parts and materials and tax applies to the sale of the property to him/her. § 1546(b)(2).

135. 1995-96 BUDGET ANALYSIS, *supra* note 22, at 56-57.

136. Litvan, *supra* note 121, at 28R.

137. TAXATION OF SERVICES, *supra* note 74, at 3, 15-17.

138. *Id.* at 4.

139. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 121. In 1969, Governor Reagan proposed that the sales tax be extended to selected services, such as repairing, cleaning, and maintaining certain personal property. *Id.* This was consistent with one of the Governor's "principles of tax policy": that "the burden of taxation should fall equally on all taxpayers, in proportion to their income, and should be applied in such a way as to leave the production and distribution of goods and services in relatively the

the declining strength of the sales tax as a revenue-generating tool and the fact that the State's budget situation is "likely to remain precarious" throughout the remainder of this decade,¹⁴⁰ it is time to revisit seriously the possibility of service taxation in California. The suggested scope for such a review and the benefits and costs of such a proposal will be treated in-depth in Subpart V.A.

B. Fairness I: Equity

1. The Historical Debate

One of the original goals of the California sales tax was a tax that was equitable.¹⁴¹ From its earliest formations in the United States, the sales tax had its social, as well as economic, critics.¹⁴² The most common criticism was (and still is) that a sales tax in any form is regressive, that is, it bears more heavily on poorer taxpayers because the overall rate of taxation increases less rapidly than the increase in tax base (here, income) or, in some cases, decreases as the tax base increases.¹⁴³ John Due summarized the typical argument advanced against the "second-best tax"¹⁴⁴ as follows:

[A sales tax] tends to penalize persons whose circumstances compel them to spend relatively higher percentages of their incomes to attain given standards of living, and it cannot be adjusted satisfactorily in terms of various considerations which effect taxpaying ability at given income levels, such as numbers of dependents and medical expenses. It frequently operates in perverse fashion, striking more heavily the persons least able to pay.¹⁴⁵

Other early critics labeled it an "upside down income tax" because it was felt to be based on "inability to resist rather than ability to pay taxes."¹⁴⁶

same position as before taxation." RONALD REAGAN, TAX REFORM PROGRAM FOR CALIFORNIA 3 (1969). The estimated annual revenue gain at that time was \$50 million. Although approved by the Assembly Committee on Revenue and Taxation, the bill (AB 2046) was never passed. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 121.

140. 1995-96 BUDGET ANALYSIS, *supra* note 22, at 20.

141. Cf. S.J. RES., 1933 CAL. SENATE J. 3199.

142. See, e.g., MABEL L. WALKER, GENERAL WELFARE TAX LEAGUE, WHERE THE SALES TAX FALLS (1934), *microformed on* ALA BX-84 (Council of St. Gov't).

143. BLACK'S LAW DICTIONARY 1285 (6th ed. 1990).

144. DUE, *supra* note 7, at 41. Professor Due considered the income tax to be a more "suitable" tax. *Id.*

145. *Id.* at 39-40.

146. WALKER, *supra* note 142, at 1. The early belief in the intractable regressivity of the sales tax was quite strong. The Walker article began with the assumption that the "discrimination [of the sales tax] against the poor cannot seriously be questioned" and then spent the balance of the paper attempting to quantify not the existence, but the

Even using the most simplistic analysis, however, these critics agreed that "certain modifications, such as the exemption for food, may alleviate the basic objection of the heavy burden placed on the poor."¹⁴⁷ This was the reasoning behind California's exemption of food for home consumption when the rate of the sales tax was increased in 1935.¹⁴⁸

A 1934 study showed that a household with an annual income of \$1000 (all figures are in 1934 dollars) spent sixty-one percent of its income on taxable commodities, assuming food to be taxable. This compares to thirty-two percent for a household with an annual income of \$10,000, sixteen percent for those with income of \$100,000, and just one percent for those with incomes in excess of \$1,000,000 per year. However, if food were exempted from sales tax, the effects of the tax were shown to be much less regressive; the lowest income group spent twenty-seven percent of its income on taxable commodities, compared to fourteen percent for incomes of \$100,000 and eight-tenths of a percent for incomes over \$1,000,000. But the most significant change was that the tax, while regressive overall, was actually progressive through incomes up to \$10,000. Also, unlike the case where food was not exempt from the tax, the percentage of income spent on taxable goods did not drop quickly as income rose. In fact, only after income rose above \$25,000 did the proportion of income spent on taxable commodities drop below twenty percent and it did not drop below ten percent until incomes rose above \$300,000.¹⁴⁹

In 1949, the Senate Interim Committee on State and Local Taxation studied the equity aspects of California's sales tax system specifically. Including food as taxable, the tax burden as a percentage of income for a household with an annual income of about \$2000 was 2.29 percent; for a household with income of about \$12,500, this number decreased to 1.49 percent. However, exempting food from taxation not only eliminated this regressivity, but actual made the sales tax progressive. The tax burden was measured at 0.58 percent of annual income for the lower income families and 1.05 percent for the higher income families.¹⁵⁰

amount of discrimination. Id.

147. DUE, *supra* note 7, at 40.

148. See discussion *supra* note 55.

149. WALKER, *supra* note 142, at 3-5.

150. DUE, *supra* note 7, at 27.

Today, a majority of states exempt food for home consumption and other necessities such as utilities and prescription medicine from sales tax.¹⁵¹ From a policy perspective, these exemptions (or alternative means designed to produce the same results, such as an income tax credit for “necessary” purchases) are essential to the equity of the sales tax system.¹⁵² They are also useful for creating socially-desired economic effects.¹⁵³ In evaluating the creation or elimination of tax expenditures, California policymakers today are still mindful of the equity considerations of such actions, with recent examples by both the Legislature¹⁵⁴ and Governor¹⁵⁵ mentioning the equity effects of their respective proposals.

The equity considerations of the sales tax can be discussed both in terms of vertical equity and horizontal equity. Vertical equity refers to the distribution of taxes among taxpayers with different income levels. Horizontal equity compares sales tax paid among taxpayers with similar income levels, but different living situations (e.g., married or single, children or no children).¹⁵⁶

151. HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 12.01. This survey noted that 26 states (of the 45 with sales taxes) and the District of Columbia provide a broad exemption for food. The scope of this exemption normally covers only food purchased for home consumption, not meals or other on-premise consumption. *Id.* In addition, a total of 27 states exempt consumer electric and gas utilities and an overwhelming 43 exempt prescription medication. *Id.* In a novel expansion of the “necessities” concept, New York recently enacted a one-week sales tax exemption for purchases of clothing costing \$500 or less. MACKEY, *supra* note 59, at 6-7.

152. SOMERS, *supra* note 102, at 131. As will be discussed in more detail throughout the balance of this Article, however, these exemptions conflict directly with the efficiency of the sales tax. For instance, the most efficient tax of all would be a “lump-sum” or “head” tax levied in the same amount on all taxpayers regardless of any other factors, such as consumption or income. This tax is also obviously considered the most unfair. Hamond, *supra* note 5.

153. For example, in addition to their use in dampening the regressivity of the sales tax, exemptions can also be used deliberately in place of other government assistance or subsidies. For example, they can be used to promote the activities of nonprofit organizations or other desirable activities that might otherwise be funded by the government through more direct means. SOMERS, *supra* note 102, at 131. For a further discussion on tax expenditures used in this manner, see *infra* note 397.

154. See, e.g., 2 DUBAY, *supra* note 119, at 10. This report, among other things, addresses the impact of the proposed elimination of two tax exemptions. It notes that taxing candy and snack foods would make the tax system slightly less regressive. Taxing newspapers and periodicals, however, would have little equity impact because this tax would be borne proportionally across all income levels. *Id.*

155. See 1995-96 BUDGET, *supra* note 3, at 117. This budget summary notes that exemptions for certain essentials makes the sales tax “relatively progressive.” *Id.*

156. 2 DUBAY, *supra* note 119, at 6.

2. Vertical Equity

As concerns vertical equity considerations among various income levels, studies have continued to show that the regressive elements of the sales tax exist to varying degrees under a traditional current-year net income approach.¹⁵⁷ However, when other sources of income such as capital liquidations or net worth are included to reach an amount more closely tied to actual consumer resources, regressivity decreases and, in fact, the tax becomes progressive.¹⁵⁸

Two studies within the last ten years have looked specifically at the California tax and determined, under the current-year income methodology, that it is regressive. The first, a 1988 study by Citizens for Tax Justice (CTJ), found that California households in the bottom quintile of annual income spent 3.3 percent of their income on sales tax. This compares to 1.9 percent for the top fifteen percent and a little under one percent for the wealthiest households.¹⁵⁹ A 1989 study made findings generally consistent with the CTJ study. This report found that households with incomes between \$4,000 and \$7,000 spent 3.28 percent of their income on sales tax compared to 1.12 percent of income for households with incomes above \$50,000.¹⁶⁰ One can assume that these results would show the tax to be even more regressive under the model considered next.

A 1993 study by Frederick Derrick and Charles Scott provides a comprehensive, modern analysis of the equity of sales tax using current-year income statistics. The pair also added another level to the traditional analysis by evaluating, in addition to taxes paid directly by consumers, taxes passed on to consumers by businesses indirectly. These "hidden" sales taxes represent taxes paid by businesses for goods and services used throughout the process of producing and selling the product, but not otherwise exempt from tax because not discretely

157. See generally PATTERSON, *supra* note 118, at 5-17; DUBAY, *supra* note 119; Frederick W. Derrick & Charles E. Scott, *Businesses and the Incidence of Sales and Use Taxes*, 21 PUB. FIN. Q. 210 (1993).

158. SOMERS, *supra* note 102, at 31-71; PATTERSON, *supra* note 118, at 18-21.

159. 2 DUBAY, *supra* note 119, at 7-8. The bottom quintile, with an average income of \$9,301, spent 55% of their incomes on taxable commodities. The top 15%, with \$75,448 in income, spent 32%. Those in the top 0.7% had incomes of \$695,219 and spent only 15% of their incomes on taxable goods. *Id.* at 8.

160. *Id.* at 9.

purchased for resale.¹⁶¹ Looking only at the direct tax, the lowest income quintile spent 3.48 percent of its annual pre-tax income on sales tax compared to 1.04 percent for the highest quintile.¹⁶² The indirect tax is much more regressive. Using data from Maryland, adding the direct and indirect taxes results in taxes of 9.15 percent as a percentage of income for the lowest quintile compared to only 2.43 percent for the highest quintile.¹⁶³

While there is no exact data for California, the authors note that the indirect tax may be proportional to the direct tax in states where there is a broad consumer sales tax base.¹⁶⁴ Because of California's pervasive exclusions and exemptions, the tax base is narrow and the indirect tax is likely to be higher than the direct tax. Additionally, where businesses pay a large share of the taxes, as in California, the incidence of indirect tax is higher.¹⁶⁵ Both of these factors will tend to exacerbate the regressive aspects of the sales tax.

Looking simply to current-year income, however, does not provide an entirely accurate picture of the ability of the consumer to pay sales tax and, thus, of the true equity of the system. In a note to their study, Derrick and Scott make an important observation:

The extent of the regressivity may be overstated, as the lowest income group includes the poor who receive transfers; individuals who are temporarily low-income people and have either financial reserves accumulated or expectation for future increases in salary; and retirees who are often consuming accumulated wealth. Each of these subgroups makes this group unusual and leads to more than 100% of their income being spent.¹⁶⁶

Therefore, the most basic approach to improve the accuracy of these statistics is to exclude deficit-spending households in the lowest income categories so as to include only those persons who have "permanently" low incomes.¹⁶⁷ With this change, California's sales tax, as measured by a 1980 Assembly Office of Research study, is regressive overall, but

161. Derrick & Scott, *supra* note 157, at 210-11. The analysis assumes the business portion of the tax is ultimately passed on to the final consumer. *Id.* at 211.

162. *Id.* at 219. The percentage spent on sales tax drops sharply as income rises. From 3.48% for the lowest quintile, the ratio drops to 1.82% for the next quintile, 1.49% for the middle quintile, and 1.30% for the next quintile. *Id.*

163. *Id.* at 221. Again, this ratio drops quickly as income rises. The second-lowest quintile spent 4.62% of its income on total sales taxes, the middle quintile 3.60%, and the next highest quintile 3.08%. *Id.*

164. *Id.* at 223-24.

165. *Id.* at 224. In California, businesses pay as much as 48% of all sales taxes. 2 DUBAY, *supra* note 119, at 1; *see also infra* notes 223-26 and accompanying text.

166. Derrick & Scott, *supra* note 157, at 225 n.11.

167. *See* PATTERSON, *supra* note 118, at 18-19.

progressive at the lower income levels.¹⁶⁸ Single taxpayers with less than \$10,000 in annual income spent twenty-four percent of their income on taxable purchases; those with incomes between \$10,000 and \$20,000 spent thirty-two percent; those between \$20,000 and \$30,000 spent thirty-one percent; and those between \$30,000 and \$50,000 spent twenty-six percent. Only when income rises above \$50,000 does the tax become regressive, with the percentage spent on taxable goods declining to sixteen percent.¹⁶⁹

A more thorough approach to providing an accurate analysis of the equity of the sales tax is to expand the definition of available resources for the denominator of these ratios. In 1964, Dr. Harold Somers prepared a comprehensive study of the California sales tax for the Assembly Interim Committee on Revenue and Taxation.¹⁷⁰ In this report, he summarized data from contemporary studies made using different measures of income. In addition to the traditional net income method discussed *supra*, there are at least two other measures of annual income. The "disposable receipts" method takes into consideration not only net income, but also net capital liquidations in arriving at its measure of annual income.¹⁷¹ The second method, utilizing "net resources," considers the individual's net worth at the beginning of the period and adds net income.¹⁷² Both of these methods represent means of income averaging which greatly increase the base for the lowest income classes while raising income at the upper levels relatively much less.¹⁷³

168. *Id.* at 19.

169. *Id.* at 20.

170. SOMERS, *supra* note 102.

171. *Id.* at 35. This is the method used by David G. Davies in his 1960 study published in the *American Journal of Economics and Sociology*. Disposable receipts = net income + (assets sold + liabilities added) - (assets acquired + liabilities disposed of). *Id.* The data used were for California taxpayers residing in Los Angeles, San Francisco-Oakland, and San Jose areas, representing 56% of the total California population. The income, disposable receipts, and consumption numbers were all drawn from a 1956 study conducted by the University of Pennsylvania. *Id.* at 35-37.

172. *Id.* at 37-38. This study, conducted by J.J. Launie, used the same survey data developed by the University of Pennsylvania for income and consumption numbers, but used information for the largest western cities, not just California. *Id.* at 38. Net worth was estimated from the *Survey of Financial Characteristics of Consumers* provided in the *Federal Reserve Bulletin*. *Id.* at 46.

173. *Id.* at 41.

Once developed, these various income measures are then used to evaluate two different taxes, a two percent tax including food and a four percent tax excluding food.¹⁷⁴ A progressivity-regressivity index (PRI) is developed, where a number greater than one denotes a progressive tax, a number less than one a regressive tax, and a number of exactly one a proportional tax.¹⁷⁵ Using net income, both taxes are regressive, with the two percent tax receiving a PRI of 0.738 and the four percent tax a PRI of 0.931 (remember that the tax will be less regressive with an exemption for food).¹⁷⁶ Using disposable receipts, the two percent tax is still slightly regressive (PRI of 0.971), but the four percent tax is now progressive, with a PRI of 1.202.¹⁷⁷ Finally, using net resources, both taxes are strongly progressive, with PRI's of 1.110 and 1.359, respectively.¹⁷⁸

The final means for evaluating income is to use not current income or any of its progeny, but rather to study lifetime or life-cycle income. This theory notes that individuals consume varying percentages of their incomes at different times in their lives, with high consumption relative to income typically occurring in early adulthood and after retirement. These consumption levels are not related so much to income levels for the corresponding period as they are to the individual's expected permanent or lifetime income. Therefore, analysis under this theory averages annual consumption over the life of the consumer to arrive at a lifetime spending/income level.¹⁷⁹

In a recent study, utilizing this measure shows the sales tax to be significantly progressive.¹⁸⁰ Using current income, the study found the lowest third of households spend 1.90 percent of their income on sales tax, compared to 1.33 percent for the middle third and 1.07 percent for the highest third. Using lifetime income, however, the results reversed,

174. Although it would appear from the two tax structures chosen that a change in the tax rate impacts the equity of the tax, this is not the case. Rather, it is the act of narrowing the pool of taxed transactions, not increasing the rate, that contributes to the equity effects (either positively, as in this case where food is exempted, or negatively). In fact, mere changes in the tax rate without changes in the tax base do not change the relative regressivity or progressivity of the tax. *Id.* at 102.

175. *Id.* at 37-38.

176. *Id.* at 39, 41.

177. *Id.* at 44-45.

178. *Id.* at 46.

179. See Hamond, *supra* note 5.

180. Gilbert E. Metcalf, *The Lifetime Incidence of State and Local Taxes: Measuring Changes During the 1980s*, in TAX PROGRESSIVITY AND INCOME INEQUALITY 59 (Joel Slemrod ed., 1994) [hereinafter Metcalf, *State and Local Taxes*]; see also *Rethinking Fairness*, FORTUNE, April 19, 1993, at 26. The Metcalf study assumes that consumption is relatively smooth over the life cycle and uses it as a proxy for lifetime income. Metcalf, *State and Local Taxes*, *supra*, at 66.

with sales tax expenditures equalling 1.03 percent of household income for the lowest third, 1.63 percent for the middle third, and 1.74 percent for the highest third.¹⁸¹

The disparity in results based on different measures of income points up the important fact that the lowest income group is extremely mixed in terms of economic resources. In fact, the portion of this group with high net worths is dominant statistically over the portion without.¹⁸² Therefore, any policy decision impacting vertical equity of the sales tax must carefully consider its effect on *both* components of the lowest income group by recognizing their disparate access to resources.¹⁸³

3. Horizontal Equity

We now turn our attention to evaluating the horizontal equity of the sales tax. Here, socio-economic factors have a noticeable effect on regressivity and equity. First, the 1980 California Assembly Office of Research study mentioned *supra* also examined the differential impact of the sales tax on married and single households. The study found that the tax is more equitable for single taxpayers than married households;

181. Metcalf, *State and Local Taxes*, *supra* note 180, at 73. This analysis can also be applied to other taxes, including consumption taxes such as a VAT. Studies have shown that the burden of a VAT would be at least proportional based on lifetime income, assuming, as these studies and those measuring the retail sales tax do, that lifetime income equals lifetime consumption (i.e., that all income is eventually consumed). *E.g.*, Hamond, *supra* note 5 (observing that this “finding is so broadly accepted that it is mentioned as an aside, without citation, throughout the consumption tax literature”). At worst, the incidence of the VAT would be “moderately regressive over the life cycle.” Erik Caspersen & Gilbert Metcalf, *Is a Value Added Tax Regressive? Annual Versus Lifetime Incidence Measures*, 47 NAT’L TAX J. 731, 744 (1994). In the Caspersen and Metcalf study of a VAT, the lowest income households spent 3.93% of their lifetime income on taxes, compared to 2.94% for those with the highest income, a ratio of 1.3:1. *Id.* at 740-41. This ratio would drop to 1.1:1 under a VAT with zero-rated food, housing, and health care expenditures, thus making it roughly proportional. *Id.* at 742.

182. SOMERS, *supra* note 102, at 71.

183. The political realities of these policy decisions, however, may have more to do with taxpayer perception than economic theory. One economist has noted:

[W]hile consumption spending [under a life-cycle income model] might be a better proxy for ability to pay than annual income, most consumption decisions are based on funds presently available through savings or borrowing, not on future income. This means that the life-cycle paradigm, no matter how accurate in a mathematical simulation, may not be politically persuasive since taxes must also be paid out of current income.

Hamond, *supra* note 5.

it was regressive for married households at all income levels, but was proportional for single taxpayers to \$30,000 in annual income and regressive only at higher income levels.¹⁸⁴

Second, family size also impacts the equity of the sales tax system. As might be expected, the tax burdens large families more than smaller households with the same income because the larger households must spend a higher percentage of income on taxable goods to achieve the same standard of living.¹⁸⁵ Studies have shown that, for families earning less than \$10,000 per year, families of six or more spend fifty-four percent of their income on taxable purchases compared to married couples with no children who spend thirty-nine percent.¹⁸⁶ From 1970 to 1990, the national average household size dropped from 3.1 to 2.6 persons.¹⁸⁷ This trend towards smaller household size will contribute to a decreasing horizontal regressivity.

By evaluating income measures that more fully take into account consumers' overall ability to pay sales taxes (by utilizing not just current year income, but also various measures including capital liquidations, net worth, and(or) lifetime income) and by examining other socio-economic factors, the sales tax is, at a minimum, less regressive than feared at its inception and, at best, substantially progressive.¹⁸⁸ In this regard, the

184. PATTERSON, *supra* note 118, at 12.

185. DUE, *supra* note 7, at 37. The larger family has less taxpaying ability than the smaller one, yet the sales tax burden is greater. *Id.*

186. PATTERSON, *supra* note 118, at 11, 14. This relative spread holds true at all income levels. Families earning between \$30,000 and \$50,000 spend 33% of their income on taxable purchases if there are six or more in the household, but 28% if there are only two people. For families earning more than \$75,000 per year, the percentages drop to 21% for families of six or more and 14% for families of two people. *Id.* at 14.

187. Duncombe, *supra* note 16, at 300.

188. It is helpful to compare the sales tax to other types of non-consumption-based taxes. The best example of a tax clearly designed to be progressive is the income tax. I.R.C. § 1(a)-(e) (1994). In addition to the obvious progressivity of taxing the very thing used to measure the taxpayer's ability to pay (income), most such systems are designed with several brackets, utilizing successively higher rates as income rises. Not surprisingly, the empirical data confirm that such a tax is significantly progressive using annual income. Metcalf, *State and Local Taxes*, *supra* note 180, at 76 (showing the tax burden in the highest decile to be over nine times that in the lowest). This holds true under a lifetime income analysis, where the tax burden in the highest decile is still over five times that in the lowest-income households. *Id.*

On the other hand, the property tax is strongly regressive using annual income. As expected, these results are attenuated using the lifetime income analysis, but the tax is still regressive. *Id.* at 80.

Portions of the payroll taxes discussed *supra* note 11 are a clear example of a tax that is regressive by design. The Social Security component of FICA taxes is applied at a single rate, but only on the first \$62,700 in wage income annually. There are no taxes on income beyond that point. I.R.S. 1996, *supra* note 11, at 14.

California sales tax system meets, or at least does not violate, its original goal of tax equity.

C. *Administration, Reporting, and Collection*

In evaluating the performance of the California sales tax in terms of administrative efficiency, we must look at four factors: (1) the arguments espousing the ease of administration that made the sales tax so initially attractive to lawmakers compared with the total costs of its collection and administration, including those of retailers in addition to those of the Board of Equalization, (2) the scarcity of information about the law and its interpretation made available by the Board and the impact of this dearth of information on compliance, (3) the complexity of interpreting the sales tax system and its reporting requirements and exemptions, and (4) the price of incorrectly applying the law in terms of audits, reliance, and dispute resolution.

The confusion common among retailers in California related to collection of the sales tax is of particular concern due to the nature of the tax and the potential for audit. Because this tax is generally collected from the consumer at the time of sale, the timing of any deficiency determination is especially unfortunate for the taxpayer. Although the tax is unreimbursed from the customer, it is still payable by the retailer.¹⁸⁹ Therefore, retailers must carefully analyze their business transactions in advance to determine the tax treatment of each such transaction. The sales tax is clearly not an "unimportant miscellaneous tax";¹⁹⁰ it is one which can and must be actively managed by businesses.¹⁹¹ The California sales tax system, however, is not structured to allow effective management.

1. *Costs*

Part of the initial allure of the sales tax as a revenue-generating vehicle was the simplicity and cost-effectiveness of its administra-

189. ADMINISTERING THE SALES TAX, *supra* note 132, at 2.

190. Kenneth Plante, *Avoiding Sales and Use Tax Traps*, 26 TAX ADVISER 541 (1995).

191. Clark, *supra* note 15, at 31.

tion.¹⁹² Information available during the time of its implementation suggested that the ratio of costs to collections should be somewhere between one and one-half and two percent.¹⁹³ For the fiscal year 1934-35, California's cost of administration was 1.98 percent of taxes collected.¹⁹⁴

Each study of administrative costs, however, was careful to point out that any exemptions to the sales tax would negatively impact these costs.¹⁹⁵ This proved especially true in California. With the exemption for food for home consumption added to the tax code on July 1, 1935,¹⁹⁶ the cost of administration for the 1935-36 fiscal year as a percentage of collected tax jumped to 2.28 percent (even with an increase in the tax rate from two and one-half to three percent), a relative increase of fifteen percent.¹⁹⁷ Exemptions increase costs for two reasons. First, they increase the Board of Equalization's administrative cost because the validity of exemptions must be determined through audits, an expensive and time-consuming process involving extensive investigation of a retailer's records.¹⁹⁸ Second, exemptions increase the costs to retailers because they must maintain adequate records in support of any claimed exemptions and justify them to auditors.¹⁹⁹

192. There are two primary arguments advanced in this regard. First, the sales tax is collected from a relatively small group of businesses as opposed to a much larger group of individuals, as is the case with income taxes. Second, the tax is collected on the basis of total sales, a figure much less subject to interpretation and manipulation than net income which includes deductions. DUE, *supra* note 7, at 34.

193. ARCH D. SCHULTZ, OHIO CHAMBER OF COMMERCE, THE SALES TAX IN FIVE STATES 20, 27-28 (1934) *microformed on* ALA Mar. 31, 1934. As the title suggests, this report studied the sales tax systems in place in five states in anticipation of the passage of such a tax in Ohio. Reported administration cost ratios ranged from 0.5% for Pennsylvania to 1.25% for Michigan, 1.5% for New York, 2.0% for Illinois, and a high of 2.50% for Indiana. *Id.* The author believed that 2.0% would be an "outside guess on the probable administrative expense." *Id.* at 28. Remember that the sales taxes in effect at that time were of a much lower percentage (typically in the one to three percent range) than they are today. See discussion *infra* notes 205-08 and accompanying text to see the effect of this difference on the ratio of administrative costs to collected revenues.

194. 1935-36 BD. REPORT, *supra* note 1, at 29. Keep in mind that California's sales tax rate was two and one-half percent at the time. Retail Sales Act of 1933, ch. 1020, § 3, 1933 Cal. Stat. 2600.

195. See, e.g., SCHULTZ, *supra* note 193, at 21. The Michigan State Board of Tax Administration noted that "our tax with so few exceptions makes a very simple tax for our taxpayers to report upon." *Id.* (emphasis added). See also the discussion *supra* note 51 stating that administrative simplicity is exaggerated, especially in light of any exemptions.

196. Act of June 25, 1935, ch. 355, 1935 Cal. Stat. 1252.

197. 1935-36 BD. REPORT, *supra* note 1, at 29.

198. SOMERS, *supra* note 102, at 14.

199. *Id.* Recall that the burden on proving an exemption is on the retailer. EXEMPTIONS & EXCLUSIONS, *supra* note 92, at 1; see also discussion *infra* notes 312-16

Turning to more recent performance, the total cost of all Board of Equalization functions 1979-80 as a percentage of total sales and use tax revenues collected was 0.74 percent.²⁰⁰ But performance has been declining steadily ever since. By 1989-90, it had risen to 0.82 percent,²⁰¹ by 1992-93 to 0.89 percent, by 1993-94 to 0.96 percent,²⁰² and by 1994-95 to 0.97 percent.²⁰³ For the most recent fiscal year for which statistics are available, the total cost of all Board functions related to the sales and use taxes alone was \$228 million.²⁰⁴

Comparing these relative performance numbers to prior years, it would appear that Board efficiency, while diminishing in recent years, has improved overall since the inception of the sales tax. For example, in 1959-60, total administration as a percentage of revenue collected was 1.50 percent.²⁰⁵ However, to determine the true cost of administration, we must weight these administrative costs according to the relative tax rates in effect at the time. In 1960, the combined state and local tax rate was 4.0 percent.²⁰⁶ Today, the base rate is 7.25 percent, exclusive of special districts.²⁰⁷ Assuming constant costs and using the differing tax rates, the 1959-60 costs would translate into a cost ratio of 0.83 percent of current tax collections, compared to the Board's recent

and accompanying text.

Consumers are also impacted by the additional exemptions. First, they will most likely bear the majority of the economic burden of these additional costs. Second, they will tend to be even more confused than retailers about the tax system and, therefore, unsure if they are being properly taxed. SOMERS, *supra* note 102, at 14. The impact of this confusion on retailers will be discussed in greater detail in the text *infra* Section IV.C.3.

200. 1979-80 CAL. ST. BD. OF EQUALIZATION ANN. REP. A-3.

201. 1989-90 CAL. ST. BD. OF EQUALIZATION ANN. REP. A-3.

202. 1993-94 BD. REPORT, *supra* note 49, at A-3. By way of comparison, the cost of administering the federal income tax in 1985 was measured at 0.56% of collected revenue. The average administration cost of the VAT in European nations in 1992 was 0.68%. Hamond, *supra* note 5.

203. 1994-95 BD. REPORT, *supra* note 24, at A-3.

204. *Id.* These statistics include the costs of administering the entire sales and use tax program, including the city and county portions of the tax as well as the special district taxes. Therefore, the total revenue over which to spread these costs is significantly higher than just the State's sales tax percentage. Costs are split *pro rata* among the various programs based on revenue. *Id.* at A-1 to A-3.

205. 1960-61 BD. REPORT, *supra* note 71, at A-5.

206. 2 DUBAY, *supra* note 119, at 2.

207. 1993-94 BD. REPORT, *supra* note 49, at 27.

performance of 0.97 percent.²⁰⁸ This translates into a diminution in efficiency of almost sixteen percent.

To get an accurate picture of the total cost of administering the sales tax, however, we must examine its impact not just on the Board of Equalization, but also on the businesses whose responsibility it is to calculate, collect, and remit the tax.²⁰⁹ The sales tax is a tax imposed upon the retailer of tangible personal property, the law clearly stating that “[f]or the privilege of selling tangible personal property at retail a tax is hereby imposed *upon all retailers*.”²¹⁰ The retailer, however, may add a sales tax reimbursement to the sales price of the item, depending on the terms of sale.²¹¹ Generally, the tax is due to the

208. If costs are 1.50% of the tax collected at a 4.0% rate, administration costs are 0.06¢ per \$1.00 of taxable sales. Dividing this cost into a 7.25% tax rate yields a cost to collected tax ratio of 0.83%.

209. DUE & MIKESELL, *supra* note 35, at 325. Throughout this Article, the term “administrative costs” refers to those costs necessary for the state to collect the tax. “Compliance costs” are those costs borne by taxpayers in collecting and remitting the tax to the state. The costs of administration and compliance “cannot be seen in isolation from each other . . . there is a significant element of transferability between the two kinds of costs.” Sijbren Cnossen, *Administrative and Compliance Costs of the VAT: A Review of the Evidence*, 63 TAX NOTES 1609, 1609 (1994).

210. CAL. REV. & TAX. CODE § 6051 (West Supp. 1996) (emphasis added).

211. Such a reimbursement is presumed agreed upon in cases where (1) the agreement of sale expressly provides for the addition of the reimbursement, (2) the reimbursement is shown on the sales draft, or (3) the retailer posts a notice that a reimbursement will be added to the purchase price. CAL. CIV. CODE § 1656.1(a) (West Supp. 1996); *see also* CAL. CODE REGS. tit. 18, § 1700(a)(2) (1996). Conversely, the price at which a taxable item is sold is presumed to include the sales tax reimbursement if the retailer posts a notice to that effect. CAL. CIV. CODE § 1656.1(b); *see also* CAL. CODE REGS. tit. 18, § 1700(a)(2). Both presumptions are rebuttable. CAL. CIV. CODE § 1656.1(d).

This reimbursement, however, is limited to the amount of the tax itself and the entire amount collected from the customer must be remitted to the State. In the event the retailer collects an amount in excess of the properly-calculated reimbursement, the entire amount collected from the customer must be paid over to the State unless the retailer refunds the excess reimbursement to the customer from whom it was actually collected. CAL. CODE REGS. tit. 18, § 1700(b)(1)-(2). This is generally impractical or impossible to do.

California is among the states that do not compensate retailers for collection costs. On the other hand, approximately half of all states with sales taxes provide some form of compensation to retailers to cover the business’ administrative overhead associated with collecting the tax. While this compensation is generally in the form of a discount, structures vary. Most commonly, the State will offer a uniform percentage discount, usually ranging from one percent to over three and one-half percent, but some states offer a discount that diminishes with the amount of tax paid. Additionally, some states allow the discount on use taxes paid by consumers as well as sales taxes paid by retailers and some allow the discount only if tax is paid on time. While many states that allow overhead compensation do so because the tax is technically levied on consumers, not vendors, even some states where the tax is clearly imposed on vendors allow for this compensation. DUE & MIKESELL, *supra* note 35, at 327-28.

Board of Equalization quarterly,²¹² although retailers with estimated monthly sales tax liabilities in excess of \$17,000 must prepay the tax on a monthly basis.²¹³

The cost of accounting for this tax can be significant, particularly for businesses that generate a high percentage of exempt transactions.²¹⁴ A 1983 study prepared by Peat, Marwick, Mitchell & Co. calculated that the average cost of compliance across all retailers was 3.13 percent of the total tax collected.²¹⁵ Of this amount, over sixty percent is associated with collections on exempt items, accounting for a cost of 1.90 percent of *total* tax collected.²¹⁶ This is double the cost ratio of administering the *entire* tax by the Board of Equalization, and, using the Governor's projections for fiscal year 1996-97, would represent an expenditure of \$309 million.²¹⁷

As expected, the highest costs were found in industries with the most exemptions; drug stores face a compliance cost of 3.48 percent while food retailers incur a staggering 9.06 percent cost.²¹⁸ When these industries are further broken down by size, smaller grocery stores are clearly harder hit than larger stores. Stores with sales of less than \$1 million had compliance costs of 12.83 percent while stores with sales

212. CAL. REV. & TAX. CODE § 6451 (West 1987); *see also* CAL. REV. & TAX. CODE §§ 6452-6455 (West 1987 & Supp. 1996) (setting forth the specific requirements concerning the content and filing of returns).

213. CAL. REV. & TAX. CODE § 6471 (West Supp. 1996); *see generally* CAL. REV. & TAX. CODE §§ 6470-6478 (West 1987 & Supp. 1996) (setting forth the entire prepayment system and its requirements).

214. *Cf.* Robert J. Shapiro, *Introduction to 4 ENTERPRISE ECONOMICS AND TAX REFORM; THE CASE FOR AND AGAINST VALUE-ADDED TAXATION* (Robert J. Shapiro ed., 1995), *reprinted in* 95 TAX NOTES TODAY 146-75 (July 27, 1995), *available in* LEXIS, Taxana Library, TNT File (noting that the total cost of complying with the federal income tax is estimated at \$100 billion annually, or a deadweight loss to the U.S. economy equal to 1.5% of GDP); Cnossen, *supra* note 209, at 1624 (stating that federal and state income tax compliance costs for individuals alone was estimated in 1982 to be between \$17 billion and \$27 billion annually).

215. This study is reprinted in the 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 167-72.

216. *Id.* at 169, 171.

217. 1996-97 BUDGET, *supra* note 3, at 59. Estimated General Fund sales tax revenue for the period is \$16,275 billion. *Id.*

218. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 169, 172.

greater than \$10 million had costs of 8.01 percent, almost forty percent less.²¹⁹

A study using data from 1960-61 in Ohio reached a similar conclusion. While finding that the average cost of compliance was 3.93 percent of aggregate tax liability, the study also concluded that the cost of compliance for exemption-heavy businesses was significantly higher.²²⁰ Drug stores had an average direct compliance cost of 6.80 percent of tax revenue and grocery stores a cost of 10.77 percent.²²¹

These compliance costs are ultimately passed on to the consumer by means of higher product costs.²²² Two other factors contribute to the indirect components of the sales tax eventually passed on to consumers, one by increasing it and the other by potentially decreasing it. First, the sales tax is not limited strictly to the sale of consumption goods. Retailers are the consumers of some producers' goods, such as capital equipment or other items comprising part of the production process (such as the minor parts associated with repair services mentioned *supra*).²²³ Various studies have estimated the portion of sales taxable to retailers (i.e., not intended for direct resale) is between a little over thirty-three percent²²⁴ and forty-eight percent.²²⁵ These taxes are also factored into the final price of the product and lead to an increase in retail prices in excess of the discrete amount of the tax reimbursement based on the purchase price.²²⁶ Thus, although these costs are not

219. *Id.* at 172; *cf.* Cnossen, *supra* note 209, at 1610 (noting that the administrative and compliance costs under a VAT are minimized with a broad-based, single-rate tax with few exemptions and further noting that compliance costs under a VAT fall with "exceptional severity on small businesses").

220. DUE & MIKESELL, *supra* note 35, at 325.

221. *Id.* at 327.

222. See SOMERS, *supra* note 102, at 14.

223. DUE, *supra* note 7, at 19. Initially, these sales taxes were viewed by many as a means of imposing an "adequate and fair" tax on businesses. Martin & Tolman, *supra* note 34, at 1. This was based on the belief that property taxes alone failed to impose the same proportionate burden on businesses that they did on other taxpayers. *Id.*

224. 1995-96 BUDGET ANALYSIS, *supra* note 22, at 53.

225. Raymond J. Ring, Jr., *The Proportion of Consumers' and Producers' Goods in the General Sales Tax*, 42 NAT'L. TAX J. 167, 171 (1989); see also 2 DUBAY, *supra* note 119, at 5-6 (citing another 1990 study showing that only 47% of the California sales tax is collected from households, with the remainder from businesses and non-household entities).

226. DUE, *supra* note 7, at 19-20. In an effort to avoid this "stacking" problem, eight states during their 1995-96 fiscal years enacted some form of sales tax exemptions for the purchase of certain producers' goods, such as manufacturing machinery, research and development equipment, and (or) utility or other purchases by businesses. MACKAY, *supra* note 59, at 6.

passed on to consumers directly, it is ultimately the consumer who pays, albeit indirectly via price adjustments.

Second, although retailers will generally raise final prices by the amount of the tax, either by readjustment of the price or by quoting the sales tax reimbursement separately,²²⁷ several factors may impede the ability of retailers to shift this tax to consumers perfectly. Markets that are competitive, even imperfectly, will in some cases restrict shifting, especially in periods of depressed business conditions.²²⁸ Also, high demand elasticity for a particular commodity may adversely affect the ability of the retailer to shift the tax burden profitably.²²⁹ Finally, retailers may not bother to adjust prices for the tax if its rate is very low.²³⁰

2. Compliance

Most of the time and money spent by businesses in administering the sales and use tax is the result of its Byzantine structure. As discussed *supra*, elements of the law can be found in the California Revenue and Taxation Code as well as regulations, annotations, and explanatory pamphlets promulgated by the Board of Equalization. This leads to the seemingly contradictory situation where there is at once too much and yet too little information. This problem is compounded by a lack of information concerning actual audit findings and determinations. One commentator observed:

227. DUE, *supra* note 7, at 12.

228. *Id.* at 16. If the retail markets are purely competitive, retailers may be unable to shift the tax forward at all. *Id.* Assuming businesses follow the theory of profit maximization, they will generally bear some portion of the tax themselves "under the imperfectly competitive conditions that are widely prevalent." SOMERS, *supra* note 102, at 24.

229. DUE, *supra* note 7, at 16. Even in the case of a general price increase, to which usual discussions of demand elasticity cannot be applied, relative shifts in purchasing will occur due to differing demand elasticities for different products. *Id.*

230. *Id.* This was the case in an early University of Mississippi study which found that only about two-thirds of businesses in that state passed the tax, which ranged from one-eighth to one-quarter of a percent, on to consumers. WALKER, *supra* note 142, at 2. Another 1934 study, by Columbia University, showed that a surprisingly large portion of retailers failed to shift taxes ranging from one to three percent and that smaller merchants experienced much more difficulty in passing this tax on to consumers than did larger businesses. *Id.* at 2-3.

With all forms of sales taxes, it is highly desirable that adequate, clearly understandable information be made readily available to taxpaying firms. *The old doctrine that ignorance is no excuse is particularly objectionable with sales taxation*, because of the importance of cooperation on the part of vendors for successful operation of the tax. The vendors are essentially tax collecting agents, and should be treated as such.²³¹

Thus, just having the information available is not the entire solution. In addition to being adequate and understandable, such information must be reliable, up-to-date, and consistent—a test it fails today.

These problems were addressed in a 1987 report from the California Legislative Analyst tellingly subtitled *Improved Information Management Should Improve Compliance*.²³² In a survey of taxpayers, the three most commonly-expressed concerns were that the Board and its staff (1) arbitrarily apply the tax law, often reinterpreting such laws, (2) inconsistently administer the law both vertically (treating the same transaction differently from one audit period to the next) and horizontally (failing to treat all taxpayers uniformly), and (3) fail to provide adequate guidance to California taxpayers.²³³ The report also found several deficiencies and/or inaccuracies in the information made available (or not made available, as the case may be) by the Board of Equalization.

First, it noted that there is no regular method for the review of Board-issued regulations and that, in some cases, they had not been updated to reflect statutory changes or developments in a particular industry.²³⁴ Second, the Board does not generally provide advice concerning

231. DUE, *supra* note 7, at 384 (emphasis added).

232. ADMINISTERING THE SALES TAX, *supra* note 132. The report was prepared at the request of the Legislature. Act of Sept. 30, 1984, ch. 1728, 1984 Cal. Stat. 6280. Its primary focus was to study “[t]he feasibility and cost-effectiveness of requiring [the Board of Equalization] to obtain, file and retrieve information regarding specific types of transactions reported by registered taxpayers and the types of transactions covered by a board audit” and, if such disclosure were desirable, the manner in which it should occur. ADMINISTERING THE SALES TAX, *supra* note 132, at 1. The purpose of such information would be:

[Its] later use in administrative or court proceedings [for] determining, with respect to any taxpayer’s activity or transaction, whether or not other taxpayers have paid sales or use tax on the same activity or transaction and whether or not the board has applied tax to other taxpayers engaged in the same activity or transaction.

Act of Sept. 30, 1984, ch. 1728, § 3(a)(1), 1984 Cal. Stat. 6280, 6282.

233. ADMINISTERING THE SALES TAX, *supra* note 132, at 2, 7.

234. *Id.* at 11. This finding was coupled with a recommendation to implement a program for the regular review of existing regulations. *Id.* While regulations are reviewed and revised periodically, there is no established program for systematically doing so.

precedential court decisions.²³⁵ Third, there is no central record of the sources of frequent taxpayer errors.²³⁶ Fourth, there is no central record of either audit issues and outcomes or petitions for redetermination of audit findings filed with the Board.²³⁷ Additionally, formal

235. *Id.* at 3. The study noted that this information should be included in the Board's taxpayer information bulletins. Moreover, because of the lack of a formal process for the selection of articles, the bulletin does not ensure that recurring problem areas of the law are addressed. *Id.* Recently, summaries of court decisions and new sales tax legislation are included in the Board's annual report. *See, e.g.*, 1993-94 BD. REPORT, *supra* note 49, at 32-38; 1994-95 BD. REPORT, *supra* note 24, at 32-34. Additionally, some selected court opinions have now been included in the *Business Taxes Law Guide* published by the Board. *Sales and Use Tax Court Decisions*, 2 BUS. TAXES L. GUIDE 1301-77 (1995 & 1996). *See also* discussion *infra* note 238 (concerning recent publication of Board opinions in the same guide).

236. ADMINISTERING THE SALES TAX, *supra* note 132, at 8. The Board used to prepare a common error report to provide guidance to taxpayers. Prior to the 1987 study, however, the last such report was prepared for the 1974-75 audit period. *Id.* Recently, such a summary has again been compiled and published in the Board's annual report. *See* 1993-94 BD. REPORT, *supra* note 49, at 31; 1994-95 BD. REPORT, *supra* note 24, at 31.

237. ADMINISTERING THE SALES TAX, *supra* note 132, at 8. Admittedly, there are conflicting goals of general compliance and respecting individual taxpayers' confidentiality. The problem with creating a comprehensive database appears to lie mostly in the tax code itself. The Board is specifically prohibited from divulging "in any manner whatever the business affairs, operations, or any other information pertaining to any retailer or any other person required to report to the board or pay a tax pursuant to this part, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any return, or to permit any return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person." CAL. REV. & TAX. CODE § 7056(a)(1) (West Supp. 1996) (emphasis added); *cf.* CAL. REV. & TAX. CODE § 19542 (West Supp. 1996) (making it a misdemeanor for any members of the Franchise Tax Board, responsible for the administering the income tax, or its staff "to disclose or make known in any manner information as to the amount of income or any particulars" contained in income or other tax returns); *but see* CAL. GOV'T CODE §§ 7460, 7461, 7480 (West 1995) (California Right to Privacy Act). The California Right to Privacy Act was enacted in recognition that "[p]rocedures and policies governing the relationship between financial institutions and government agencies have in some cases developed without due regard to citizens' constitutional rights." Its purpose was "to clarify and protect the confidential relationship between financial institutions and their customers and to balance a citizen's right of privacy with the governmental interest in obtaining information for specific purposes." CAL. GOV'T CODE § 7461(a). However, as a part of this balance, the Act specifically authorizes disclosure of certain taxpayer information to the Board of Equalization by a financial institution in situations involving the attachment of security and other property of the taxpayer. CAL. GOV'T CODE § 7480(f); *see also* CAL. REV. & TAX. CODE §§ 6702-6703 (West 1987 & Supp. 1996).

In contrast to the difficulty in obtaining California tax information, see the discussion *infra* note 239 regarding the stringent public access requirements placed on the Internal

decisions of the Board are for the most part unavailable,²³⁸ unlike the Board's decisions as the appellate body for disputes arising from actions of the Franchise Tax Board in State income tax matters.²³⁹ There was, in fact, so little information available that the report was unable to ascertain even how many cases were resolved in favor of the Board's staff, whether audit findings sometimes presented reinterpretations of the

Revenue Service regarding analogous taxpayer information.

238. In its Correction Mailing M96-1 (issued in January 1996) to the *Business Taxes Law Guide*, the Board of Equalization for the first time published some of its rulings. It added an entirely new section, entitled "Sales and Use Tax Memorandum Opinions." This section includes selected and abridged opinions by the Board ruling on petitions for redetermination or claims for refund. The 32 opinions included cover a period from 1967 to 1994. *Sales and Use Tax Memorandum Opinions*, 2 BUS. TAXES L. GUIDE 4501-85 (1996).

This information is useful to many taxpayers in similarly-situated industries or businesses. Because of needs such as this, the State Legislature in 1968 enacted the California Public Records Act, which "declares that access to information concerning the conduct of the people's business is a fundamental and necessary right of every person in this state." CAL. GOV'T CODE § 6250 (West 1995). The State Board of Equalization is specifically included in the list of agencies required to make their public records (defined as "any writing containing information relating to the conduct of the public's business prepared, owned, used, or retained by any state or local agency") available to the public. CAL. GOV'T CODE §§ 6252(d) (definition), 6253(a) (list of agencies) (West 1995). However, exempted from this requirement is "[i]nformation required from any taxpayer in connection with the collection of local taxes which is received in confidence [when] the disclosure of the information to other persons would result in unfair competitive disadvantage to the person supplying the information." CAL. GOV'T CODE § 6254(i) (West 1995); *cf.* CAL. CODE REGS. tit. 18, § 313 (1996) (noting that hearings for property tax appeals are open to the public except any portion of the hearing related to "trade secrets whose disclosure to the public will be detrimental to the business interests of the owner of the trade secrets"). Thus, the following items are public records and open for inspection: public meeting agendas, minutes of the meeting and exhibits, and documents distributed to Board members for discussion or consideration at a public meeting. This is, however, subject to the important caveat that these materials not be otherwise exempted from disclosure by state or federal law and not include confidential taxpayer information. CAL. CODE REGS. tit. 18, § 5085 (1996). See also the discussion *infra* in the next note concerning the disclosure requirements of the United States Tax Court.

239. *See generally* DECISIONS OF THE STATE BOARD OF EQUALIZATION. These volumes publish decisions concerning franchise, corporate income, and personal income taxes. The Board of Equalization serves as the final administrative hearing body for these matters, following an adverse determination by the Franchise Tax Board. CAL. REV. & TAX. CODE §§ 19084(b)(1), 19085 (West 1994 & Supp. 1996). Only after unsuccessfully appealing to the Board of Equalization may the taxpayer bring a civil action seeking to reverse a deficiency judgment. § 19084(c)(1).

In federal income tax matters, all reports of and evidence by the United States Tax Court are public records open to inspection by the public. I.R.C. § 7461(a) (1994). The only exceptions to this presumption are trade secrets and other confidential information for which the Tax Court may make any provision necessary to prevent their disclosure. I.R.C. § 7461(b)(1).

law, or how often audit findings were inconsistent with each other.²⁴⁰ The availability of such information would allow lawmakers to understand the sources of taxpayer error and determine the best strategies for mitigating or eliminating such errors through improvements in the tax system.²⁴¹

In an effort to provide some guidance to taxpayers, the Legislature, concurrently with its request for the report, also passed a statute requiring the Board to implement a formal process for answering taxpayer inquiries.²⁴² If a taxpayer makes a written request to the Board concerning either the amount of taxes to pay or how sales tax applies in a specific situation, the Board will answer in writing and the taxpayer may rely on the answer. If this answer is later determined to be wrong, the taxpayer is relieved of responsibility for tax, interest, and penalties. This exculpation, however, is contingent upon (1) a full description of the specific facts and circumstances of the activity or transaction, (2) the taxpayer's customer not having been charged tax, and (3) the transaction(s) in question occurring prior to a rescission of the advice by the Board or a change in the law, Board decision, or court decision.²⁴³ In addition to these restrictions, this tax advice is further

240. ADMINISTERING THE SALES TAX, *supra* note 132, at 7-8. There are still no statistics or other information available on these matters.

241. *Id.* at 12. Publication is also "of great importance if competitive disturbances are to be avoided and cooperation of taxpayers retained." DUE, *supra* note 7, at 384. These "competitive disturbances" occur when businesses selling the same product or providing the same service treat the same transaction differently based on their (or, perhaps more accurately, their tax counsel's or tax attorney's) reading of the sales tax law. This, in turn, leads to further disillusionment on the part of vendors trying to comply with the law.

242. Act of Sept. 30, 1984, ch. 1728, § 2, 1984 Cal. Stat. 6280, 6281-82 (codified as amended at CAL. REV. & TAX. CODE § 6596 (West Supp. 1996)). Prior to this time, there was no process by which a taxpayer could obtain an interpretation concerning the tax treatment of a specific transaction. ADMINISTERING THE SALES TAX, *supra* note 132, at 11.

243. CAL. REV. & TAX. CODE § 6596(a)-(c) (West Supp. 1996). This is somewhat analogous to the statute applicable to the Internal Revenue Service for federal income tax. Upon request, the I.R.S. will issue a written determination concerning the tax treatment of the issue presented in the form of a ruling, a determination letter, or a technical advice memorandum. I.R.C. § 6110(b) (1994). Unlike private letter rulings issued by the Board of Equalization, however, written determinations issued by the I.R.S. (along with any background file documents) are open to public inspection. I.R.C. § 6110(a). This requirement is so strong that any person (after first exhausting administrative remedies) may file a petition in the United States Tax Court for an order compelling release of the written determination for public inspection. § 6110(f)(4)(A).

limited because it may only be relied on by the person or entity to which it was issued.²⁴⁴

Continuing in its efforts to make the sales tax laws more understandable to the general public and to improve the public's access to Board interpretations of the law, the California Legislature in 1988 passed The Harris-Katz California Taxpayer's Bill of Rights.²⁴⁵ The law's stated purpose was to "promote improved voluntary taxpayer compliance by improving the clarity of tax laws and efforts to inform the public of the proper application of those laws."²⁴⁶ Among other things, this law established an education and information program, a system to identify recurring areas of taxpayer noncompliance, and other obligations of the Board and its staff designed to improve administrative efficiency and accountability.²⁴⁷

Privacy and confidentiality concerns are covered by sections requiring the I.R.S., prior to release of any written determination, to delete, among other things, such information as the name or other identifying details of the requestor, trade secrets or other information that is privileged or confidential, or other "information the disclosure of which would constitute a clearly unwarranted invasion of privacy." § 6110(c).

244. CAL. REV. & TAX. CODE § 6596(d) (West Supp. 1996); Cal. Sales & Use Tax Annotation 465.0070, 2 BUS. TAXES L. GUIDE 3854 (Cal. State Bd. of Equalization) (1996). Section 6596(d) reads: "Only the person making the written request shall be entitled to rely on the board's written advice to that person." § 6596(d). While the definition of "person" in the code is quite broad, it specifically does *not* include successors or assignees. CAL. REV. & TAX. CODE § 6005 (West Supp. 1996). Therefore, it is conceivable that the company relying with impunity on advice from the Board may not be able to delegate that right to its successor-in-interest, even one transacting exactly the same business.

In the case of written determinations from the I.R.S. in federal income tax matters, "[u]nless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent." I.R.C. § 6110(j)(3) (1994). However, the Internal Revenue Code does suggest that successors-in-interest, executors, and/or other persons authorized by law to act on behalf of the person to whom a written determination pertains may also rely on its contents. *Cf.* I.R.C. §§ 6110(f)(1) (requiring sending of notice of intention to disclose to those persons), 6110(f)(3)(A) (creating a remedy for those persons when they disagree with disclosure of the written determination).

245. The Harris-Katz California Taxpayers' Bill of Rights, ch. 1574, 1988 Cal. Stat. 5676 (codified as CAL. REV. & TAX. CODE §§ 7080-7099 (West Supp. 1996)); *see also* CALIFORNIA STATE BD. OF EQUALIZATION, THE CALIFORNIA TAXPAYERS' BILL OF RIGHTS (1994) (summarizing the rights of taxpayers and the Board's obligations in plain language).

246. § 7081 (West Supp. 1996). This section also noted that "there is a delicate balance between revenue collection and freedom from government oppression." *Id.* The Legislature was careful, however, to point out its intent "to place guarantees in California law to ensure that the rights, privacy, and property of California taxpayers are adequately protected during the process of the assessment and collection of taxes." *Id.*

247. *See, e.g.*, CAL. REV. & TAX. CODE §§ 7083 (creation of office of Taxpayer's Rights Advocate), 7084 (education and information program), 7085 (identification of taxpayer noncompliance), 7086 (preparation of "brief but comprehensive statements in simple and nontechnical language which explain procedures, remedies, and the rights and obligations of the board and taxpayers") (West Supp. 1996). Mindful of the conflicting

3. *Confusion*

Despite these efforts by the Legislature and the Board of Equalization, businesses are still faced with a confusing and often inscrutable tax system. A recent survey of tax directors at *Fortune* 100 companies and the top ten accounting firms rated California the third most "capricious" state in terms of tax fairness and predictability.²⁴⁸

The most common areas of taxpayer confusion involve cases where (1) the retailer itself is the consumer of the product, (2) a similar transaction is treated differently depending on its attendant circumstances, or (3) there is conflicting direction from the Board concerning the treatment of the activity. This section will examine each of these areas in the context of specific examples.

First, confusion can arise concerning whether the end-seller of an item must itself pay sales tax to its supplier of a particular good. The answer hinges on whether this end-seller is considered the "retailer" or "consumer" of tangible personal property.²⁴⁹ In the former case, the seller purchases the property at a wholesale price for resale (a non-taxable transaction) and sells it to the end-user for a final price (a taxable transaction).²⁵⁰ In some cases, the issue can be simple,

goals of disseminating taxpayer information and protecting taxpayer privacy, the report of "recurrent taxpayer noncompliance" is only to include such general information as the statute or regulation violated, the amount of the tax involved, the industry or business of the taxpayer, the audit period, whether professional tax preparation assistance was utilized, and whether sales tax returns were filed. § 7085(b)(1); *cf.* CAL. REV. & TAX. CODE § 408.3 (West Supp. 1996) (noting that information summarizing property characteristics maintained by the county assessors is a public record open for public inspection, but limiting available information to such non-proprietary statistics as the property's year of construction, square footage, number or bedrooms, acreage, amenities, zoning, use code, and number of dwelling units).

248. Springsteel, *supra* note 15, at 29. Respondents were asked to rate state tax environments on a scale from 1 (fair and predictable) to 5 (unfair and unpredictable). California scored a 3.79, behind only Louisiana (4.09) and Massachusetts (3.89). *Id.*

249. This confusion dates to the earliest days of the sales tax. Writing in 1939, Marvel Stockwell noted that explicit Board regulations did not solve the difficulties because many of their decisions seemed "hairsplitting." He cited the example of a nursery being the retailer of seeds sold to gardeners, but consumers when the seed is sold to farmers, but only when the products raised from them are to be sold for home consumption. STOCKWELL, *supra* note 31, at 211. These sometimes incomprehensible dichotomies exist to the present day.

250. A "retail sale" is defined in the code as "a sale for any purpose other than resale in the regular course of business in the form of tangible personal property." CAL.

especially where individual items or industries are always treated the same. For example, by definition morticians are retailers of such items as caskets, vaults, and clothing, but consumers of items such as acknowledgement cards, registration books, and prayer books used in connection with the services they provide.²⁵¹ Also, many health-related professionals are considered the consumers of the products they use and furnish as a part of their services.²⁵²

The issue becomes clouded, however, when the same item can be considered either for consumption or resale by the retailer. One such case is the parts and materials used in the repair of tangible personal property discussed *supra*. In certain cases, the repairperson may be the consumer of the parts and, in other cases, the retailer of those exact

REV. & TAX. CODE § 6007 (West Supp. 1996). While sales tax does not apply to "occasional sales," the exemption is extremely narrow, including (in addition to a special exemption for hay producers) only:

(a) A sale of property not held or used by the seller in the course of activities for which he or she is required to hold a seller's permit or permits or would be required to hold a seller's permit or permits if the activities were conducted in this state, provided the sale is not one of a series of sales sufficient in number, scope, and character to constitute an activity for which he or she is required to hold a seller's permit or would be required to hold a seller's permit if the activity were conducted in this state.

(b) Any transfer of all or substantially all the property held or used by a person in the course of those activities when after the transfer the real or ultimate ownership of the property is substantially similar to that which existed before the transfer.

CAL. REV. & TAX. CODE § 6006.5(a)-(b) (West 1987); *see also* CAL. REV. & TAX. CODE § 6367 (West 1987) (exempting mobilehomes, aircraft, and selected other vehicles from the exemption, i.e., making their sale or use taxable).

A seller's permit is required of every retailer, defined as "[e]very individual, firm, copartnership, joint venture, trust, business trust, syndicate, association or corporation making more than two retail sales of tangible personal property during any 12-month period." CAL. REV. & TAX. CODE § 6019 (West 1987); *see* *Hotel Del Coronado Corp. v. State Bd. of Equalization*, 15 Cal. App. 3d 612, 92 Cal. Rptr. 456 (1971). In *Hotel Del Coronado*, the court found that the hotel was liable for sales tax on the liquidation sale of the tangible personal property of the entire business because it had made a series of sales of used capital items, including furniture and fixtures, over the previous 12 months. Because these sales were "sufficient in number, scope and character to constitute an activity requiring a seller's permit," they were subject to the sales tax, regardless of the fact that such sales were not the principal business activity of the taxpayer. *Id.* at 619-20, 92 Cal. Rptr. at 460-61.

251. CAL. CODE REGS. tit. 18, § 1505(a) (1996). As with most such situations where the retailer is deemed the "consumer" of tangible personal property, this only applies in the absence of a separate charge by the retailer to the purchaser of the property. If there is such a separate charge, that portion of the transaction is taxable to the end-user (who, in this case, is the "consumer"), not the retailer. *Id.*

252. *See, e.g.*, CAL. REV. & TAX. CODE §§ 6018 (optometrists), 6018.1 (veterinarians), 6018.4 (chiropractors), 6018.5 (podiatrists) (West 1987); *see also* CAL. CODE REGS. tit. 18, § 1592 (1996) (describing in detail the tax treatment of eyeglasses and ophthalmic materials).

same parts.²⁵³ The difficulty for the business owner comes not just in determining the tax treatment of the repair transaction, but, more significantly, in determining whether the parts should be purchased for resale or not at the time of their initial purchase (i.e., whether the purchase by the end seller is taxable or not).

Second, much more complicated issues arise when dealing with items whose tax treatment depends on the circumstances surrounding their sale. One example of such a situation concerns student meals. Under the sales tax code, the sale of student meals is exempt from taxation.²⁵⁴ That simple concept, however, is the subject of complicated regulations designed to define "student meals." To begin with, if a single price (e.g., \$5.00) is charged for a combination of a food product (a hamburger) and a nonfood product (a carbonated beverage), the entire amount is exempt from tax.²⁵⁵ If, however, the two items are priced separately (e.g., \$4.00 for the hamburger and \$1.00 for the soda), the price of the nonfood item (the \$1.00 soda) is now taxable.²⁵⁶ Additionally, this exemption only applies to sales made during "a time set aside for meals." Tax applies to *any* sales (regardless of whether the sale is of a food or nonfood item) made during periods "designated as a 'nutrition break,' 'recess,' or similar break."²⁵⁷

The distinctions concerning exemptions for food products for home consumption (non-taxable) and hot prepared food products (taxable) are a second category of items presenting the possibility of differing treatment of the same item or of extremely similar items. This area of the sales tax law is probably the most arcane and is the subject of many

253. CAL. CODE REGS. tit. 18, § 1546(b)(1) (1996); see discussion *supra* notes 126-28 and accompanying text. The rationale behind this tax treatment is that the tax is meant to cover those transactions that primarily involve the transfer of tangible personal property. The difficult-to-classify transactions involve vendors providing primarily services, but selling some goods incidently. STOCKWELL, *supra* note 31, at 212.

254. CAL. REV. & TAX. CODE § 6363 (West 1987). This applies to "meals and food products for human consumption furnished or served to the students of a school by public or private schools, school districts, student organization, [and] parent-teacher associations." *Id.* This exemption does not apply to meals sold within a place subject to an admission charge. *Id.*; CAL. CODE REGS. tit. 18, § 1603(d)(4) (1996).

255. CAL. CODE REGS. tit. 18, § 1603(j)(1)(B) (1996).

256. *Id.*

257. *Id.* (excluding any "products" sold during these times from the definition of "meals").

sections of the code, several regulations, and dozens of annotations.²⁵⁸ It is also the source of much confusion. For example, artificial casings used by manufacturers of wieners, if sold as part of the wiener itself, are exempt from tax as a “food product for human consumption.”²⁵⁹ However, for the makers of skinless wieners where the casings are removed prior to sale, such casings are subject to tax as a component of the manufacturing process; they are not part of the otherwise-exempt food product itself.²⁶⁰ In another case, hot nuts, when part of a hot fudge sundae, are not “hot food products,” and are therefore not taxable.²⁶¹ The sales of those same nuts, however, when “sold from enclosed display cases and . . . heated through use of ordinary light globes constitutes a sale of hot food product and is therefore subject to tax.”²⁶²

The repair and/or alteration of fur garments is a yet another example of differing treatment of seemingly extremely similar, if not identical, transactions. Like other repair services, tax is sometimes applied only to the retail selling price of the materials themselves and sometimes to the total charge for materials plus labor. Fur repair is the subject of an elaborate regulation distinguishing among various services and addressing the tax treatment of each.²⁶³ For example, a customer bringing in a fur coat to be remodeled into a jacket would be taxed only on the materials, with the repair labor tax-exempt.²⁶⁴ Should that customer request the coat be made into a cape, however, the entire charge is taxable.²⁶⁵

258. See, e.g., CAL. REV. & TAX. CODE § 6359 (West Supp. 1996) (exemption of food products); CAL. CODE REGS. tit. 18, §§ 1602, 1603 (1996); Cal. Sales & Use Tax Annotations 245.0020-.1920, 550.0020-.2020, 2 BUS. TAXES L. GUIDE 3254-89, 3996-4025 (Cal. State Bd. of Equalization) (1996).

259. Luer Packaging Co. v. State Bd. of Equalization, 101 Cal. App. 2d 99, 224 P.2d 744 (1950).

260. *Id.* at 102-03, 224 P.2d at 746-47 (upholding a determination by the Board).

261. Cal. Sales & Use Tax Annotation 550.1720, 2 BUS. TAXES L. GUIDE 4024 (Cal. State Bd. of Equalization) (1996); see also CAL. REV. & TAX. CODE § 6359 (West Supp. 1996). Implicit in this distinction, like many in the tax system, is the administrative difficulty of costing out the various components of an item sold and treating each differently for tax purposes.

262. Cal. Sales & Use Tax Annotation 550.1770, 2 BUS. TAXES L. GUIDE 4024 (Cal. State Bd. of Equalization) (1996).

263. CAL. CODE REGS. tit. 18, § 1549 (1996).

264. § 1549(c)(2).

265. § 1549(c)(3). The rationale is that the services performed on the fur garment in the latter case are a step in the producing, processing, or fabricating of tangible personal property and, therefore, taxable. §1549(b). However, even in some cases where new material is added, the transaction is a non-taxable repair. This is true where a customer brings in a fur coat to be remodeled and it requires additional fur for the collar and cuffs or where a customer requests that a coat be relined. § 1549(c)(9)-(10).

A final example is the alteration of clothing. In general, new garment alteration services are taxable.²⁶⁶ There is, however, an exception to this treatment based on a distinction not among types of transactions, but rather among types of retailers. If a garment, new or old, is altered by a person who owns a clothes cleaning or dyeing establishment and seventy-five percent of the business' receipts are from cleaning or dyeing and no more than twenty percent of its revenues are from alterations, then (and only then) the alteration service is non-taxable.²⁶⁷

The third and perhaps most confusing area for businesses to determine the proper application of sales tax concerns transactions about which there is conflicting information. One of the best examples of such a situation is gratuities paid to the servers of banquets. The explanation of this problem necessitates some background information both on the taxation of gratuities and on catering industry practices. As a general rule, gratuities are non-taxable if paid on an entirely voluntary basis by the customer and retained by employees of the retailer.²⁶⁸ Tips

266. CAL. CODE REGS. tit. 18, § 1524(b)(1) (1996). It is immaterial whether or not such charges are stated separately. Additionally, it seems that the rationale for this rule is that the alteration is fabrication labor and, therefore, part of the total retail price of the garment which is not "finished" until altered because the tax on alterations also applies regardless of whether it is performed by the seller of the garment or another party. § 1524(b)(1)(B). "Essentially we regard ourselves as buying the finished article, whether the suit or the dress . . . is made in the back of the shop by special order or in the factory a thousand miles away." STATE AND LOCAL TAXATION, *supra* note 7, at 581.

267. CAL. CODE REGS. tit. 18, § 1524(b)(2) (1996); CAL. REV. & TAX. CODE § 6018.6 (West 1987). In this case, the cleaner is considered the consumer of the materials used or furnished in the alterations and must pay tax on those materials as measured by their purchase price. CAL. CODE REGS. tit. 18, § 1524(b)(2) (1996).

268. CAL. CODE REGS. tit. 18, § 1603(g) (1996); CALIFORNIA STATE BD. OF EQUALIZATION, TAX TIPS FOR THE DINING AND BEVERAGE INDUSTRY 8 (1994) [hereinafter TAX TIPS]. The regulation additionally requires that the employer not use these gratuities to credit against wages owed the employees. § 1603(g).

The policy behind this rule was described persuasively, if somewhat floridly, in a 1943 California Court of Appeal decision:

A tip is not intended for the proprietor of a restaurant. It is a gratuity, i.e., "a free gift, a present." *It is intended by the donor to be in excess of the compensation paid to the donee by the latter's employer or a gift where there is neither consideration for it nor a legal obligation upon the donor to part with it.* In the western world diverse motives incite the instincts of the tipper. With some it is to gratify the charitable impulse; with others it is the desire for gratitude or esteem or arises from a zeal for extending one's good will. Still in others the motive is to abide by an iniquitous practice under compulsion of popular opinion. But whatever be the motive of the giver, his[her] tip remains a gift to the donee. *It cannot be fairly said that such gifts are*

received directly by employees from customers without prearrangement are presumed voluntary.²⁶⁹ Mandatory tips (also known as “service charges” and denoted as such herein to avoid confusion), on the other hand, are taxable.²⁷⁰ Examples of these mandatory arrangements include cases where tips are automatically added to meal prices at a predetermined rate.²⁷¹ Although many caterers automatically charge a fixed percentage service charge, many do not. The confusion surrounds when exactly a gratuity is “voluntary” and when it is not; this distinction is the focus of the following analysis.

For banquets arranged through a caterer or, more commonly, through a hotel, the customer and the business routinely make all arrangements in advance of the function. This will normally include a discussion of the gratuity; the caterer may or may not suggest a standard, customary percentage or amount and the customer may choose to designate this amount or another amount (or, for that matter, no amount) for a gratuity in advance.

intended to be additional compensation for the viands or liquids purchased from the restaurateur. . . .

. . . [It has] long been a universal custom . . . for the patrons of restaurants to herald their benevolence or munificence by bestowing coins upon waiters who in the course of their employment with grace or dignity arrayed the ordered comestibles before their benefactors.

Herbert’s Laurel-Ventura, Inc. v. Laurel Ventura Holding Corp., 58 Cal. App. 2d 684, 694-95, 138 P.2d 43, 48 (1943) (emphasis added) (citations omitted).

269. This is true even in the case where the restaurant owner collects and distributes the tips on behalf of the employees, so long as the tips are not applied against the employees’ minimum wages. Cal. Sales & Use Tax Annotation 550.0800, 2 BUS. TAXES L. GUIDE 4008 (Cal. State Bd. of Equalization) (1996) (promulgated in 1953).

These “voluntary” tips are treated as not part of the price of the meal. Professors Hellerstein note that the law indulges this fiction, “even though few people would be bold or ungenerous enough as to fail to leave a tip. The law indulges the fantasy that tips are voluntary.” HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 17.03.

270. TAX TIPS, *supra* note 268, at 8; CAL. CODE REGS. tit. 18, § 1603(g) (1996); Cal. Sales & Use Tax Annotations 550.0740, 550.0760, 2 BUS. TAXES L. GUIDE 4008 (Cal. State Bd. of Equalization) (1996). The rationale is that these charges are really part of the meal price and, therefore, must be included in the retailer’s gross receipts. CAL. REV. & TAX. CODE § 6012(b)(1) (“gross receipts” includes “[a]ny services that are a part of the sale”) (West Supp. 1996). This is true even if the service charge is in lieu of a gratuity and is paid entirely to employees. CAL. CODE REGS. tit. 18, § 1603(g) (1996).

271. TAX TIPS, *supra* note 268, at 8. The mandatory nature of a gratuity can be shown by “written statements on menus, brochures, or advertisements that *tips will be added* to meal prices.” *Id.* (emphasis added). This is often the case in restaurants, where a predetermined service charge (typically 15%) is automatically added to checks for large parties (typically eight or more) to ensure an adequate gratuity. Note, however, that in such a case, the price of the meal was the same as for eight individual diners and the entire tip goes to the server, yet the tax treatment is completely the opposite.

Other than the general information already cited, there are no references to gratuities in the sales tax law or regulations. Therefore, the only guidance is the Board's own *Tax Tips* pamphlet and several annotations. The first such annotation provides that banquet tips are not part of the selling price of the meals (i.e., not taxable) when the caterer adds a gratuity specified by the customer and distributes this amount to its employees.²⁷² In the case forming the basis of this ruling, the amount was specified in advance and was determined on a voluntary basis.²⁷³ The second applicable interpretation is found in Annotation 550.0780 which reads, in pertinent part:

As in the case of banquets, when the customers will ordinarily discuss all aspects of the meals with the retailer beforehand, the payment of tips will be presumed to have been voluntary, even if the tips are a generally standard amount or percentage suggested by the retailer, unless other evidence supports the conclusion that the tip was, in fact, a required payment. Such other evidence may consist of written statements on menus, brochures, or advertisements that tips will be added to meal prices, or union contract clauses requiring the retailer to guarantee a certain amount of tips to his[her] employees.²⁷⁴

In other words, there is a presumption that the tip was voluntary in the absence of specific evidence to the contrary. This annotation, however, was removed by direction of Board counsel in 1992.²⁷⁵

Despite these annotations, the current position of the Board's audit staff is that *any* gratuity designated in advance of a function, either of a fixed amount or percentage, is taxable. According to the staff's

272. Cal. Sales & Use Tax Annotation 550.0770, 2 BUS. TAXES L. GUIDE 4008 (Cal. State Bd. of Equalization) (1996).

273. The case giving rise to the annotation was a May 19, 1977 Decision and Recommendation by Board staff in favor of the Petitioner on its Petition for Redetermination in the matter. It is available from the Librarian of the State Board of Equalization, P.O. Box 942879, Sacramento CA 94279-0001. Because of privacy concerns, the name of the Petitioner and other confidential information has been redacted from the copy available for distribution.

274. Cal. Sales & Use Tax Annotation 550.0780 (Cal. State Bd. of Equalization) (issued June 7, 1972, removed August 12, 1992) (on file with the author).

275. State Board of Equalization (Mar. 29, 1996). According to Board staff's records, the annotation was removed on August 12, 1992 based on an internal memorandum from Board of Equalization counsel not available for public inspection. The memorandum determined that "[t]he annotation is subject to interpretation that a 'service charge' may be excluded from gross receipts even though it is payable by contractual agreement between the retailer and the customer." *Id.* As discussed *infra* note 284, however, it is unclear when exactly the annotation was removed from the looseleaf services.

revised interpretation of the law, this is true whether or not the amounts so designated by customers vary from function to function and regardless of whether such gratuities are clearly voluntary under the test established previously in Annotation 550.0780.²⁷⁶ The distinction seemingly being made is that, while a specific amount or percentage was not mandatory as a service charge, it was nonetheless mandatory that *some* amount be designated in advance of the function.²⁷⁷ Gone is the presumption that tips are paid voluntarily in the absence of evidence to the contrary. Under this new interpretation, *any* amount established in advance, no matter how small (or, for that matter, offensive to its recipients), would be considered a mandatory service charge. It would, in essence, tax all voluntary gratuities arising out of this scenario.²⁷⁸

276. This position is contained in a private Decision and Recommendation issued by the Board staff on a Petition for Redetermination on March 21, 1995. This determination was made primarily because the gratuities paid were of a generally consistent amount, but despite the fact that Petitioner's contracts clearly stated that the gratuity amount was "suggested." *Id.* at 4. Note that the rescinded annotation was in effect during the entire audit period (January 1986 through June 1991). The case was appealed to the Board of Equalization and heard in September 1996. On October 9, 1996, the Board issued a Notice of Redetermination upholding the staff's position. Without further comment, "[t]he Board concluded that the gratuity charges (tips) added to food and beverage sales were mandatory and therefore are includible in taxable gross receipts." Both documents are available, with the name of the Petitioner and other confidential information redacted, from the author.

277. Decision and Recommendation, *supra* note 276, at 4.

278. This exact situation has been addressed in many other states with differing results. In addition to the sources noted *infra*, see generally Jack L. Litwin, Annotation, *Applicability of Sales Tax to "Tips" or Service Charges*, 73 A.L.R.3d 1226 (1976).

Some states tax gratuity/service charge amounts automatically added to the customer's bill. *E.g.*, 95 State Tax Day (CCH) 181-007 (June 30, 1995) (Oklahoma, tips added at a set percentage and stated separately); 92 State Tax Day (CCH) 321-008 (Nov. 16, 1992) (Virginia, club members charged gratuity did not have option of changing the recommended amount); 90 State Tax Day (CCH) 136-008 (May 16, 1990) (South Dakota, gratuity automatically added); 88 State Tax Day (CCH) 245-006 (Sept. 1, 1988) (Kansas, mandatory gratuity part of taxable cost of food and liquor); 85 State Tax Day (CCH) 253-012 (Sept. 10, 1985) (Idaho, mandatory gratuity part of "full price of meals").

In a few instances where gratuities automatically added to customer bills are taxable, however, the distinction seems to be drawn not based on the nature of the gratuity itself (i.e., the voluntary/mandatory distinction), but rather on other circumstances. First, the fact that the charge is either not passed on to servers or is put against their minimum wages is sometimes dispositive of the charge being part of the overall selling price of the meal and, thus, taxable. *See* 92 State Tax Day (CCH) 289-006 (Oct. 15, 1992) (New York, service charge taxable because servers received no other compensation); 92 State Tax Day (CCH) 108-019 (Apr. 17, 1992) (Tennessee, mandatory tips taxable because not turned over to servers); 92 State Tax Day (CCH) 059-009 (Feb. 28, 1992) (Missouri, share of gratuity taxable to the extent given to servers "to increase their lower-than-average hourly wages to the average rate"). Second, an exemption from sales tax may not be applicable if the gratuity is not stated separately, but rather is part of the lump sum charged for the meal. *Cf.* *La Cascade, Inc. v. State Tax Comm'n*, 458 N.Y.S.2d 80,

One of the most troubling aspects of this recent ruling is its direct contradiction of information contained in the Board of Equalization's own *Tax Tips* pamphlet on the topic. This document was distributed not only throughout the audit period in question, but is still being handed

82 (N.Y. App. Div. 1982).

In contrast, several other states have ruled that automatic tips of a set amount are not taxable. For some, this is simply a matter of definition—gratuities are not part of the taxable sale. *E.g.*, 94 State Tax Day (CCH) 159-004 (June 8, 1994) (Indiana, sales tax does not apply to charges for serving or delivering food or beverages provided the charge is stated separately); 90 State Tax Day (CCH) 029-005 (Jan. 29, 1990) (Arkansas, a “plain reading” of the law determined that taxable sales do not include the rendering of services and, furthermore, that the “sale of [food and drink] was completed prior to the time the [gratuity] was applied, and the [gratuity] itself had nothing to do with the transfer of title to or possession of tangible personal property at the time the . . . sales were made”); 84 State Tax Day (CCH) 220-028 (Aug. 7, 1984) (Louisiana, mandatory service charge not taxable when shown separately); *see* St. Paul Hilton Hotel v. Commissioner of Taxation, 214 N.W.2d 351 (Minn. 1974) (service charges added to the bill and apportioned among employees not taxable). For others, it is because the gratuity is an extra charge for *service*, and not part of the *sale* of food and/or beverages. *See* Ragland v. Meadowbrook Country Club, 777 S.W.2d 852, 854 (Ark. 1989).

Most states that exempt automatic gratuities from sales tax do so with the requirement that the entire amount collected be passed on to the servers. *E.g.*, 92 State Tax Day (CCH) 232-003 (Aug. 19, 1992) (Illinois, mandatory service charges not taxable to the extent paid to servers as tips, but taxable to extent designated as shift pay); 91 State Tax Day (CCH) 017-011 (Jan. 17, 1991) (Utah, gratuities taxable unless the total amount is passed on to the server); 87 State Tax Day (CCH) 161-013 (June 10, 1987) (Texas, gratuities subject to sales tax if not “disbursed to the employees who customarily and regularly provide the service”); 84 State Tax Day (CCH) 332-021 (Nov. 27, 1984) (North Dakota, service charge subject to tax unless passed on to the server or other employees); *see also* Green v. Surf Club, Inc., 136 So. 2d 354, 356 (Fla. Dist. Ct. App. 1961), *cert. denied*, 139 So. 2d 699 (1975) (noting that the employer did not receive any “benefit” from the mandatory charge and was merely an “instrumentality or a conduit for the collection of gratuities or ‘tips’”).

Tipping food servers is a customary component of every meal, whether eaten alone in a restaurant and paid for individually or at a banquet and paid for in total. The line between which tips are “voluntary” and which are “mandatory” is fuzzy and becoming increasingly blurred as both the custom itself and the acceptable percentage amount of this tip become more standard. *See* discussion *supra* note 268. An individual diner in a restaurant feels some compulsion to leave a tip, generally in the range of 15%. It seems difficult to distinguish that situation from the same diner attending a banquet whose tip suddenly becomes mandatory because it is paid by the host.

A far better solution is to abandon the voluntary/mandatory distinction in favor of a less ambiguous and more easily applied test. Following the lead of other states, California should adopt the rule that gratuities, regardless of their nature, are not subject to sales tax, provided that (1) the charge is separately stated on the bill, (2) the entire amount is passed on to servers or other employees of the retailer, and (3) the gratuity is in addition to any minimum or other negotiated wage payable to the servers or other employees of the retailer.

out at Board offices as of November 1996. It states that “[i]n the case of banquets, where your customers ordinarily discuss all aspects of the meals beforehand, tips are considered voluntary even if they are a generally standard amount or percentage suggested by you (unless the tips are, in fact, required payments).”²⁷⁹

Even more worrisome is the ease with which the Board can change its interpretation of the law to the detriment of those businesses that have relied on it.²⁸⁰ First, unlike the promulgation of regulations, there is no formal or standard system for the issuance of annotations. In its *1994-1995 Annual Report*, the Board notes that “annotations are *synopses of selected Board legal opinions, judicial opinions, Letters to Assessors, and attorney general opinions.*”²⁸¹ However, in its Correction Mailing M96-3 (issued in August 1996) to the *Business Taxes Law Guide*, the Board issued Annotation 550.0695 entitled “Banquet Tips.”²⁸² This annotation contains the position of the Board’s audit staff discussed *supra* and is based directly upon the specific case containing that determination.²⁸³ Besides the shift in interpretation, the

279. TAX TIPS, *supra* note 268, at 8.

280. The Board is free to make these radical redeterminations on a purely administrative basis because, in its opinion, it is only the *interpretation* of the law that is changed as opposed to the law itself. This will be discussed more in the next section of the text.

281. 1994-95 BD. REPORT, *supra* note 24, at 12 (emphasis added).

282. Cal. Sales & Use Tax Annotation 550.0695, 2 BUS. TAXES L. GUIDE 4007 (Cal. State Bd. of Equalization) (1996). The full text of the annotation reads as follows:

To help customers plan banquets, the taxpayer employs convention coordinators and caterer coordinators. These employees meet with the customers, give them written policy information and enter into agreements for the parties or meetings, in addition to the banquets. The standard policy information and the standard agreement both state that “the suggested gratuity is 15%” for food and beverage. Before the banquet, the parties sign a prospectus and specify, among other things, the details of the food and beverage service and the agreed upon gratuity. The prospectus, the policy information, and the standard agreement collectively constitute the contract for the banquet.

... While the suggested gratuity of 15% is not mandatory, the fact remains that some gratuity negotiated in advance between the taxpayer and its customers is mandatory. Customers do not have the option to enter into contracts for the sale of food and beverages, and not specify an amount for the gratuity. For sales and use tax purposes, when a retailer asks one price for the sale of merchandise, but accepts a lower price following negotiations with the buyer, the amount ultimately received remains subject to the sales or use tax. The result is not different merely because the negotiated amount is for services that are a part of the sale. Therefore, the taxpayer’s gratuities are considered mandatory and subject to sales tax.

Id.

283. See *supra* notes 276-78 and accompanying text.

most disturbing aspect of this annotation is that it was issued *after an appeal had been filed by the taxpayer, prior to any action by the Board, and thus in advance of formal Board ratification of staff's position.*²⁸⁴ Moreover, in the case of removal of an annotation, the taxpayer may be completely unaware of the change because there is no requirement for formal notice of removal or revocation.²⁸⁵

Second, because such interpretations by the Board and/or its staff are not the law, the law itself (which is largely silent on this issue) remains unchanged. Therefore, the new interpretation of the law applies retroactively to all transactions within the statute of limitations.²⁸⁶ Some taxpayers have successfully fought such retroactive applications of administrative interpretations,²⁸⁷ but such victories are rare.²⁸⁸

284. The matter was heard in September 1996 and the Board's Notice of Redetermination was issued October 9, 1996. See *supra* note 276.

285. In fact, there was no formal notice of the removal of Annotation 550.0780 and there is some dispute as to exactly when it was removed from the looseleaf services. At the least, it was not removed promptly after the Board decided to withdraw it and removal may have lagged by as long as three years.

286. Except in the case of fraud, intent to evade, or failure to file a return, a notice of deficiency determination must be made within three years after the last day of the month following the quarterly period (or one-year period, as applicable, depending on whether quarterly or annual filings are required) for which the determination is made or within three years after the return is filed, whichever is later. This time period expands to eight years in the case of failure to file a return. CAL. REV. & TAX. CODE § 6487(a)-(b) (West Supp. 1996).

287. See *Pacific Southwest Airlines v. State Bd. of Equalization*, 73 Cal. App. 3d 32, 140 Cal. Rptr. 543 (1977). In *Pacific Southwest Airlines*, the airline (PSA) took delivery of a plane intended for use as a common carrier of persons. Such a transaction was and is exempt from sales tax under CAL. REV. & TAX. CODE § 6366 (West 1987). During the four years PSA owned the airplane, it was used 67% of the time to transport passengers. During its first six months of operation, however, it was used primarily (63%) to train pilots, not carry passengers. After the plane was sold, the Board of Equalization audited the airline. During approximately the same time, the Board issued an opinion that the law was meant to exempt only those planes used as common carriers more than 50% of the time during their first six months of operation, not over some longer period during which the airline owned the plane. This ruling was contained in Annotation 105.0210 (since removed). *Pacific Southwest Airlines*, 73 Cal. App. 3d at 34-35, 140 Cal. Rptr. at 544-45.

The court found for PSA, resting its decision on two foundations, lack of notice to the taxpayer and "insurmountable obstacles of statutory construction." *Id.* at 35, 140 Cal. Rptr. at 545. First, the statutory language was silent on this specific factual situation. Moreover, the only regulation which addressed the issue noted that it was limited to the specifics of the situations described therein, none of which matched PSA's. *Id.* at 35-36, 140 Cal. Rptr. at 545. Second, the court noted that PSA "reasonably relied on the plain meaning" of the statute. Thus, PSA could not have foreseen the Board's posture and

These facts, coupled with the fact that “revenue and taxation offices tend to see a taxable transaction everywhere,”²⁸⁹ spell trouble for businesses legitimately trying to comply with the law. Under such circumstances, “compliance, let alone planning, is very difficult.”²⁹⁰

4. Consequences

The Board of Equalization, like many of its counterparts across the nation, has stepped up its compliance efforts in recent years.²⁹¹ In 1985-86, the Board conducted 20,505 audits,²⁹² by 1994-95, this number had increased to 24,923.²⁹³ Despite the increased number of audits, some of the recent education and information efforts by the Board may be paying off in the form of fewer challenged audit findings. In 1985-86, 4,337 petitions for redetermination were filed, which represented twenty-one percent of all audits conducted; of these petitions, 299, or seven percent, reached the Board itself on final administrative appeal.²⁹⁴ The number of petitions for redetermination dropped to thirteen percent by 1994-95, with a total of 3221 appeals received; however, 272, or eight and one-half percent of these petitions, reached the Board.²⁹⁵ The prospect of an audit, however, is still

was under no duty to request a specific ruling from the Board. Moreover, retroactive application of the Board’s six-month test was “inconsistent with the principles of due process.” *Id.* at 36, 140 Cal. Rptr. at 546.

288. *E.g.*, *Market St. Ry. v. California State Bd. of Equalization*, 137 Cal. App. 2d 87, 290 P.2d 20 (1955). The court in *Market Street* noted that “estoppel based on reliance upon an erroneous construction of the statute by an administrative ruling will not lie against the government, particularly in tax matters.” *Id.* at 100, 290 P.2d at 28. A taxpayer was held responsible for payment of tax it had not collected based on reliance on a written regulation because all retailers are “deemed to act with knowledge that administrative officials cannot bind the government by their erroneous interpretation of tax statutes.” *Id.* at 102, 290 P.2d at 29. The court, however, did hold that the State was estopped from collecting penalties and interest on the tax deficiency. *Id.* at 101, 290 P.2d at 29.

289. *Taxing Questions: Some Hotel Goods and Services May Be Exempt from Retail Sales Tax*, *LODGING*, Nov. 1995, at 39. This article cited a Colorado Court of Appeals decision upholding a finding that complimentary bar snacks are subject to use tax (measured by the purchase price by the bar owner) because they are “merely incidental to the primary purpose of the later transaction” which was “to promote its bar business.” *Id.* at 40.

290. *Springsteel*, *supra* note 15, at 29.

291. *See generally* *Clark*, *supra* note 15, at 29-30; *Preston*, *supra* note 15, at 650.

292. *ADMINISTERING THE SALES TAX*, *supra* note 132, at 6.

293. 1994-95 BD. REPORT, *supra* note 24, at 31. This represents approximately 2.5% of the total outstanding permits of 998,970 (as of December 31, 1994). *Id.* at A-23.

294. *ADMINISTERING THE SALES TAX*, *supra* note 132, at 7.

295. 1994-95 BD. REPORT, *supra* note 24, at 30.

frightening for many businesses, especially in light of the Board's average recovery of \$310 in net tax deficiencies per audit hour.²⁹⁶

Because of the disjointed nature of the sales tax system, with its combination of statutes, regulations, annotations, and special publications such as the *Tax Tips* pamphlets, the ultimate decision on many particular situations come from the courts. While the case law governing the outcome of disputes over the construction and interpretation of the sales tax law tends to focus on the very specific circumstances involved in each case, some general tenets are evident.

First, in tax matters, the state is afforded "very great latitude" and the court will allow flexibility and a variety of tax schemes.²⁹⁷ These tax statutes will generally not be subjected to close scrutiny; distinctions among classifications can be justified simply by the promotion of legitimate state interests, including administrative convenience.²⁹⁸ Such a distinction, however, still must rest on differences having a "fair and substantial relation to the object of the legislation"²⁹⁹ and be "founded on natural, intrinsic or fundamental distinctions."³⁰⁰ Additionally, the sales tax must then be applied uniformly to all persons within the classification.³⁰¹

Second, in cases where the Board has promulgated a formal regulation classifying the tax treatment of a particular situation and the regulation itself is the subject of challenge, the proper scope of review is one of

296. *Id.* at 31. For the 24,923 audits, auditors spent an average of 58 hours per audit, for a total time of 1,436,614 hours. These audits uncovered tax deficiencies of \$444,627,077, while only discovering refunds of \$27,044,253. *Id.*

297. *Amador Valley Joint Union High School Dist. v. State Bd. of Equalization*, 22 Cal. 3d 208, 234, 583 P.2d 1281, 1292, 149 Cal. Rptr. 239, 250 (1978) (upholding Proposition 13); *Haman v. County of Humboldt*, 8 Cal. 3d 922, 925, 506 P.2d 993, 995, 106 Cal. Rptr. 617, 619 (1972) (per curiam).

298. *Haman*, 8 Cal. 3d at 925-26, 506 P.2d at 995, 106 Cal. Rptr. at 619.

299. *Id.* at 926-27, 506 P.2d at 996, 106 Cal. Rptr. at 620.

300. *Capitol Records, Inc. v. State Bd. of Equalization*, 158 Cal. App. 3d 582, 599, 204 Cal. Rptr. 802, 813 (1984); *accord* *Garrett Corp. v. County of Humboldt*, 189 Cal. App. 2d 504, 507, 11 Cal. Rptr. 421, 423 (1961) (classifications cannot be based on "purely adventitious condition"); *Koenig v. Johnson*, 71 Cal. App. 2d 739, 753, 163 P.2d 746, 753 (1945); *see also* *General Electric Co. v. State Bd. of Equalization*, 111 Cal. App. 2d 180, 188, 244 P.2d 427, 431 (1952) ("[c]lassifications will not be overthrown unless plainly arbitrary").

301. *Garrett*, 189 Cal. App. 2d at 507, 11 Cal. Rptr. at 423; *General Electric*, 111 Cal. App. 2d at 188, 244 P.2d at 431 ("[r]ulemaking bodies have a wide discretion in exercising the power to classify"); *Koenig*, 71 Cal. App. 2d at 752, 163 P.2d at 752-53.

limited judicial review.³⁰² Where the Board's discretion in promulgating the regulation is within the scope of the statute granting that authority, the regulation will only be struck down where it is arbitrary, capricious, or has no reasonable or rational basis.³⁰³ When a dispute falls into this category, the taxpayer almost never prevails.³⁰⁴

If it is the Board's *interpretation* of the sales tax regulation that is in question, however, the accuracy of that interpretation is a question of law, just like the interpretation of a statute. While the administrative agency's interpretation of its own regulations will be given great weight, the ultimate decision of these legal questions rests with the courts.³⁰⁵ In fact, "[a]dministrative regulations that alter or amend the statute or

302. *California Ass'n of Psychology Providers v. Rank*, 51 Cal. 3d 1, 11, 793 P.2d 2, 6, 270 Cal. Rptr. 796, 800 (1990); *Wallace Berrie & Co. v. State Bd. of Equalization*, 40 Cal. 3d 60, 65, 707 P.2d 204, 207, 219 Cal. Rptr. 142, 145 (1985); *Culligan Water Conditioning of Bellflower, Inc. v. State Bd. of Equalization*, 17 Cal. 3d 86, 92, 550 P.2d 593, 596, 130 Cal. Rptr. 321, 324 (1976); *Mission Pak Co. v. State Bd. of Equalization*, 23 Cal. App. 3d 120, 125, 100 Cal. Rptr. 69, 72 (1972). The "construction of a statute by officials charged with its administration . . . is entitled to great weight." In fact, the rule "comes before the court with a presumption of correctness and regularity, which places the burden of demonstrating invalidity upon the assailant." *Id.*

303. *California Ass'n of Psychology Providers*, 51 Cal. 3d at 11, 793 P.2d at 7, 270 Cal. Rptr. at 801; *Wallace Berrie & Co.*, 40 Cal. 3d at 65, 701 P.2d at 208, 219 Cal. Rptr. at 146; *Culligan*, 17 Cal. 3d at 93 n.4, 550 P.2d at 597 n.4, 130 Cal. Rptr. at 325 n.4; *Pacific Southwest Airlines v. State Bd. of Equalization*, 73 Cal. App. 3d 32, 35, 140 Cal. Rptr. 543, 545; *Henry's Restaurants of Pomona, Inc. v. State Bd. of Equalization*, 30 Cal. App. 3d 1009, 1021, 106 Cal. Rptr. 867, 874 (1973). Here, the administrative agency is acting in a quasi-legislative capacity. *Mission Pak*, 23 Cal. App. 3d at 125, 100 Cal. Rptr. at 72.

304. In all of the sales tax cases noted in the preceding two notes, the only successful case for the taxpayer was *Pacific Southwest Airlines*. For the facts of the case and the court's reasoning, see discussion *supra* note 287.

305. *J.E. Robinson v. Fair Employment & Hous. Comm'n*, 2 Cal. 4th 226, 235, 825 P.2d 767, 771, 5 Cal. Rptr. 2d 782, 786 (1992); *California Ass'n of Psychology Providers*, 51 Cal. 3d at 11, 793 P.2d at 7, 270 Cal. Rptr. at 801; *Wallace Berrie & Co.*, 40 Cal. 3d at 65, 701 P.2d at 207, 219 Cal. Rptr. at 145; *Culligan*, 17 Cal. 3d at 93, 550 P.2d at 596, 130 Cal. Rptr. at 324; *Carmona v. Division of Indus. Safety*, 13 Cal. 3d 303, 310, 530 P.2d 161, 165-66, 118 Cal. Rptr. 473, 477-78 (1975); *Coca-Cola Co. v. State Bd. of Equalization*, 25 Cal. 2d 918, 921, 156 P.2d 1, 2-3 (1945) (courts generally will not depart from such a construction unless it is clearly erroneous or unauthorized); *Szabo Food Service, Inc., of Cal. v. State Bd. of Equalization*, 46 Cal. App. 3d 268, 271, 119 Cal. Rptr. 911, 912 (1975) ("Board's finding becomes subject to judicial review for errors in factual analysis and legal interpretation"); *King v. State Bd. of Equalization*, 22 Cal. App. 3d 1006, 101, 99 Cal. Rptr. 802, 806 (1972) (the rule giving weight to contemporaneous administrative construction does not apply when the construction is incorrect); *Anders v. State Bd. of Equalization*, 82 Cal. App. 2d 88, 98, 185 P.2d 883, 889 (1947) (affirming a determination by the Board of Equalization against a taxpayer where gratuities were interpreted to be taxable to the extent used to credit against minimum wages owed by the taxpayer to the employees receiving the tips).

enlarge or impair its scope are void and courts not only may, but it is their obligation to strike down such regulations.”³⁰⁶

There are literally thousands of situations that are not precisely covered under the sales and use tax statutes. Therefore, interpretation by the Board and its staff will, of necessity, be involved in making determinations on the tax treatment of many transactions. Even in those cases where an on-point regulation is available, however, the taxpayer still cannot rely on the regulation in a legally-absolving sense.³⁰⁷ Because the Board’s interpretations are subject to judicial review on questions of law, they must be correct to withstand the court’s scrutiny. Where such regulations are struck down, the taxpayer is still responsible for payment of any tax deficiency, despite having acted in accordance with an established and published regulation.³⁰⁸

Third, the only “official” aspects of the tax law are the statutes and regulations (and, based on the discussion *supra*, regulations can only loosely be considered so). While the Board attempts to disseminate meaningful information from these sources to specific industries through its *Tax Tips* pamphlets, these publications contain a very specific warning that it is the law itself that controls, not the information in the pamphlet.³⁰⁹ The situation is even more troubling as concerns the annotations. These advisory interpretations of specific cases are written

306. *California Ass’n of Psychology Providers*, 51 Cal. 3d at 11, 793 P.2d at 7, 270 Cal. Rptr. at 801; *Dyna-Med, Inc. v. Fair Employment & Hous. Comm’n*, 43 Cal. 3d 1379, 1389, 743 P.2d 1323, 1328, 241 Cal. Rptr. 67, 71 (1987); *Morris v. Williams*, 67 Cal. 2d 733, 748, 433 P.2d 697, 707, 63 Cal. Rptr. 689, 699 (1967); *cf. Hittle v. Santa Barbara County Employees Retirement Ass’n*, 39 Cal. 3d 374, 387, 703 P.2d 73, 80, 216 Cal. Rptr. 733, 740 (1985) (“[t]he administrative agency must confine itself to reasonable interpretation in adopting regulations for administration of its governing statute; if it goes beyond that, the legislative area has been invaded and the regulation counts for nought.”).

307. This excludes those instances where the taxpayer has specifically sought a written ruling from the Board under CAL. REV. & TAX. CODE § 6596 (West Supp. 1996). Remember, however, that such determinations are still subject to rescission. *See* discussion *supra* notes 241-43 and accompanying text.

308. *See supra* notes 280-88 and accompanying text.

309. *See, e.g.,* TAX TIPS, *supra* note 268, at i. The applicable warning reads:

Note: This pamphlet summarizes the law and applicable regulations in effect when the pamphlet was written, as noted on the cover. However, changes in the law or in regulations may have occurred since that time. If there is a conflict between the text in this pamphlet and the law, the latter is controlling.

Id. This is exactly the situation with banquet tips discussed *supra* where the only remaining guidance is the *Tax Tips* pamphlet, yet the Board staff found contrary to its own explicit advice contained therein.

by the staff of the Board and relied upon heavily by industries for concrete answers as to the tax treatment of very technical, real-life situations.³¹⁰ Despite their status as possibly the only guidance on particular issues and despite the reliance placed upon them, these interpretations are not the law. Therefore, they are subject to administrative change and rescission without notice, leaving the taxpayer who reasonably relied on them for guidance with unreimbursed tax liabilities and no available means of redress.³¹¹

Fourth, and perhaps most importantly for businesses analyzing their particular tax situation with guidance from the preceding publications, exemptions are “solely a matter of legislative grace.”³¹² As such, any exemptions stated in the tax code or regulations are strictly enforced against the retailer.³¹³ In fact, it is presumed that “all gross receipts are subject to the tax until the contrary is established.”³¹⁴ It is the taxpayer’s burden to prove that the activity or transaction in question fits squarely within the confines of the exemption.³¹⁵ The message here is clear: businesses may only take sales tax exemptions at their own

310. During the 1993-94 fiscal year alone, the Board drafted more than 400 new annotations. 1993-94 BD. REPORT, *supra* note 49, at 11.

311. As discussed in the text *supra*, although the Board’s interpretation of a specific situation may be published as an annotation, it is not an “official” interpretation inasmuch as it is removable at any time without notice and only a person or entity actually receiving a written response to a written request for advice can rely on the contents of the interpretation. *Cf.* CAL. REV. & TAX. CODE § 6596(d) (West Supp. 1996).

312. *Hotel Del Coronado Corp. v. State Bd. of Equalization*, 15 Cal. App. 3d 612, 617, 92 Cal. Rptr. 456, 459 (1971).

313. *Cedars of Lebanon Hospital v. Los Angeles County*, 35 Cal. 2d 729, 734, 221 P.2d 31, 34 (1950) (exemptions can neither be enlarged nor extended beyond the plain meaning of the language of the statute); *Favalora v. County of Humboldt*, 55 Cal. App. 3d 969, 975, 127 Cal. Rptr. 907, 912 (1976); *Hotel Del Coronado*, 15 Cal. App. 3d at 617, 92 Cal. Rptr. at 459; *Garrett Corp. v. County of Humboldt*, 189 Cal. App. 2d 504, 509, 11 Cal. Rptr. 421, 424 (1961); *Good Humor Co. of Cal. v. State Bd. of Equalization*, 152 Cal. App. 2d 873, 879, 313 P.2d 640, 644 (1957) (an administrative agency cannot expand the scope and effect of a statute by rule).

314. CAL. REV. & TAX. CODE § 6091 (West 1987).

315. *Cedars of Lebanon*, 35 Cal. 2d at 734, 221 P.2d at 34; *see* CAL. REV. & TAX. CODE § 6091 (West 1987). This rule of strict construction applies to other tax cases as well, such as those for claimed property tax exemptions. It can be distinguished, however, from the liberal construction rule applied in determining exemptions under other statutes, such as those for social security and unemployment compensation. *Cedars of Lebanon*, 35 Cal. 2d at 734-35, 221 P.2d at 34-35.

risk.³¹⁶ Record-keeping for such exemptions is costly, but mistakes can be many times more costly still.

Based on the costs to both the Board and retailers of administering the current sales tax system, the confusion that surrounds many aspects of its structure, and the potential consequences for businesses that, their best intentions for compliance notwithstanding, fail to collect and remit accurately the tax as determined by the Board and its audit staff, the burden of the sales tax on businesses, and ultimately consumers, is immense. In this regard, the California sales tax does not live up to its original goal of being a relatively simple tax to understand, administer, and collect.

D. Fairness II: Neutrality

The last original goal of the sales tax system in California to be examined here, and the one which it fails to achieve most severely, is fairness.³¹⁷ Fairness here means tax neutrality, measured by the consistent application of the tax across similar industries and among similar types of transactions. Optimal tax theory states "that taxes should be designed to minimize unintended distortions of business and consumer decisions to avoid affecting economic neutrality and equity."³¹⁸ Sales taxes in general, however, tend to distort the relative prices of goods and services because they tax only certain transactions.

This degradation of neutrality is exacerbated by increasing the number of exemptions and, thus, narrowing the tax base or changing the taxation of business purchases.³¹⁹ This effect was noted in the 1983-84 California budget analysis prepared by the Legislative Analyst:

316. Remember, however, that a business *not* taking these exemptions is at a relative competitive disadvantage compared to another business that does. This results from the inevitable side-effect of taxing the transaction—a higher overall cost to the customer, thus creating either a decrease in demand for the taxing business or a shift in demand to the non-taxing business.

317. Fairness in terms of neutrality is still a stated goal of many lawmakers introducing certain tax reform measures. A recent bill introduced in the United States Senate, entitled the Tax Fairness for Main Street Business Act of 1994 (S. 1825), was aimed at mail-order businesses. The law would allow states to collect taxes from out-of-state firms for personal property delivered within the state. Its stated goal was to make the competition between these mail-order businesses and local retailers "fair." *Sales and Use Tax Bill Introduced in Senate*, J. ACCT., Aug. 1994, at 24.

318. Derrick & Scott, *supra* note 157, at 211.

319. *Id.* at 211-12.

[W]idespread use of the tax system to achieve public policy objectives may have an adverse impact on the tax system itself. The proliferation of tax expenditures is one of the main reasons why the present tax system is so complicated. While the impact of adding one more line or one more form to a tax return packet may—by itself—be minor, the cumulative burden placed on the tax system by all expenditures is a heavy one. In fact, *the plethora of special provisions . . . added to the tax system over the years has . . . given many taxpayers the impression that the tax system is inequitable.*³²⁰

While we have previously investigated the cost impact of exemptions in terms of administration, we now turn to the two-fold impact of such exemptions on tax fairness.

First, exemptions affect consumer choice by impacting relative pricing and, thus, materially altering the economic balance. Because consumption will tend to shift towards untaxed items, the prices of those items and the items used to produce them will increase while the prices of taxed items will decrease relatively.³²¹ Assuming that the pre-tax pricing structure was economically efficient, this will lead to an inefficient and, therefore, less desirable result.³²² Additionally, the implementation of a sales tax will decrease spending in general by reducing consumption in favor of savings.³²³

Second, such exemptions unfairly burden some businesses either within the same industry (in the case of only portions of the production process being taxed) or in other competing industries (in the case of exemptions designed to benefit a particular industry). In the case of vertical neutrality, examples of the adage that “exemptions beget exemptions” are clearly evident.³²⁴ For example, the exemption of food products for home consumption has spawned a series of exemptions down the production chain.³²⁵ The next level of exemption is for

320. 1983-84 BUDGET ANALYSIS, *supra* note 98, at 117-18 (emphasis added). It also notes that such exemptions will increase the opportunities for tax evasion. *Id.* at 117.

321. DUE, *supra* note 7, at 25. For consumers, this means that those persons consuming untaxed goods will bear a portion of the burden created by the tax, while those consuming taxed goods will be freed from a corresponding portion. *Id.*

322. SOMERS, *supra* note 102, at 17.

323. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 7. This incentive to save is based on the assumption that such savings will be used for purposes other than consumption in the immediate future during a time when the tax will still be in effect. DUE, *supra* note 7, at 16. While encouraging savings may be a valid public policy objective, it nonetheless interferes with the efficient functioning of market incentives.

324. SOMERS, *supra* note 102, at 13. This is also true in the situation between different industries, one producing a non-taxable good and the other producing a taxable good, where the additional exemptions are urged to eliminate the unfair competition created by the first exemption. *Id.*

325. For a general description of the food products exemption, see CAL. REV. & TAX. CODE § 6359 (West Supp. 1996) and CAL. CODE. REGS. tit. 18, § 1602 (1996)

products used directly in the creation of food products, such as animal life and seeds and annual plants, then feed for such animals or fertilizer applied to land used for the production of food for human consumption.³²⁶ The final level, just added in 1993, is for "wood shavings, sawdust, rice hulls, or other products that are used as litter in poultry and egg production and that are ultimately resold as, or incorporated into fertilizer products."³²⁷ So, the chain goes backwards from the food itself, to plants used to create the food, to fertilizer to grow the plants to make the food, and finally to the products used to make the fertilizer to grow the plants to make the food.

Perhaps the most damaging distortions, however, occur where a particular industry is favored for public policy reasons without a sound tax justification. Among the most common "policy" rationales for such exemptions are economic influence and/or political pressure. Understandably, complaints of unfair competition generally accompany exemptions in this category.³²⁸

Examples of modern-day, industry-specific exemptions are abundant. They include an exemption for the sale or lease of aircraft to common carriers.³²⁹ This exemption alone accounts for an annual tax expendi-

(non-taxable sales of food products).

326. CAL. REV. & TAX. CODE § 6358 (West 1987). These animals, seeds, and plants must be of a type "the products of which ordinarily constitute food for human consumption." § 6358(a), (c). Fertilizer must be used for the production of food for human consumption. This can be done directly by using it to grow food or indirectly by growing a product that will be fed to animals that will eventually become food. Thus, hay grown to be fed to cattle is exempt, while hay grown to feed to racehorses is not. SOMERS, *supra* note 102, at 14; *cf.* CAL. CODE REGS. tit. 18, § 1587(b) (1996). If the hay were for cattle which were raised for human consumption, this would add yet another layer to the exempt production chain noted in the text.

327. CAL. REV. & TAX. CODE § 6358.2 (West Supp. 1996).

328. Such allegations, however, are nothing new to the tax system. When sales taxes were first being implemented in this country in the 1930s, one of the initial reasons they were unpopular among merchants stemmed from the fact that compliance with the tax was largely voluntary. There was a feeling that it unfairly discriminated against larger retailers in favor of smaller merchants who, with a lower public profile, could avoid paying the tax and still avoid detection. SCHULTZ, *supra* note 193, at 18. Because the policymakers generally envisioned little field work to enforce the tax, they relied heavily on businesses to report competitors who were attempting to evade the tax, a legitimate belief assuming most retailers properly understood the competitive advantage enjoyed by non-complying retailers. Martin & Tolman, *supra* note 34, at 15.

329. CAL. REV. & TAX. CODE §§ 6366, 6366.1 (West 1987); *see also* CAL. CODE REGS. tit. 18, § 1610 (1996). In his 1996-97 budget proposal, Governor Wilson proposes to expand this exemption to include "property that becomes a component part of an

ture of \$523 million.³³⁰ The exemption for custom computer programs³³¹ costs the State \$67 million annually.³³² Motion picture production services and the leasing of motion pictures for commercial exhibition are also exempt from sales tax.³³³ These exemptions cost the State \$93 million annually.³³⁴

One of the most recent special-interest exemptions concerns the master recording tapes used by the record industry. Music producers lease these master tapes, used to manufacture sound recordings to be sold at retail, from production companies or directly from recording artists. Under a 1965 change in the statute, these leases, like all leases of tangible personal property, became taxable sales.³³⁵ Arguing that leasing these tapes really constituted a service and should, therefore, be non-taxable,³³⁶ the industry won an exemption for this activity in 1975.³³⁷ In 1982, this exemption was expanded to include the original production and fabrication of these master tapes as well, thus making the entire recording process tax-free.³³⁸ In 1983, the annual revenue loss from

exempt aircraft as a result of maintenance, repair, overhaul, or improvement of the aircraft." 1996-97 BUDGET, *supra* note 3, at 72.

330. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 11. The exemption mentioned in the preceding note will result in a further loss of \$4.5 million annually. 1996-97 BUDGET, *supra* note 3, at 72.

331. CAL. REV. & TAX. CODE § 6010.9 (West 1987).

332. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 11.

333. CAL. REV. & TAX. CODE §§ 6010.4, 6010.6 (West 1987 & Supp. 1996); *see generally* CAL. CODE REGS. tit. 18, § 1529 (1996). This exemption does not apply to the sale of raw film, sound tape, video stock, paintings, models, or artwork to the producers of motion pictures. In that case, the producer is the consumer of the goods and their sale is taxable. § 1529(a)(1).

334. 1995-96 TAX EXPENDITURE REPORT, *supra* note 94, at 11. An exemption for the rental of videotapes for private use was repealed in 1983, for estimated first year revenue of \$17 million. 1985-86 BUDGET, *supra* note 95, at 73.

335. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 55-56.

336. Dan Walters, *End of the Loopholes?*, L.A. DAILY J., July 22, 1983, at 4.

337. Act of Sept. 27, 1975, ch. 1116, 1975 Cal. Stat. 2708 (codified as amended at CAL. REV. & TAX. CODE § 6362.5 (West 1987)); 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 56. This exemption grew out of extensive audits and litigation surrounding the recording industry. *See, e.g.*, Capitol Records, Inc. v. State Bd. of Equalization, 158 Cal. App. 3d 582, 204 Cal. Rptr. 802 (1984) (supporting a Board determination assessing sales tax for transactions involving master tapes for the years 1968 through 1971). It is worth noting that the Governor who signed this bill into law, Edmund G. "Jerry" Brown Jr., relied on heavy campaign support from the entertainment industry and was romantically involved with singer Linda Ronstadt, herself an interested party. Walters, *supra* note 336, at 4.

338. Act of Sept. 10, 1982, ch. 951, 1982 Cal. Stat. 3442 (codified as amendment to CAL. REV. & TAX. CODE § 6362.5(b)(2) (West 1987)); *see also* 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 56; Walters, *supra* note 336, at 4 (noting that only the raw material itself would be taxed).

this exemption was estimated at \$6 million,³³⁹ or over \$9 million in current dollars.³⁴⁰

This exemption is horizontally inconsistent for two reasons. First, fabrication labor is ordinarily subject to tax.³⁴¹ Here, the "true object of the transaction is to gain possession of the physical object, the tape or record[,] which is a physically necessary component in the manufacturing process."³⁴² This is equivalent to the labor necessary to fabricate a custom suit,³⁴³ attach ski bindings to new skis,³⁴⁴ and string a new tennis racket,³⁴⁵ all taxable. Second, other artistic or creative processes are taxable when they result in tangible personal property.³⁴⁶ For example, works of art such as paintings, drawings, and sculptures are subject to tax³⁴⁷ as are, ordinarily, other items of tangible personal property incidental to the production of the objects, but not physically incorporated into them, such as molds, patterns, and lithographic plates.³⁴⁸

What all of these exempted items have in common is their significant impact on the California economy.³⁴⁹ Lawmakers fear that not

339. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 55.

340. This is based on increases to the consumer price index, as published in BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, CONSUMER PRICE INDEXES (Nov. 1995).

341. CAL. REV. & TAX. CODE, § 6011(a)(2) (West Supp. 1996) ("sales price" specifically includes "the cost of . . . labor or service cost."). Tax even applies to "charges for producing, fabricating, processing, printing, or imprinting of tangible personal property for a consideration for consumers who furnish either directly or indirectly the materials used." CAL. CODE REGS. tit. 18, § 1526(a) (1996).

342. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 58.

343. Cal. Sales & Use Tax Annotation 435.1760, 2 BUS. TAXES L. GUIDE 3797 (Cal. State Bd. of Equalization) (1996).

344. Cal. Sales & Use Tax Annotation 435.1520, 2 BUS. TAXES L. GUIDE 3794 (Cal. State Bd. of Equalization) (1996).

345. Cal. Sales & Use Tax Annotation 435.1700, 2 BUS. TAXES L. GUIDE 3796 (Cal. State Bd. of Equalization) (1996).

346. Compare discussion *supra* note 131 concerning "canned" computer software that is taxable when transferred on tangible storage media, but non-taxable when transferred via modem.

347. However, such works of art are exempt from tax if they are specifically purchased for donation to certain public or nonprofit organizations for the purpose of display to the public in museums or are purchased to replace museum pieces destroyed by calamity. CAL. CODE REGS. tit. 18, § 1586(a) (1996).

348. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 58.

349. See 1996-97 BUDGET, *supra* note 3, at 7-9, 65 (praising the computer and motion picture industries for contributing to the State's economic recovery and noting that even the aerospace industry, heavily impacted by defense cutbacks, is a significant

providing enough deference to such industries will force them to seek more tax-friendly states in which to set up shop, especially for industries that can be readily housed in alternative locations.³⁵⁰ Of course, these industries also have in common powerful lobbies in Sacramento and the ability to fund hefty campaign contributions to State lawmakers.³⁵¹

Providing incentives to important State industries can produce economic effects that benefit the economy as a whole. However, when these incentives are created through the sales tax system, such benefits come at the cost of seriously impacting the fairness of the system and creating an inefficient and inequitable distribution of resources. Additionally, these exemptions further alienate vendors (on whom the State relies for collection of the tax) who may feel they are being unfairly burdened and placed at a competitive disadvantage. It is in this regard that the California sales tax system has most severely failed its original goals.

V. A LOOK AT SOME ALTERNATIVES

Having evaluated the current California sales tax system and found it inadequately addressing its goals, there are several options available to lawmakers wishing to revamp its basic structure. These range from broadening the tax base under the existing system to radically altering the method of taxation through such means as a value-added tax (VAT).

A. Broadening the Tax Base

Those wishing to expand the tax base under the retail sales tax system have several means for accomplishing this goal, most notably by taxing selected services and deleting many of the system's current exemptions.³⁵² These methods can be used separately or in combination for

State industry and is again showing signs of growth).

350. *Cf. id.* at 14-15.

351. Walters, *supra* note 336, at 4. The article notes that, while a "first-class lobbying campaign," including campaign contributions, may cost around \$500,000, the tax break gained from such an effort could be worth many times that much annually. *Id.*

352. Another issue, not to be discussed at length here, is the current exclusion of certain other types of property from the measure of sales tax. Traditionally, items such as intangible personal property and real property are not taxable under a sales tax. HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 12.03.

Intangible personal property is generally left entirely untaxed, existing in the middle ground between the sales tax and the property tax. "Intangible" items include stocks, bonds, amounts paid for franchise rights, and similar transactions. As with the distinction between goods and services, however, questions arise at the borderline between intangible and tangible personal property. For example, there has been debate

greater effect. While proposals encompassing both concepts have been studied extensively in the past by the State Legislature, they have yet to be taken up seriously in the form of proposed legislation.³⁵³ A final

over whether currency and gold coins are tangible or intangible (recall that these items were one of the original exemptions to the California sales tax). Similar questions arise concerning computer software, where, in addition to attempting to disentangle the "good" from the "service," there is also disagreement about whether the "good" is a tangible good at all or rather a "non-taxable transfer of incorporeal information coupled with an intangible right of use." *Id.*

Intangible personal property is also left untaxed by the property tax system in most states. *See, e.g., CAL. REV. & TAX. CODE* § 212(a) ("[n]otes, debentures, shares of capital stock, solvent credits, bonds, deeds of trust, mortgages, and any interest in that property are exempt from taxation" under the property tax), (b) (money used in the "ordinary and regular course of a trade, profession, or business" is also exempt), (c) ("intangible assets and rights" are exempt except that "[t]axable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use") (West Supp. 1996). For an interesting article discussing the exclusion of intangible personal property from the property tax base, exploring the preferred status of these items over real property in the tax system, and countering conventional arguments against such a tax, see Lester B. Snyder, *Taxing the Unlanded Gentry: A New Trend in Taxation of Intangible Property*, 4 CONN. L. REV. 310 (1971).

Because of the close connection between intangible items (such as stocks) and interstate commerce, states must be mindful of commerce clause considerations in this context. *See Fulton Corp. v. Faulkner*, 116 S. Ct. 848 (1996) (holding a North Carolina intangibles tax facially discriminatory against interstate commerce because the tax, measured by the fair market value of a company's stock, allowed a reduction in value for that portion of the company's income subject to North Carolina income tax); *see also U.S. Supreme Court's Fulton Decision Prohibits Discriminatory Taxes, But Does Not Close Door on Tax Incentives*, PERSP. ST. & LOCAL TAX'N (KPMG Peat Marwick, New York, N.Y.), Mar. 1996, at 2.

Real property is excluded from application of the sales tax because it is already taxed through the property tax system. Furthermore, the original legislative purpose of sales taxes was to raise revenue specifically from personal property, not real property which was already subject to an ad valorem tax based on market value. HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 12.03. This raises difficulties in classifying building materials. The California tax system defines the construction contractor as the consumer of materials used in the performance of construction contracts. Thus, sales tax applies to the purchase price of the materials by the contractor. CAL. CODE REGS. tit. 18, § 1521(b)(2)(A)1 (1996). However, if the contractor contracts to sell the materials first and then install them for a separately stated price, sales tax applies to the retail price of the materials (but not installation, which is not taxable). § 1521(b)(2)(A)2. If the item furnished is a fixture, however, the contractor is the retailer of the fixture and sales tax applies to its retail sales price. § 1521(b)(2)(B). The distinction between "materials" and "fixtures" is whether or not the item "loses its identity to become an integral and inseparable part of the real property." § 1521(a)(4)-(5).

353. *See, e.g., 1983 REVENUE & TAXATION REPORT*, *supra* note 55 (California Assembly); 2 DUBAY, *supra* note 119 (California Senate). The Assembly report studied

alternative, to be used in combination with the deletion of exemptions, offers a means of cushioning the equity impact of such a change by offering poorer households a credit against income tax for the sales tax on necessary purchases.

1. *Taxing Services*

A tax on services could significantly improve the sales tax system in several respects, most notably in terms of its revenue-generating potential. During six months of 1987, a broad-based Florida tax on services produced additional revenue of \$495 million, measured in 1987 dollars.³⁵⁴ It is likely that the revenue effect of service taxation in California would be significantly higher due to a larger population and economy.³⁵⁵ One study estimated that California could add revenues of \$399 million (in 1992 dollars, assuming the current six percent State portion of the sales tax) by taxing just four services: automobile repair services, dry cleaning, contract janitorial services, and landscaping services.³⁵⁶ Another study concluded that a tax on all repair services (including automobiles, electronics, furniture, and other repair services) would yield \$319 million annually and a tax on admissions to sports and entertainment events would add another \$144 million (1993 dollars, six percent State sales tax rate).³⁵⁷ Extrapolating from the results of a Washington State survey shows that California could expect as much as \$48 million annually from taxing beauty salon and barber shop services, \$31 million from janitorial services, \$43 million from computer and data

six exemptions in depth (food, motion pictures, master tapes, custom computer software, aircraft, and occasional sales) and evaluated the taxation of services. 1983 REVENUE & TAXATION REPORT, *supra* note 55. None of these items, however, were changed from their pre-report condition.

354. Litvan, *supra* note 121, at 28R. This is roughly consistent with pre-enactment projections, which estimated that taxing all services would generate annual revenues of \$1.18 billion. Pierce & Peacock, *supra* note 121, at 470.

355. As concerns the relative size of the economy, one gauge is personal income. For fiscal 1994, California's share of the nation's personal income was 12.45%. This is almost twice the share of the next highest state (Texas, with a 6.43% share) and significantly above Florida, with a share of 5.33%. Victor A. Canto, The State Competitive Environment: 1995-96 Update 4 (Aug. 9, 1995) (unpublished manuscript, available from A.B. Laffer, V.A. Canto & Associates).

356. 2 DUBAY, *supra* note 119, at 5. Of course, the taxation of only selected services would only increase the seemingly arbitrary application of the sales tax to only certain consumption transactions and might lead to claims of discrimination and legal challenges to the new law. It would also create additional interpretation and enforcement problems. Cf. DUE & MIKESSELL, *supra* note 35, at 92.

357. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 129. These figures were supplied by the Board of Equalization. *Id.* at 128.

processing services, and \$30 million from trash collection.³⁵⁸ A 1992 study concluded that a comprehensive sales tax of services, including professional services, would increase California tax revenues by almost forty-five percent.³⁵⁹

Services represent a significant portion of the overall economy. More importantly, this sector is growing. Service sector employment in California is expected to increase by forty percent between 1990 and 2000, making it the fastest-growing occupational group in the State.³⁶⁰ Of the 300,000 new jobs the Department of Finance claims were created between November 1994 and November 1995, approximately 90,000 were in business services.³⁶¹ Moreover, adding services to the tax base

358. *Id.* at 122-23, 156. These figures were arrived at by multiplying the estimated Washington State tax increase by three (based on relative differences in population between the states) to obtain its effect on California tax collections. *Id.* at 122.

359. William F. Fox & Matthew Murray, *Economic Aspects of Taxing Services*, 41 NAT'L TAX J. 19, 25 (1988). This is just slightly under the projected national increase of 46.3% of all 1982 sales tax receipts for a similar expansion in the tax base of all states. *Id.* at 20. This study contemplated taxing business and business-related, personal, health, legal, education, and construction services. Consistent with previous studies, it did not include financial services such as mortgage or stock brokers. *Id.* at 25.

Financial services are tracked in the FTA study and include such categories as bank service charges, investment counseling, loan broker fees, property sales agents, and financial reporting services. These services, however, remain relatively untaxed. For example, loan broker fees are taxed in only six states. TAXATION OF SERVICES, *supra* note 74, at 36. Stock brokerage services are not even included in the survey. There are several underlying reasons for this exclusion. First, these services are thought to be only tangentially related to the transfer of tangible personal property. Where other services are taxed, it is sometimes justified through the fiction that tangible personal property is changing hands (e.g., by arguing that the real reason to engage an attorney is to obtain a will). Second, taxing these services is thought to be another tax on pure labor, already covered by other tax schemes such as the income tax. Third, in the case of stock brokers, the underlying property that forms the basis of the transaction is not tangible, but intangible personal property. As discussed *supra* note 351, such property is most often entirely excluded from the measure of sales tax.

360. 2 DUBAY, *supra* note 119, at 14. It is important to note that these numbers are calculated using traditional categorizations of manufacturing and service sectors. As discussed in detail *supra* Subpart IV.A and in the accompanying notes, these distinctions are becoming increasingly irrelevant, with more and more businesses providing hybrid good/service "products." Thus, statistics measuring "service sector" performance cannot be assumed to reflect completely accurately the overall growth of only the traditional "pure" service sector.

361. 1996-97 BUDGET, *supra* note 3, at 62-63. These jobs replaced some of the 730,000 jobs lost during the recession of the early 1990's. *Id.* at 8. By mid-1996, California is expected to return to pre-recession employment levels of approximately 12,750,000. *Id.* at 1.

is likely to increase the elasticity of the tax and decrease the volatility of tax revenue generation.³⁶²

In addition to revenue considerations, including services in the tax base can have a beneficial impact on the equity aspects of the sales tax. A majority of economists agree that taxing services will, in general, make the tax system more progressive.³⁶³ This is due simply to the fact that, unlike purchases of many tangible goods, "expenditures on services as a whole tend to rise as incomes rise."³⁶⁴ A 1988 study determined that adding a select number of progressively-consumed items to the tax base would increase sales tax paid by the wealthy by fourteen percent while only increasing the burden on poorer households by three percent.³⁶⁵

A number of more recent studies have specifically addressed the distributional effect of taxation of services. The first found that service taxation in general is far more progressive even than previously believed.³⁶⁶ The second study determined that, when the sales tax was expanded to include all services, regressivity was largely confined to those households earning less than \$30,000 annually (in 1991 dollars) and the tax was roughly proportional through those earning \$60,000 annually.³⁶⁷ Using actual data from the Florida tax on services, a third study found similar results. The tax was regressive only to the twentieth percentile of income distribution and then roughly proportional from the twentieth to the eightieth percentile.³⁶⁸ The study then compared the distributional effects of a new five percent tax on services and a one percent increase in the tax rate for currently-taxed goods. Extending the

362. Pierce & Peacock, *supra* note 121, at 476 (elasticity); cf. Fox & Murray, *supra* note 359, at 22 (elasticity); see discussion *infra* note 406 (volatility).

363. E.g., 2 DUBAY, *supra* note 119, at 15.

364. DUE & MIKESELL, *supra* note 35, at 89; see also, 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 123-24.

365. 2 DUBAY, *supra* note 119, at 16. The study was performed by the Citizens for Tax Justice and included such services as legal and accounting fees, participant sports, home improvement and maintenance, jewelry repair, lessons, parking, appliance repair, club memberships, lawn care, and landing and docking fees. *Id.*

366. See generally Donald Baum, *Economic Effects of Including Services in the Sales Tax Base: An Applied General Equilibrium Approach*, 19 PUB. FIN. Q. 166 (1991).

367. Fox & Murray, *supra* note 359, at 30-31. The authors noted that "the marginal equity implications of service taxation depend on the breadth of activity presently subject to the tax, and the existing burden distribution of the sales tax." *Id.* at 31.

368. John J. Siegfried & Paul A. Smith, *The Distributional Effects of a Sales Tax on Services*, 44 NAT'L TAX J. 41, 49-50 (1991). The total amount spent on tax by the fifth percentile of the income distribution as a percentage of income was 0.65%. This number dropped to 0.50% by the twentieth percentile and remained stable through the fortieth percentile (0.45%), the sixtieth percentile (0.44%), the eightieth percentile (0.48%), and even the ninety-fifth percentile (0.44%). *Id.* at 50.

sales tax to services was found to be slightly less regressive than the sales tax on commodities.³⁶⁹

There are, however, some complications with including services in the tax base to improve its equity. Most notably, some services are consumed in greater proportion by lower income households.³⁷⁰ Additionally, some services consumed primarily by higher income families—household personal services, foreign travel, and education—are especially difficult to tax.³⁷¹

Another benefit of taxing services is improved neutrality. From an economic standpoint, there is little distinction between a service and a commodity.³⁷² Treating all such expenditures equally will remove the perverse economic effects on consumer behavior caused by taxing only tangible personal property. Failure to tax services discriminates against persons with a relatively higher preference for commodities than services and inevitably causes some shifting of consumption towards greater use of services.³⁷³ For example, the system currently distorts decisions away from purchases of goods (a new watch, taxable) in favor of purchases of services (repairing an old one, generally non-taxable).³⁷⁴ Ideally, the tax treatment of the two transactions should not affect the consumer's choice. If it does, a sub-optimal distribution of resources will occur.

If there is, in fact, little distinction between the good and the service, first limiting the tax base to tangible personal property and then further limiting the definition of "tangible personal property" solely to goods is far too constricting and inconsistent from a policy perspective. After all, it is just as "tangible" to have one's car repaired as it is for one to purchase a part and install it oneself.³⁷⁵ In most cases, the acquisition of services constitutes a consumption expenditure equivalent to the

369. *Id.* at 52.

370. 2 DUBAY, *supra* note 119, at 16. These include utilities, coin-operated laundry services, car repairs, and towing services. *Id.*

371. DUE & MIKESELL, *supra* note 35, at 89. The problem with taxing many of these services is evasion of the tax by individuals who are administratively difficult to track and/or audit such as babysitters, housekeepers, or gardeners.

372. DUE, *supra* note 7, at 374.

373. DUE & MIKESELL, *supra* note 35, at 320; Hellerstein, *Significant Developments*, *supra* note 72, at 964.

374. 2 DUBAY, *supra* note 119, at 14; Hamond, *supra* note 5.

375. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 123.

purchase of commodities.³⁷⁶ Eliminating this good/service distinction will have the further benefit of reducing the administrative burden on businesses forced to separate taxable parts from non-taxable repair services.³⁷⁷ Both administrative and compliance costs would be reduced for those businesses providing hybrid good/service items if they were uniformly taxed.³⁷⁸

On the other hand, taxing certain services could have a deleterious effect on neutrality. If services used heavily by businesses are taxed (e.g., contract cleaning or accounting services), larger firms may elect to perform these services (or, in some cases, more of these services) in-house instead of hiring independent contractors to perform them as they now frequently do. This will increase the relative tax burden on smaller businesses who may not be able to perform such services themselves.³⁷⁹ Additionally, some inequities could be created because of the application of the sales tax to personal property, not real property.³⁸⁰ For example, repair of a floor lamp would be taxable, but repair of installed overhead lighting would not be. The same holds true for repair of built-in air conditioning systems (non-taxable) as opposed to window air conditioners (taxable).³⁸¹ Finally, tracking services as they “travel” through both intrastate and interstate commerce could be difficult to administer and burdensome to comply with because of the intangible nature of the services provided and the challenge of determining where they are rendered.³⁸²

376. Hamilton & Mikesell, *supra* note 16, at 32; DUE & MIKESSELL, *supra* note 35, at 88-89 (noting that there is not a significant difference between expenditures on services and expenditures on goods “from the standpoint of satisfaction of wants”); see also HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 15.01. The more broadly “consumption expenditures” are defined, the more closely the tax resembles a VAT. This will be discussed in greater detail in the text *infra* part V.B.

377. Jerome Hellerstein notes that *any* sale involves the rendering of some service. The difficulty comes in determining which services are rendered as part of the sale and which are ancillary. When services per se are not taxed, the taxable demarcation line is not between the sale of the commodity and the rendering of the service, but rather between the type of service rendered as a typical merchandising activity and other types of services. Obviously, “this line of distinction is highly arbitrary.” Hellerstein, *Significant Developments*, *supra* note 72, at 965.

378. See Fox & Murray, *supra* note 359, at 32-33; cf. DUE & MIKESSELL, *supra* note 35, at 89. Administrative costs are decreased because of the relative ease of auditing these businesses once the total amount of all sales, not just the goods portion, is taxable. Compliance costs are decreased because the necessity of separately invoicing goods and services is deleted. Fox & Murray, *supra* note 359, at 32.

379. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 124; see also Litvan, *supra* note 121, at 28R.

380. See discussion *supra* note 352 concerning the exclusion of real property from the sales tax and its surrounding issues.

381. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 125.

382. See Pierce & Peacock, *supra* note 121, at 479.

Perhaps the strongest argument against service taxation, however, is not theoretical, but pragmatic. First, while such a tax can be a significant source of revenue, it can also be a potential source of heated political debate. From a realistic perspective, taxation of services obviously has its opponents, especially among those businesses that provide the services in question.³⁸³ For this reason, sweeping legislation taxing most services has rarely been attempted and, when it has, it has often failed.³⁸⁴ The Florida tax on services was repealed in its entirety in December 1987, just six months after it went into effect, and a similar tax in Massachusetts was repealed in 1991.³⁸⁵ According to some, "the concept and execution of the [Florida] tax were basically sound" and its downfall was caused more by political forces than the working of the tax itself.³⁸⁶

Second, an expansion of the tax base to services can be less attractive than an increase in the tax rate for administrative and revenue reasons. While taxing services that are rendered in connection with the transfer of tangible personal property actually increases administrative efficiency, adding new services to the tax base, at least initially, does not. To begin, a significant number of new vendors must be registered, educated about the tax, and made to comply with the new law.³⁸⁷ This, along with the costs associated with ensuring compliance, increases the

383. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 126. Not only are professional organizations well-organized and powerful, but some professionals are additionally exceptionally well-placed. It is no secret that the legal professional has vigorously opposed taxation of its services and that most lawmakers are attorneys. It should then be no surprise that attempts to tax their services have met with little success. HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 12.05.

384. For a comprehensive explanation of the environment and analysis leading up to the enactment of the Florida tax on services, see Pierce & Peacock, *supra* note 121.

385. Litvan, *supra* note 121, at 28R. The Florida sales tax on services extended to legal services and, not surprisingly, lawyers were at the forefront of the political campaign that successfully argued for repeal of the tax. HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 12.05.

386. James Francis, *The Florida Sales Tax on Services: What Really Went Wrong?*, in THE UNFINISHED AGENDA FOR STATE TAX REFORM 129, 130 (Steven D. Gold ed., 1988). This article provides an excellent summary of the conceptual basis of the tax, refutes the criticisms leveled at the tax, and analyzes the political factors leading to its eventual repeal. *Id.* at 129-45.

387. Results have ranged from an actual 60% increase in registered vendors in Iowa, to an actual 36% under the Florida program, to an estimated 23% increase for a proposed Nebraska tax. DUE & MIKESSELL, *supra* note 35, at 89 (Iowa); Fox & Murray, *supra* note 359, at 32 (Nebraska and Florida).

administrative burden on the State.³⁸⁸ While overall tax revenues obviously increase under this base expansion scenario, they do so less than with a simple increase in the tax rate using the existing tax base.³⁸⁹

Primarily because of these examples, a far more common approach to service taxation has been the individual consideration and selection of certain services for taxation. A majority of sales tax related actions by states since the mid-1980s has involved an expansion of the tax base through the addition of services.³⁹⁰ While twenty-eight states added some business services to their tax bases between 1990 and 1992 and twenty-seven added some personal services, no state added more than twelve specific services.³⁹¹ Those states adding services generally selected specific services, targeting mostly those hybrid consumption expenditures involving services associated with tangible personal property (e.g., alteration and laundry services).³⁹² These services are relatively efficient to tax because, theoretically, some reporting and record-keeping is already being done for the goods portion of the transaction.³⁹³ Additionally, taxing certain services may be easier than others, depending on the political organization and clout of the various industries.³⁹⁴ However, such selective taxation, while having fewer opponents, may face more violent opposition from affected industries who may feel they are being unfairly singled out.³⁹⁵

388. In addition to registering new vendors, these cost increases include hiring and training new auditors, devising new audit selection methods, enhancing computer capacity, and intensifying taxpayer education programs. Fox & Murray, *supra* note 359, at 32.

389. *Id.* at 33.

390. Duncombe, *supra* note 16, at 304.

391. TAXATION OF SERVICES, *supra* note 74, at 3. Also, none extended the tax to professional services such as doctors and attorneys. *Id.* Taxation of these services has met with great resistance. Hellerstein, *Significant Developments*, *supra* note 72, at 966. It has proved especially unpopular for both public policy and political reasons and, in some cases, untenable for constitutional reasons. *See, e.g.*, Walter Hellerstein, *Florida's Sales Tax on Services*, 41 NAT'L TAX J. 1, 10-14 (1988).

392. TAXATION OF SERVICES, *supra* note 74, at 9-10. Even in Florida, a 1991 tax commission was again proposing the abolition of exemptions for certain service transactions. 91 State Tax Day (CCH) 330-005 (Nov. 26, 1991). These proposals were championed by Governor Chiles in his State of the State address in January 1992. 92 State Tax Day (CCH) 016-016 (Jan. 16, 1992). Several of these suggestions were passed into law by the Florida Legislature, effective September 1992. TAXATION OF SERVICES, *supra* note 74, at 5. These included nonresidential cleaning services, protective services, and extermination services. *Id.*

393. *See supra* notes 377-79 and accompanying text.

394. *See supra* notes 383-86 and accompanying text.

395. 1983 REVENUE & TAXATION REPORT, *supra* note 55, at 126.

2. Eliminating Exemptions

This Article previously examined the effect of sales tax exemptions—those granted for policy considerations as well as those that are more politically-motivated—on the California sales tax system. As noted, these exemptions account for annual losses of \$4.29 billion or approximately one-fifth of all potential sales and use tax revenues (both measured in 1993 dollars).³⁹⁶ Of course, many of these exemptions are granted to further social and economic policy goals of the State.³⁹⁷ They are not, however, without their costs in exactly those same areas.

The granting of such “sweeping exclusions and important exemptions destroys the feature of a universal levy and the resulting retail sales tax resembles a system of selective excise taxes, with the adverse features of such taxation.”³⁹⁸ Many of these problems have been mentioned previously. They include the increased complexity of audits due to more

396. For these calculations and the methodology, see discussion *supra* note 107.

397. The California Legislative Analyst has noted that tax expenditures can further economic goals by offering incentives to change consumer behavior in such areas as transportation, health, education, housing, and industrial development. They also further social policies by granting tax relief or aid to particular groups of people. CALIFORNIA LEGISLATIVE ANALYST, THE 1984-85 BUDGET: PERSPECTIVES AND ISSUES 131. For example, sales to and by charitable, religious, and educational organizations are in many cases exempt from sales tax. HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 12.03. Examples of these exemptions abound in the California sales tax code. *E.g.*, CAL. REV. & TAX. CODE §§ 6359.45 (vending machine sales and photocopies in libraries), 6360 (prisoner of war bracelets), 6361 (intermittent sales by youth organizations), 6361.1 (intermittent sales of items handcrafted by children with severe emotional disturbances), 6361.5 (yearbooks), 6363 (student meals), 6363.5 (religious organization meals), 6363.7 (meals for homebound elderly or disabled persons), 6375 (sales by charitable organizations), 6375.5 (sales of new children's clothing to a nonprofit organization) (West 1987 & Supp. 1996).

Some of these organizations also qualify for property tax exemptions in California. *See* CAL. CONST. art. XIII, §§ 4(a) (exempting the homes of disabled veterans or their spouses), 4(b) (exempting property used for religious, hospital, or charitable purposes); *see also* CAL. REV. & TAX. CODE §§ 202, 203, 214, 214.02, 214.13 (West 1987 & Supp. 1996) (granting exemptions of specific property types and specific cases).

Many states, as part of their attempts to broaden their tax bases, are rolling back exemptions for some or all charitable organizations and/or tightening down on their definition of “charitable” activities. *See* Boyd J. Black, *Searching for the Revenue: Eroding State and Local Tax Exemptions*, C726 A.L.I.-A.B.A. 227 (1992) (discussing recent state actions scrutinizing exemptions from both property taxes and sales and use taxes).

398. SOMERS, *supra* note 102, at 24.

numerous chances for evasion³⁹⁹ coupled with an increased incentive to evade the tax (because, with a smaller coverage, the rate is inevitably higher), discrimination against those with relatively high preferences for the taxed goods, and a reallocation of consumer demand leading to an “unjustifiable distortion in resource allocation.”⁴⁰⁰

To avoid the negative impacts on equity among income levels and neutrality across industries, the sales tax must be uniform across all consumer expenditures.⁴⁰¹ In general, the sales tax with the broadest base and the lowest rate is the most equitable.⁴⁰² Exemptions reduce the base and, in turn, reduce revenue gained from the tax. Therefore, higher rates are necessary to produce the required revenue.⁴⁰³ These higher rates, in turn, exacerbate the economic distortions caused by the selective taxation in the first place.⁴⁰⁴

Broadening the tax base in this manner can have significant ramifications both inside and outside the State. Within the State, it can minimize the competitive disturbances unintentionally caused by the exemptions.⁴⁰⁵ It can also serve an important role in the stabilization of the State economy. A recent study showed that the broadest and most diverse tax base exhibited the lowest variability through economic cycles of any of the alternative tax bases analyzed.⁴⁰⁶ This broad base and

399. DUE & MIKESELL, *supra* note 35, at 66.

400. DUE, *supra* note 7, at 35, 41.

401. *Id.* at 41.

402. SOMERS, *supra* note 102, at 13.

403. Using the tax base under a VAT, one study of this phenomenon noted that exempting housing, physician services, financial services, life insurance, and education reduced the tax base to less than 80% of total consumption. Excluding food for home consumption, medical services, and utilities would further constrict the base to less than 45% of total consumption (and making the tax base roughly analogous to that under most current sales tax schemes). These exemptions alone would require a tax rate more than twice as high to achieve revenue equivalence. Hamond, *supra* note 5.

404. SOMERS, *supra* note 102, at 13. Recall that changes in the tax rate without changes in the tax base do not, by themselves, change the relative regressivity or progressivity of the tax. *Id.* at 102; *see also* discussion *supra* note 174.

405. DUE & MIKESELL, *supra* note 35, at 24.

406. Richard F. Dye & Therese J. McGuire, *Expanding the Sales Tax Base: Implications for Growth and Stability*, in SALES TAXATION 169, 174 (William F. Fox ed., 1992); *see also* Fox & Murray, *supra* note 359, at 24 (noting that expansion of the tax base to include services would tend to stabilize collections). The Dye & McGuire study measured the relative fluctuation of various components of the sales tax base. The average real growth rate of the “core” group (which included items in the tax base common to almost every state such as meals away from home, alcohol, home furnishings, and most other durables and nondurables) was 2.16% over a twenty year period. During that time, it experienced variability of 4.25% around its trend. On the other hand, the most expansive tax base (including the core plus food, drugs, fuels, utilities, telephone service, consumer services, business services, and professional services) increased 2.42%, but only varied 2.38%, the lowest volatility of any of the tax base combinations studied. Dye & McGuire, *supra*, at 172-74.

associated low tax rate can also have far-reaching economic impacts outside the State as well by increasing the State's competitive advantage in attracting and retaining interstate businesses.⁴⁰⁷

These factors lead inevitably to the conclusion that "an exemption is as powerful an instrument as the sales tax itself. It must be used judiciously to achieve equity and promote the development of the California economy."⁴⁰⁸ The California Legislature has yet to heed this admonition.

3. Sales Tax Credits

An alternative scheme for advancing the equity goals of the sales tax without impacting its administrative efficiency and fairness goals is the use of sales tax credits.⁴⁰⁹ This system allows an offset against personal income tax for the purchase of certain necessary purchases or a cash refund for those households without an income tax liability.⁴¹⁰ The principal benefit of such a system is that it meets the public policy goal of assisting lower-income households while at the same time allowing states to delete many of the traditional exemptions for "necessities" (e.g., medicine and food for home consumption). This

407. Robert D. Ebel & Christopher Zimmerman, *Sales Tax Trends and Issues*, in SALES TAXATION 3, 13 (William F. Fox ed., 1992).

408. SOMERS, *supra* note 102, at 132. If exemptions are to be granted, they must be carefully evaluated in terms of the points discussed *supra* in the text. While ultimately a political failure, much can be learned from what is referred to as "the Florida experience." The Florida tax on services provided very few exemptions in an attempt to create as broad a base as possible. More importantly, it set forth comprehensive and specific criteria to be used in evaluating any future exemptions. These criteria are applicable to any contemplated tax expenditure and include (1) the expected economic impact of the exemption measured by the additional jobs or businesses created, (2) the effect of the exemption on other statutory policy, (3) the consistency of the exemption with other state tax policy, (4) whether the legislature would appropriate money to fund the exemption, (5) whether granting the sales tax exemption is the most efficient way to grant favored status to an industry or group, (6) the continuing validity of the reasons for granting the exemption, and (7) whether the exemption should be subject to period review or appeal. Pierce & Peacock, *supra* note 121, at 475.

409. See generally Steven D. Gold, *Simplifying the Sales Tax: Credits or Exemptions?*, in SALES TAXATION 157 (William F. Fox ed., 1992). This system is the course recommended by the Advisory Committee on Intergovernmental Relations. HELLERSTEIN & HELLERSTEIN, *supra* note 74, ¶ 13.08[1].

410. DUE & MIKESSELL, *supra* note 35, at 72-73. The authors argue that the sales tax exemption for food is actually a "second-best substitute" for such an income tax credit. *Id.* at 320.

means the assistance or subsidy is going only to those families at whom it is specifically targeted.⁴¹¹

As of 1992, this type of system was in place in nine states.⁴¹² While the theory behind this credit is the same in all cases, the actual mechanics of the credit/rebate program vary greatly. Some states coordinate this credit with their state income tax while others administer it as a separate program.⁴¹³ In almost all states, the credit decreases as income rises, eventually vanishing at higher income levels.⁴¹⁴ Additionally, in some states, the credit varies according to the number of people in the household or distinguishes between single people and married couples, thus addressing horizontal equity issues in addition to the vertical equity issues that are the primary focus of such credits.⁴¹⁵

Proponents of this credit as a substitute for specific exemptions argue that it is a more equitable means of reducing the sales tax burden on the poor, costs less in terms of revenue loss, and is much easier to administer.⁴¹⁶

411. See *supra* notes 100-01 and accompanying text discussing the fact that tax expenditures tend to have a shrapnel-like effect, hitting not only their intended target, but many of those around them as well, as opposed to subsidies which have a more precise, rifle-like aim.

412. Gold, *supra* note 409, at 158. The states allowing this credit are Georgia, Hawaii, Idaho, Kansas, New Mexico, Oklahoma, South Dakota, Vermont, and Wyoming. *Id.* In eight of the nine, the credit is provided in lieu of an exemption for food; the ninth has a sales tax credit even though it exempts food. *Id.* at 158-59. The eight with no exemption for food are: Georgia, Hawaii, Idaho, New Mexico, Oklahoma, Kansas (senior citizens, the disabled, and families with children under 18 only), and South Dakota and Wyoming (seniors and the disabled only). *Id.* at 158. It is interesting to note that these eight states comprise almost half of the seventeen states that do not exempt food from the sales tax measure. Hamilton & Mikesell, *supra* note 16, at 29. Vermont is the only state to both issue a credit and exempt food. Gold, *supra* note 409, at 158-59.

Although this credit has gained some favor among states, the federal government repealed the income tax credit for state and local sales taxes in the Tax Reform Act of 1986, Pub. L. No. 99-514, § 134, 1986 U.S.C.A.N. (100 Stat.) 2085, 2116. This credit was previously available for state and local taxes that met a simple test (the tax had to apply at one rate to sales of a broad range of items). It was removed for several reasons, including the desire to (1) broaden the federal income tax base, (2) improve the consistency of the tax, (3) make the income tax more neutral by not favoring taxpayers with particular consumption patterns, and (4) simplifying the tax system. JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 46-48 (1986).

413. Ebel & Zimmerman, *supra* note 407, at 12.

414. Gold, *supra* note 409, at 159. Idaho is the only state without a sliding scale. *Id.*

415. *Id.*

416. DUE & MIKESSELL, *supra* note 35, at 75, 320 (noting that, “despite some defects, the [credit] system is greatly to be preferred to food exemption”); *but cf.* Surrey, *Tax Incentives*, *supra* note 95, at 734 (suggesting that, after an exhaustive comparison is made between a tax expenditure and a direct subsidy designed to perform the same function, it is “unlikely that clear advantages in the tax incentive method will be found”). This system could just as easily be utilized under any consumption-based tax, such as

B. Revising the Tax Structure

A more severe alternative is to scrap the existing system and create an entirely new system. Assuming a desire to utilize an alternative consumption-based tax, there are several options, including a value-added tax (VAT) or cash-flow tax.⁴¹⁷ Given the direction of commentaries and political current, the most likely option appears to be a VAT.⁴¹⁸

In terms of its basics, a VAT, like a sales tax, is collected and paid only by businesses. It is a combination of multiple-stage and single-stage taxes, the latter currently being the predominant form in the United States. Unlike a sales tax, however, the tax is calculated on the difference between gross receipts and the sum paid for materials and

a VAT. The arguments in its favor remain the same. See Metcalf, *VAT*, *supra* note 5, at 134.

417. The actual incidence of these taxes is quite similar among all consumption-type taxes and, in fact, depends more on the tax base (what is taxed?) than the actual structure of the tax (how is it levied?) or its administration (how is it collected?). The burden of a consumption tax falls on the ultimate consumer of the taxed items, regardless where in the production and/or distribution chain the tax is levied. From this standpoint, a retail sales tax and a VAT have substantially the same economic burden. JCT, PROPOSALS TO REPLACE THE FEDERAL INCOME TAX, *supra* note 4.

Using the definition of income as the "total value of rights exercised in the market, together with the accumulation of wealth in that period," or consumption plus the change in net wealth for the period, the only difference between a wage tax (such as the current income tax) and a consumption tax is that the tax base for the latter does not include savings. *Id.*

In the long-run, consumption taxes and wage taxes (especially purer versions such as a cash-flow tax which, in its simplest form, taxes wages less savings) are equivalent. However, if a new consumption tax is enacted, it will tax existing wealth because of the eventual use of savings on taxable consumption purchases. Thus, from the perspective of equivalency, a broad-based consumption tax is equivalent to a tax on wages plus a tax on income from existing capital used for consumption expenditures. *Id.*

For a detailed discussion of this topic, see DAVID F. BRADFORD, UNTANGLING THE INCOME TAX (1986). Professor Bradford takes a comprehensive look at the tax theories lurking (explicitly or implicitly) behind the federal income tax and the extent to which they conform to the realities of the system. He then argues that efforts to reform the income tax should place it on a consistent consumption basis, shifting away from existing accrual-income standards. *Id.*

418. In addition to the sources cited *supra* note 5 and throughout this section of the text, for a general survey of the economic, political, and technical issues surrounding the consideration, structuring, and implementation of a VAT in the United States, see THE VALUE ADDED TAX: ORTHODOXY AND NEW THINKING (Murray L. Weidenbaum et al. eds., 1989).

other inputs purchased from other tax-paying businesses. It applies to all stages of production and distribution, not just the final retail sale to the ultimate consumer. In theory, because the sum of the value added at various stages is equal to the retail selling price, the overall burden of the tax by commodity is the same as in a retail sales tax, all other factors being equal.⁴¹⁹

The VAT systems in place around the world, while sharing the same basic policy, do nonetheless vary in their particulars.⁴²⁰ The credit-invoice VAT is commonly referred to as a "European-style VAT" and is in place in the European Union countries and New Zealand. It requires a business to record the VAT separately on all sales invoices and allows a business to credit the tax paid on purchases or inputs (including imports) from the tax it owes on its outputs or sales.⁴²¹ The credit-subtraction VAT is the method utilized by the Japanese consumption tax. Output tax liability is calculated by extending taxable sales (exclusive of the tax rate) by the tax rate. Credits are calculated by multiplying the tax-inclusive costs of inputs by a fraction having the tax rate as the numerator and the tax rate plus 100 as the denominator.⁴²² A third method is the sales-subtraction VAT. Under this scenario, the tax base is calculated by reporting all taxable sales and deducting taxable purchases. This amount as a whole is then multiplied by the tax rate.⁴²³

From a jurisdictional perspective, almost all VAT's utilize the destination principle of taxation wherein goods and services are taxed

419. DUE, *supra* note 7, at 4-5.

420. See generally JOINT COMM. ON TAXATION, COMPARISON OF THE TAX SYSTEMS OF THE UNITED STATES, THE UNITED KINGDOM, GERMANY, AND JAPAN, 104th Cong., 1st Sess. (1995), reprinted in 92 TAX NOTES TODAY 148-1 (July 21, 1992), available in LEXIS, Taxana Library, TNT File; Metcalf, *VAT*, *supra* note 5.

421. Oldman & Schenk, *supra* note 5, at 1549; Hamond, *supra* note 5; see generally SCHENK, *VAT/U.K.*, *supra* note 5. This is the type of VAT selected by Professor Schenk in creating the model VAT statute for the American Bar Association Section on Taxation. SCHENK, *VAT MODEL STATUTE*, *supra* note 5.

422. Oldman & Schenk, *supra* note 5, at 1550. Japan also uses a very high small business exemption level of approximately \$300,000, meaning that those businesses with annual gross receipts less than \$300,000 are exempt from the tax. *Id.* at 1551. For firms paying the tax, input purchases include purchases from tax-exempt small business, but not purchases that are themselves exempt from the tax (such as education). *Id.* at 1550. For a practical and historical evaluation of the unique Japanese consumption tax, see Schenk, *Japanese Consumption Tax*, *supra* note 5.

423. Oldman & Schenk, *supra* note 5, at 1551. Because tax-inclusive sales and purchases are used, the tax rate necessary to achieve equivalence to a 10% European-style VAT is less, approximately 9.1%. *Id.* Under this scenario, administrative and compliance costs are greatly reduced because of the simplified reporting requirements. This method causes problems, however, when items are exempted or zero-rated. Hamond, *supra* note 5.

only in the country where they are consumed.⁴²⁴ Thus, exports are completely free of tax (that is, they are zero-rated) and all imports are subject to tax.⁴²⁵ Several unusual jurisdictional issues arise in the context of a VAT within the United States. First, as among states, application of the destination principle would alter the imposition of tax from the current system utilized in many states.⁴²⁶ Second, most countries that impose a VAT do not have political subdivisions that have the power to impose their own taxes, as do the several states.⁴²⁷ Taxation of consumption expenditures and/or retail sales on both a national and state level would create extraordinary administrative difficulties and could lead to animosity from state governments who view the adoption at the federal level of a VAT as an intrusion into their traditional sales tax domain.⁴²⁸

424. Oldman & Schenk, *supra* note 5, at 1552. The other option is the origin principle which results in the opposite tax treatment of exports and imports as under the destination principle. *Id.*

425. *Id.* The zero-rating of exports is not a preference. Rather, the export sales are beyond the jurisdictional reach of the taxing authority. *Id.* at 1558. The entity importing the property or providing the services is generally responsible for the tax liability. *Id.* at 1553.

From an international macroeconomic perspective, both a destination- and origin-based VAT are trade neutral. Under both principles, the relative prices of traded goods, assuming equilibrium, are the same as those that would prevail under free trade. Metcalf, *VAT*, *supra* note 5, at 130; David G. Raboy, *Value-Added Taxes and International Competitiveness*, in 4 ENTERPRISE ECONOMICS AND TAX REFORM: THE CASE FOR AND AGAINST VALUE-ADDED TAXATION (Robert J. Shapiro ed., 1995), reprinted in 95 TAX NOTES TODAY 146-74 (July 27, 1995) available in LEXIS, Taxana Library, TNT File.

426. See, e.g., CAL. REV. & TAX. CODE § 6010.5 (West 1987) (defining the place of sale and, hence, the place of application of the tax, as "the place where the property is physically located at the time the act constituting the sale or purchase . . . takes place"). This would not be a problem as regards use taxes, which generally tax the use or consumption within the State of goods purchased outside the State. See CAL. REV. & TAX. CODE §§ 6201 (imposing a tax on the "storage, use, or other consumption in this state of tangible personal property purchased from any retailer"), 6246 (noting a presumption that "tangible personal property shipped or brought to this State by the purchaser was purchased . . . for storage, use, or other consumption in this State") (West 1987 & Supp. 1996) (emphases added). This is consistent with the destination principle.

427. Oldman & Schenk, *supra* note 5, at 1564. The exception is Canada, where such a political system exists and where both the national government and the provinces tax sales. However, significant problems exist, including difficulty trying to harmonize multiple taxing systems, differing tax bases and rates among the provinces, and the associated costs of administering a national tax. *Id.* at 1564-65.

428. *Id.* at 1565; Hamond, *supra* note 5; see also Schenk, *Federal VAT*, *supra* note 5, at 291.

In general, a VAT does offer several advantages over a single-stage retail sales tax. First, the impact of the tax is spread over all firms instead of being concentrated only on retailers.⁴²⁹ Second, underreporting or evasion of taxes can be more easily determined because of the ability to cross-check returns filed by various businesses in the same production and distribution chain.⁴³⁰ Third, producers' goods are excluded from the measure of tax by deduction. This eliminates the interpretation and compliance problems inherent in a retail sales tax system, especially those distortions created when an item purchased by the retailer is considered for resale in one circumstance and for consumption by the retailer in another.⁴³¹

Objections to the VAT include the increased number of taxpayers and the somewhat more complicated task of determining tax liability.⁴³² In addition, it is more difficult to provide exemptions in the few cases where they are desired, mainly because the tax depends heavily on uniform, universal application.⁴³³ As with a sales tax, any exemptions granted will increase the administrative and compliance costs of the VAT, especially in the case where a business makes both taxable and tax-exempt sales.⁴³⁴

Administrative and compliance problems could be exacerbated should there be any divergence in national and state tax bases. It should, of course, be possible for states to "piggy-back" on a federal VAT or retail sales tax by adopting its tax base. This is similar to the way many states, California included, have adopted the federal government's income tax base to simplify state income tax collections. Hamond, *supra* note 5. Such efforts, while possible, would require extraordinary coordination and legislative cooperation.

429. DUE, *supra* note 7, at 4-5.

430. *Id.*; Hamond, *supra* note 5. The credit-invoice VAT method is often called "self-enforcing" because (1) the requirement to separately state the tax and the corresponding invoice trail makes it difficult to overcharge customers or overstate credits and (2) each firm has an incentive not to allow its suppliers to understate their tax liabilities so that it may receive the maximum credit for its own purchases. *Id.*

431. DUE, *supra* note 7, at 366.

432. Both of these criticisms, however, depend greatly on the structure of the tax. The number of tax-paying business can be substantially reduced by setting the reporting threshold at an appropriate level. See discussion *infra* note 437. Additionally, the difficulty of calculating and reporting the tax depends on the method selected.

433. DUE, *supra* note 7, at 366.

434. Oldman & Schenk, *supra* note 5, at 1559; Hamond, *supra* note 5 (observing that experience with sales tax in the states "should make one skeptical that the VAT's potential for being nondistortionary is likely to be realized in practice in an American political process"). Such exemptions also have international trade ramifications. If the exemptions are designed primarily to redress regressivity, the goods most likely impacted will be those that do not enter international trade. Preferences for exempt/non-traded goods will increase, thus causing a contraction in the traded goods sector and creating a distortion in relative prices. Raboy, *supra* note 425.

Absolute administrative and compliance costs under a VAT scenario vary greatly depending on a number of factors, including the breadth of the tax base, the rate structure, the number of exemptions, accounting and reporting requirements, and the threshold, if any, for small businesses.⁴³⁵ Total operating costs should be an important consideration in the design of any tax and, just as under a sales tax, a VAT's structural design and organizational framework can profoundly impact its efficiency.⁴³⁶ While estimates of overall costs vary, studies have consistently shown that smaller businesses are disproportionately impacted by a VAT.⁴³⁷ For both policy and efficiency reasons, any VAT design must therefore pay particular attention to its projected effect on such businesses.

Such a tax, while rare, is not entirely unknown in the United States. In addition to many federal and state proposals throughout the last few decades, Michigan passed the Single Business Tax Act in 1975, making it the first state in the country with a value-added tax variant in lieu of

435. See generally Cnossen, *supra* note 209. Professor Cnossen's article provides an excellent summary of studies conducted by the OECD, Treasury Department, KPMG Peat Marwick, General Accounting Office, IRS, and Congressional Budget Office. *Id.*

436. For example, in an OECD study, administrative costs of the VAT in selected countries ranged from a low of \$46 annually per registrant in New Zealand to a high of \$200 in the United Kingdom. *Id.* at 1611. Compliance costs ranged between 3.7% of tax collections for the U.K. and 7.3% for New Zealand. *Id.* at 1620.

As with the retail sales tax, numerous exemptions and(or) rates will substantially increase administrative costs. One study estimated that a more complex VAT with typical sales-tax-type exemptions would increase collection costs by between 30% and 50% over a single-rated VAT. Hamond, *supra* note 5.

437. For example, the VAT compliance costs measured as a percentage of sales for businesses in the U.K. with annual taxable sales of between \$50,000 and \$100,000 was 0.70% in 1986-87; for businesses with revenues between \$100,000 and \$1,000,000, the figure was 0.07%. Studies of other countries provide similar results. Compliance costs in New Zealand were 0.91% for small businesses as compared to 0.04% for larger businesses; for Canada, the numbers for small and large businesses were 0.39% and 0.06%, respectively. Cnossen, *supra* note 209, at 1624.

In addition to increased compliance costs attributable to small businesses, administrative costs are also adversely impacted because the number of potential vendors in this category is sizeable. Setting the threshold for reporting at a higher level can have significantly positive effects on administrative costs with little impact on revenue. For example, a General Accounting Office study estimated that applying a VAT in the United States to only those businesses with annual gross revenues greater than \$100,000 would decrease the number of tax-paying businesses from 24 million to 9 million. This decrease translated into an expected decrease in administrative costs of 33%, but only a 3% drop in tax revenues. Hamond, *supra* note 5.

more traditional business income and retail sales taxes.⁴³⁸ Like a retail sales tax, this tax is imposed upon businesses for the privilege of conducting business activity within the state.⁴³⁹ This tax replaced seven conventional business taxes with a single tax at the single low rate of 2.35 percent.⁴⁴⁰

Even though its measure of tax (gross receipts less deductions) is similar to an income tax, the Michigan tax has been held to be value-added tax.⁴⁴¹ From a policy standpoint, it is not an income tax⁴⁴² because it is designed to tax what a business has *added to* the economy, not that which is *derived from* the economy.⁴⁴³ The tax base is the “value added” by each business during its stage of production, defined as “the increase in the value of goods and services brought about by whatever a business does to them between the time of purchase and the time of sale,” whether in the same or altered form.⁴⁴⁴

438. MICH. COMP. LAWS ANN. § 208 (West 1986 & Supp. 1995) (Single Business Tax Act); see also Alan Schenk, *The Michigan Single Business Tax: A State Value Added Tax?*, 58 MICH. B.J. 392 (1979) (noting that Michigan “once again became an innovator in the field of state taxation”). For a comprehensive discussion of the mechanics of the tax, see John L. King et al., *The Michigan Single Business Tax Act*, 54 MICH. B.J. 677 (1975). King notes that the Michigan tax is a consumption variant of a VAT because it allows for full deduction of the purchase of investment goods (whether of the nature of tangible personal property or real property) in the month and year acquired. *Id.* at 678.

439. *Cowen v. Department of Treasury*, 516 N.W.2d 511, 513 (Mich. Ct. App. 1994).

440. Robert W. Haughey, *The Michigan Single Business Tax—Background and Objectives*, 55 MICH. B.J. 262 (1976). The taxes replaced were the corporate income tax, corporate franchise fee, financial institutions income tax, business portions of the intangibles tax, privilege taxes for domestic insurance companies and savings and loan associations, and the inventory portion of the property tax. *Id.* at 262 n.1.

441. *Trinova Corp. v. Department of Treasury*, 445 N.W.2d 428, 431 (Mich. 1989); *Cowen*, 516 N.W.2d at 513; *Guardian Indus. Corp. v. Department of Treasury*, 499 N.W.2d 349, 353 (Mich. Ct. App. 1993); *H.J. Heinz Co., Inc. v. Department of Treasury*, 494 N.W.2d 850, 851 (Mich. Ct. App. 1992). Although it was a bold departure from more traditional state tax schemes, it is not a “pure” value-added tax because of various exclusions, exemptions, and industry-specific adjustments adopted by the Legislature. *Trinova*, 445 N.W.2d at 431 n.6. The Haughey article argues, however, that the Single Business Tax adheres closely enough to the concept of a VAT that the economic consequences will be virtually identical. Also, he notes that specific deviations from the value-added concept in the Michigan tax are probably less than in most European VAT’s. Haughey, *supra* note 440, at 266.

442. *Stockler v. Department of Treasury*, 255 N.W.2d 718, 723 (Mich. Ct. App. 1977). Although Federal taxable income is the starting point for determining the tax base, it is possible that a taxpayer may have no income and still be subject to payment of state tax under the Michigan Single Business Tax. *Id.* at 723-24.

443. *Town & Country Dodge, Inc. v. Department of Treasury*, 325 N.W.2d 577, 580 (Mich. Ct. App. 1982).

444. *Trinova*, 445 N.W.2d at 431; accord *Cowen*, 516 N.W.2d at 513; see Haughey, *supra* note 440, at 262 (noting that this applies to processes that turn raw materials into finished products, retail operations that break bulk purchases into convenient sizes, or

Calls for radical reevaluation of the tax structure have increased in recent years. Most of these proposals have been on a national level and have focused primarily on a flat income tax, although there have been specific proposals for VAT variants and general discussion of a national retail sales tax.⁴⁴⁵ At one point during the recent Presidential election, it was characterized as the "hottest new issue" in the race⁴⁴⁶ and the "poster child of the anti-progressive income-tax movement,"⁴⁴⁷ engendering such rhetoric as Steve Forbes' cry that "the only way to fix [the federal tax code] is to junk it. Scrap it. Kill it."⁴⁴⁸ Most of the current proposals agree (at least in principal) on the need to overhaul the federal tax system and replace it with a simpler structure. After that, however, the plans differ significantly in their rates, allowable deductions, and other features.⁴⁴⁹ Still others are difficult to evaluate due to

the provision of services).

445. See discussion *supra* notes 4-7 (outlining recent proposals), 417 (discussing the incidence and equivalence aspects of these various taxes).

446. Birnbaum, *supra* note 4, at 34.

447. Finlay Lewis, *Anti-Tax Bandwagon Groans with Overload*, SAN DIEGO UNION-TRIB., Jan. 15, 1996, at A-13.

448. Steve Forbes, Address at the Flat Tax Conference 30 (Nov. 6, 1995) (transcript available from A.B. Laffer, V.A. Canto & Associates). Although his campaign was short-lived, Forbes clearly focused the race, at least among the Republicans, on tax reform. In that respect at least, he strongly influenced the course of the election.

While still the Senate Majority Leader, Bob Dole (along with House Speaker Newt Gingrich) selected Jack Kemp, "one of America's most innovative thinkers on economic policy," to chair a commission studying the national tax system. KEMP COMMISSION REPORT, *supra* note 4, at 414. In his Foreword to the commission's report, Dole noted that "[t]he current tax system is indefensible. It is overly complex, burdensome, and severely limits economic opportunity for all Americans." *Id.* He called for a "tax system that is fairer, flatter, and simpler." *Id.* Throughout the later stages of his campaign as the Republican nominee for President, he was fond of promising "to end the IRS as we know it." Bob Dole, Address Announcing Vice Presidential Running Mate (Aug. 10, 1996) in FED. DOC. CLEARING HOUSE POL. TRANSCRIPTS, Aug. 10, 1996. Demonstrating the importance of tax reform to his campaign and the election, Dole selected Jack Kemp, a "tax-cut champion," to be his Vice Presidential running mate. John Marelius & Mark Z. Barabak, *Kemp is Dole's Running Mate*, SAN DIEGO UNION-TRIB., Aug. 10, 1996, at A-1.

449. Compare Dan Goodgame, *Is This Tax Flat Unfair?*, TIME, Jan. 29, 1996, at 30-31 (outlining the plans put forth by former presidential candidates Steve Forbes, Senator Phil Gramm, and Pat Buchanan) and OFFICE OF TAX ANALYSIS, U.S. TREASURY DEP'T, "NEW" ARMEY-SHELBY FLAT TAX WOULD STILL LOSE MONEY, TREASURY FINDS, reprinted in 70 TAX NOTES 451 (1996) (giving a detailed analysis of the plan put forth by Rep. Dick Armeay and Sen. Richard Shelby) and John Godfrey, *A Progressive Flat Tax? Gephardt Says Yes*, 70 TAX NOTES 337 (1996) (outlining the proposal made by House Minority Leader Richard Gephardt) with JCT, PROPOSALS TO REPLACE THE

a lack of detail concerning their structure and explicit financial ramifications.⁴⁵⁰ Time will tell which, if any, of these proposals succeed.

On a state level, even the California Legislative Analyst, who spent much of the 1980's arguing for amending the existing sales tax system,⁴⁵¹ has suggested studying a VAT or "similar consumption-based tax."⁴⁵² One of the strongest recent proposals is the so-called Laffer-Canto plan that was before the Assembly Revenue and Taxation Committee during its last session.⁴⁵³ The stated purposes of the plan address, at least theoretically, many of the problems with the existing sales tax system and include the following:

- (a) To replace the various complex systems of taxation in California with a system the average person can understand. . . .
- (c) To reduce the cost of implementing the tax system and collecting taxes. . . .
- (e) To increase the stability of the tax law over long periods of time to make it possible for people and businesses to engage in long-range economic planning.⁴⁵⁴

Because such a measure involves a change in the tax structure, it requires an amendment to the California Constitution which must be approved by two-thirds of the voters in the State.⁴⁵⁵

INCOME TAX, *supra* note 4 (summarizing the present federal tax system, analyzing the major issues behind any tax reform, and reviewing current proposals, including a VAT, the Arney-Shelby proposal, the Specter proposal, the USA Tax, and a national retail sales tax).

450. See, e.g., KEMP COMMISSION REPORT, *supra* note 4.

451. See, e.g., 1983-84 BUDGET ANALYSIS, *supra* note 98, at 115-21 (including the matter of tax expenditure programs under the heading of "Major Fiscal Issues Facing the Legislature").

452. 1995-96 BUDGET ANALYSIS, *supra* note 22, at 132 (mentioning this as an alternative to the Governor's proposal to lower the rate of personal and business income taxes).

453. Cal. A.C.A. 29, 1995-96 Reg. Sess. At the time, it was simultaneously being circulated for signatures in an unsuccessful attempt to qualify directly as a November 1996 ballot initiative. Entitled the Personal and Business Flat Tax, it would replace all current income and sales taxes with only two taxes, a personal flat tax and a business flat tax. Although called a "flat tax" (assumably for political reasons), the business component is really a VAT. Canto & Laffer, *supra* note 4, at 2-5.

454. Canto & Laffer, *supra* note 4, at 1.

455. CAL. CONST. art. XIII A, §§ 3-4. Proposed amendments may be put on the ballot for a vote either by the Legislature (which requires a two-thirds vote in each house) or by initiative of the people. CAL. CONST. art. XVIII, §§ 1, 3. Ordinarily, a proposed amendment or revision only requires approval of a simple majority of the electorate. CAL. CONST. art. XVIII, § 4. Proposition 13, however, changed this by requiring approval by a two-thirds "super-majority" of the electorate concerning new tax matters. CAL. CONST. art. XIII A, § 4.

While tax schemes such as this may seem radical, they may actually have a better chance for passage than piecemeal attempts to “fix” the current system. Opposition is likely to be less fierce than in the situation where certain individual taxpayers or groups of taxpayers feel they have been singled out for increased taxation. More importantly, unlike five or ten years ago, there is a strong groundswell of support in favor of some alternative methods of taxation. Admittedly, the political reform elements of these proposals are as strong, if not stronger, than their tax policy and economic content.⁴⁵⁶

VI. CONCLUSION

The California retail sales tax, simple enough in its inception over sixty years ago, has grown into an inefficient, inequitable, and burdensome revenue-generating mechanism. If the State is serious about the tax policies that guided the initial implementation of the tax, the Governor and Legislature must work together to examine honestly and comprehensively the current structure and application of the tax.

While a retail sales tax may, in theory, provide a simple, equitable means for funding State activities, it has fallen far short of its original goals. The problem is principally one of a tax base that is too narrow. The tax accounts for a declining portion of the State’s revenues, largely because of the exclusion of services from the tax measure. That oversight will only lead to ever-dwindling tax revenues as the service sector of the State economy eclipses the historically dominant manufacturing and goods-producing sectors. In addition, the plethora of exemptions and exclusions not only directly impacts revenues, but leads to a tax system that is tremendously difficult, if not impossible, to understand and extremely costly to administer. These exemptions also illuminate those aspects of the tax system that are fundamentally unfair across industries. Ironically, the only area in which the sales tax has arguably succeeded is the area which engendered the most initial criticism, its equity. The relative progressivity of the sales tax, however, is a function not so much of the tax code itself, but rather of more sophisticated study of its application vertically among various income groups using lifetime income.

456. Sal Russo, Address at the Flat Tax Conference 10 (Nov. 6, 1995) (transcript available from A.B. Laffer, V.A. Canto & Associates).

While the solution to the State's tax dilemma may be *simple*, it will not be *easy*. And it will certainly not be without its vocal critics and organized opposition, most notably from those individuals and businesses who perceive they are being adversely affected. Creation and implementation of a plan will demand vision and leadership by our elected officials and their advisors combined with a genuine dedication to change. Such a plan may contemplate the selective study of currently non-taxed goods or services or it may suggest a profound recreation of the entire system. Regardless, the examination must take place and a solution must be found if the State is to return to the still-attainable goal of its earliest tax planners: a tax that is uniform, efficient, equitable, and fair.

ROBERT H. GLEASON