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Sent by Regular Mail and E-Mail
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Mr. Gerald Parsky, Chair
Commission on the 21st Century Economy
c/o State of California Department of Finance
915 L Street, 8th Floor
Sacramento, CA 95814

Dear Commissioner Parsky,

The undersigned, all experts in tax policy, are writing to share our views regarding the proposal for a new "business net receipts tax" (BNRT), as well as possible reforms to the California's retail sales tax (RST). It is our understanding that the Commission on the 21st Century Economy will be deciding how to proceed on these and other matters in the next few weeks. The purpose of this letter is not to comment on the full range of the Commission's recommendations, but rather to address the specific BNRT/RST options the Commission now faces. In our view, the most advisable course of action at this stage would be to recommend several key reforms to the RST but *not* to recommend adopting the BNRT. Among the signatories to this letter, we differ on whether the BNRT idea is sufficiently promising to warrant further consideration in future tax reform efforts. We all agree, however, that recommending the adoption of the BNRT at this stage would be highly imprudent.

1. *Proposed Business Net Receipts Tax*

Our concerns regarding the BNRT arise primarily from the numerous uncertainties relating to administration, compliance, legal challenges, and economic distortions of such a tax. As you know, there is almost no experience—in the United States or abroad—with an apportioned business net receipts tax of the sort under consideration by the Commission. What little experience there is with similar taxes (e.g., the "Single Business Tax" in effect in Michigan from 1976 to 2007) is not positive. This fact alone is not reason to reject the proposal outright, but the lack of practical experience with the BNRT necessarily limits our ability to evaluate the proposal according to standard tax policy criteria, especially within the time constraints your Commission faces. In most cases, fundamental tax reform is preceded by years of study, not months. To go forward with so little information and such minimal analysis significantly increases the likelihood of negative unintended consequences. Based on our understanding of the core design features of the BNRT, we have several specific reservations. We do not purport to offer an exhaustive analysis in this letter, but a few examples will give some sense of the nature of our concerns.

First, the BNRT purports to be a consumption-type "value-added tax," but it is likely to have economic effects that are far different from those of a conventional VAT of the type used in most countries. The typical VAT features border tax adjustments (i.e., the tax is imposed on imports and rebated on exports) and thus burdens only consumption occurring in the taxing jurisdiction. By contrast, the proposed BNRT apportions the tax base according to the share of each firm's sales into California, including sales to other businesses. The practical effect of this difference is that firms exporting goods and services produced in California will, to the extent that they purchase inputs from firms subject to the tax, have a BNRT cost embedded in their production process. As with the current RST, a firm's ability to pass this cost on to its non-California consumers will be limited. This illustrates a fundamental design flaw with the BNRT concept—apportionment (even single-factor sales apportionment) is not an adequate substitute for the type of border tax adjustments used in typical cross-border VAT designs.

In addition to the foregoing, the treatment of capital expenditures under the BNRT is likely to be a fertile source of administrative complexity and potential economic distortions. The most recent materials available from the Commission's website suggest that capital expenditures will be either (a) immediately expensed in the year in which the asset is placed in the service, or (b) subject to a cost recovery regime based on federal law, coupled with an interest payment designed to replicate the effects of expensing. We understand the dilemma the Commission faces on this important design feature of the BNRT. If expensing is allowed, taxpayers may attempt to manipulate the timing of their investments so as to minimize their BNRT liability—for example, by making year-end purchases to reduce their net receipts tax base. The depreciation-with-interest alternative seems intended to limit such game-playing but comes with its own problems, chief among them the considerable complexity such a provision would add to the proposal. Special problems may arise with regard to multistate firms, especially if the state seeks to limit the benefits of expensing to California investments. As discussed further below, any such limitation would likely be challenged on federal constitutional grounds. These lurking issues suggest that the BNRT's treatment of capital expenditures is likely to be one of the least stable features of the new regime, exacerbating uncertainty regarding business investment decisions. It bears noting that controversy surrounding the treatment of capital expenditures dogged Michigan's Single Business Tax from the outset and played no small role in the eventual repeal of the tax in 2007. It is not the sort of experience that California should replicate.

Yet another set of uncertainties relates to potential legal challenges to the proposed BNRT. Principal among these is the litigation that is likely to ensue if the BNRT incorporates an "economic nexus" requirement as suggested by the materials posted on the Commission's website. As you know, there has been substantial litigation over the past several years relating to the scope of the U.S. Supreme Court's 1992 decision in *Quill v. North Dakota*. That decision prohibited the states from imposing a use tax collection obligation on vendors without a physical presence in the state. Litigation in state courts since *Quill* has focused on whether the Court's prohibition extends to taxes other than the sales/use tax. Because this issue has not been resolved, firms subject to the BNRT but without a physical presence in California (e.g., Amazon) would likely challenge the tax on federal constitutional grounds. Another unresolved legal issue concerns the differential treatment of in-state and out-of-state investment. As noted in the previous paragraph, any attempt to limit the benefits of expensing (or its present value equivalent) to California investments would also likely result in federal constitutional challenges. As you know, this issue was raised in the *DaimlerChrysler v. Cuno* litigation before the U.S. Supreme Court, but was not resolved since the Court dismissed the case on standing grounds. As a result, any attempt to provide for differential treatment of in-state and out-of-state investments remains open to legal challenge. Finally, we note that, to the extent that BNRT is structured to look more like an income tax than a sales tax (e.g., by using depreciation instead of expensing), the state could face challenges under federal Public Law 86-272, which limits the state's ability to impose net income taxes on out-of-state firms. There is also some risk that a BNRT with income tax features could be challenged under the GATT. Of course the outcome of these legal challenges is by no means certain, but the costs and lingering uncertainty associated with protracted litigation are virtually guaranteed. Moreover, the state would be putting itself at risk for massive BNRT refunds in the event that lawsuits challenging the tax are successful. In our view, these legal risks counsel against the BNRT in favor a more cautious approach, including perhaps a recommendation for further study of the BNRT proposal.

Finally, it bears noting that any new tax, especially one with which there is so little practical experience, will be subject to aggressive tax planning in the early years, as taxpayers exploit as yet unidentified opportunities to minimize their tax liability. Some of these issues have already come to light in testimony before the Commission. For example, as several commentators have noted, the BNRT would create an incentive for firms to outsource work to independent contractors (for which a deduction is allowed) instead of hiring employees (for which a deduction is not allowed). This incentive is mitigated to the extent that firms to which the work is outsourced are subject to the BNRT; however, the $500,000 exemption reintroduces the incentive, encouraging firms subject to the BNRT to outsource work to firms not subject to the tax. (Japan has experienced precisely such a problem because of its small-business exemption in its subtraction-method VAT.) This example illustrates the difficulty of crafting a new tax regime from scratch. It may be possible to anticipate the most obvious tax avoidance strategies and address them in the initial legislation. Experience shows, however, that it is simply impossible to predict the many and varied strategies that taxpayers and their advisors will devise to minimize their taxes. Moreover, even if the most obvious strategies are anticipated, statutory fixes to address them may generate further planning and distortions in taxpayer behavior. Thus, adoption of the BNRT proposal should be thought of as the opening of a new front in the state's ongoing tax compliance efforts, along with a concomitant increase in planning costs and tax litigation. These are wasted resources and should be minimized in any effort at tax reform.

In summary, the BNRT is an intriguing proposal, perhaps worthy of consideration in future tax reform efforts, but there are numerous reasons to believe that this is the wrong course for the state to take at this stage.

2. *Proposed Reforms to the Retail Sales Tax*

Rather than recommending the BNRT, we believe the Commission should endorse three key reforms to the RST: (1) extension of the tax to cover selected retail services, (2) exemption for business purchases, subject to provisions to prevent avoidance for nonbusiness purchases, and (3) continued efforts to include cross-border retail purchases in the tax base to the extent allowable under federal law. We will not rehearse here the rationale for each of these reforms, nor do we mean to opine on the revenue consequences of this particular combination of proposals. These issues have been vetted at length in expert testimony before your Commission. We note simply that, unlike the BNRT, these are familiar, longstanding reform proposals about which there is nearly universal consensus among tax policy experts. Moreover, because of their familiarity, these reforms are suitable for immediate legislative consideration during the special session the Governor has said he will call to take up the Commission's recommendations.

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We are mindful of the numerous administrative, legal, and political obstacles involved in any effort to reform the state's tax system, and we understand the instinct to work from a clean slate. That said, we are skeptical that the BNRT would, as some have suggested, allow the state to accomplish indirectly reforms that cannot be accomplished directly. We believe that the best and most direct path to a broad-based personal consumption tax for California is to reform the RST in the manner described above. A fully modernized retail sales tax—one that reaches all personal consumption and eliminates the existing tax burden on business inputs—would represent a landmark reform of California's tax structure consistent with the principles set forth in the Governor's Executive Order establishing the Commission.

Sincerely,

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