The Contemporary Tax Journal

Volume 1
Issue 2 *Summer 2011*

Article 6

6-2011

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Recommended Citation

Yung, Linda; Kelly, Tim; Han, Sylvia; Luong, Vuong; Ross, Brian; Lim, Zhi Jun; and Lau, Victoria (2011) "Summaries from the TEI-SJSU Tax Policy Conference-- The State of Tax Policy in California," *The Contemporary Tax Journal*: Vol. 1 : Iss. 2 , Article 6.
https://doi.org/10.31979/2381-3679.2011.010206 https://scholarworks.sjsu.edu/sjsumstjournal/vol1/iss2/6

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Summaries from the TEI-SJSU Tax Policy Conference-- The State of Tax Policy in California

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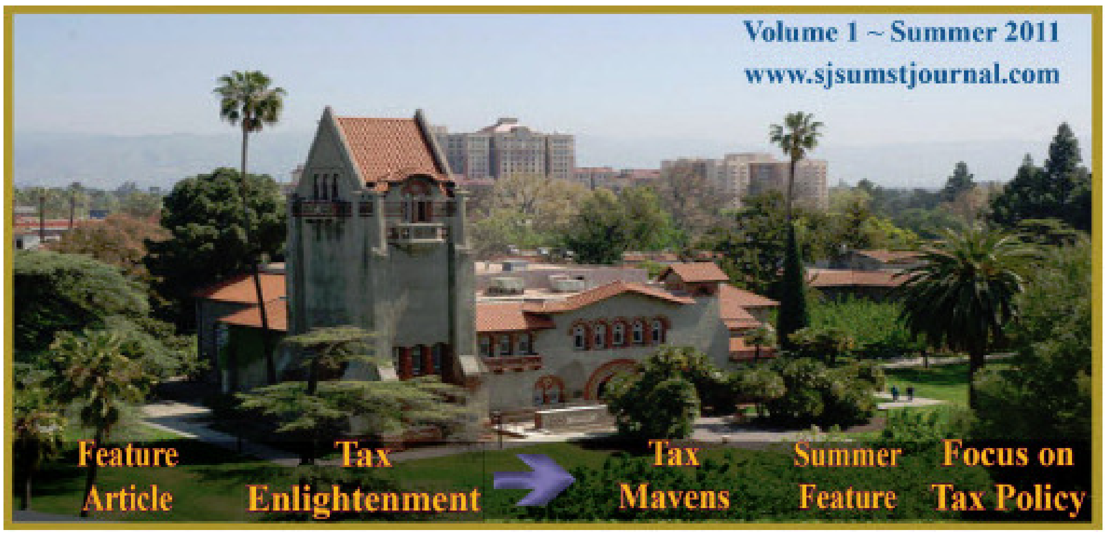
This feature is available in The Contemporary Tax Journal: https://scholarworks.sjsu.edu/sjsumstjournal/vol1/iss2/6

THE CONTEMPORARY TAX JOURNAL

A publication of the SJSU MST program



Volume 1, No. 2 ~ Summer 2011

http://www.sjsumstjournal.com

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Feature

The State of Tax Policy in California

A conference sponsored by the Tax Executives Institute, Inc. and SJSU College of Business

February 11, 2011

Topics covered:

Introduction
Understanding the California Economy
The California Business Climate
Principles of Sound State Tax Policy
The Challenged Relationship of California and Its Cities
Perspectives on the State of California's Budget, Tax Policy and Fiscal Reform
Relevance of the Feds
Looking Forward – The Final Session of the Conference

Introduction

On a beautiful Friday, February 11, 2011, the Santa Clara Valley Chapter of the Tax Executives Institute, Inc. and the MST Program within the Lucas Graduate School of Business at San José State University held a conference entitled, "The State of Tax Policy in California." This conference was held in Palo Alto, California. Tax professionals, local government officials and policy-makers were in attendance and to present on topics including California's current economy, tax climate, tax policy and possible tax reforms.

We encourage you to read the seven conference session summaries that follow to gain a better understanding of California's economic problems, possible solutions, and general guidance to avoid exacerbating the situation.

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DOI: 10.31979/2381-3679.2011.010206

Understanding the California Economy

By: Linda Yung, *MST Student*

I was among the fortunate SJSU MST students who had a chance to attend the conference. The topic I selected to cover *for The Contemporary Tax Journal* was "Understanding the California Economy" presented by Nancy Sidhu, Ph.D. Dr. Sidhu is Chief Economist of the Los Angeles County Economic Development Corporation (LAEDC), a private non-profit organization committed to assisting business firms and promoting job growth in Los Angeles. LAEDC produces economic publications that focus on forecasts of national, regional, and industry trends. Dr. Sidhu's analytical skills and experience have led to her many speaking engagements as well as appearances on network TV and radio stations.

In her presentation, Dr. Sidhu highlighted the economic recovery that is underway but emphasized that this recovery will be unlike the ones we had in the past. High unemployment might be a part of this recovery and many jobs simply might not return. In fact, many people still believe that the U.S. is still in a recession due to the high jobless rate.

According to Dr. Sidhu, while a number of key sectors are growing, construction, local government, and manufacturing are still weak. One reason for this might be related to the tighter lending standards now in place by banks, which has caused them to sit on much of the money that the Federal government made available to them in order to stimulate the U.S. economy. In California, the upturn started in 2010 but industry performances are mixed. For example, hotel occupancy rates are up but the room rates have remained stagnant. As another example, exports and imports are experiencing double-digit growth, as indicated by the numbers reported for "Total Cargo Handled at LA/LB Ports". However, the increases are due to businesses that had previously reduced inventory on hand and are now buying to restock their inventory to handle the increased level of business. The real question is whether this growth can be sustainable. Furthermore, there has been a sharp decline in personal income and taxable sales, which in turn has a negative effect on the state budget. California tax revenues are cyclical in nature because the basis of the revenue is

from highly cyclical sources: personal income tax and corporate tax revenue.

Economic Recovery: A Work in Progress

The United States and California have a long road to recovery and some important decisions to make. With the impacts of the federal stimulus program slowly declining, lawmakers will again need to revisit the spending issue. However, given that the new Congress is more fiscally conservative, recovery will most likely happen in the private sector. As indicated by Dr. Sidhu, all is not lost though; new innovations are continually being developed especially here in Silicon Valley. Further hope can be derived from the green movement, which is on track to not only help the environment but also generate new jobs. The overall 2011 economic outlook is positive even if it is slow and steady.

The California Business Climate

By: Tim Kelly, *Journal Editor, MST Student*

Announcing they were the "*grim"* panel of the day, Scott Hodge, President of the Tax Foundation, Dan Kostenbauder, Vice President – Tax Policy at Hewlett Packard, and Ray Rossi, Director of External Tax Affairs for Intel Corporation discussed various issues relevant to California's tax structure and how it affects its business climate.

Mr. Hodge got things started with a presentation titled "California Dreaming: A More Competitive Tax Climate?" A series of slides laid out a rather "*grim"* trend that does not bode well for California. Since 2000, California has lost 346,000 taxpayers to other states, mostly to Arizona, Oregon, Nevada and Texas. This exodus represents a loss of $26.3 billion adjusted gross income from the tax base. These losses also negatively affect other tax regimes such as property and sales. With a corporate tax rate of 8.84%, personal income tax rate as high as 10.55% and sales tax rates averaging 9.06%, Mr. Hodge asserted that California rates are among the nation's highest.

Using a method that looks at over 100 factors to assess the structure of a state's tax system, California ranks 49th on the Tax Foundation's State Business Tax Climate index. In addition, if you combine the federal and state corporate income tax, businesses in California face a higher rate than competitors in most OECD countries, China and Japan. What does Mr. Hodge suggest? (start looking for jobs in any other state -- except Illinois. Run now and don't look back, *see interview in Tax Mavens.*) He suggested following an approach similar to Colorado and Utah and

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DOI: 10.31979/2381-3679.2011.010206

lowering the corporate and individual rates to a uniform 5% and broadening the tax base by eliminating special incentives. Mr. Hodge noted studies from the OECD and others that indicate lower rates can lead to economic growth and may also encourage inbound foreign investment. He also cited research that places 45%-75% of the economic cost of corporate taxes on workers (suggesting that lowering rates will benefit workers). An additional point was made, that when capital flees, labor doesn't because labor is not as mobile.

Taking a somewhat less "*grim"* outlook, Mr. Rossi countered with some relevant points from the perspective of a CFO looking at investing in California. From a micro view, states need to offer incentives to targeted industries if they want them to locate in their state. Research tax incentives are important not only to differentiate between states but also to help compete globally. Mr. Rossi commented that California has a "first class" R&D credit. Additionally, targeted property and sales tax incentives are also critical to a CFO's decision to invest in plant and equipment in a given state. He also pointed out that California tax rules generally conform well to federal tax rules and that California tax administration is better relative to other states. Businesses located in California will pay less to resolve compliance issues compared to other states. Mr. Rossi concluded, "Uncertainty is the enemy of good business decisions."

Staying true to form, this panel's negative observations rolled over the positives for the future of California's business climate. They went home with the "*Grim Panel of the Day"* award. Judging from the response to the poll questions taken at the beginning and end of the conference (see *Looking Forward,* below) this panel's message dramatically changed the views of the attendees at the conference.

Principles of Sound State Tax Policy

By: Sylvia Han, *MST Student*

Professor Annette Nellen, CPA, Esq. Director of MST program of SJSU, as well as an organizer and host of this conference, gave a presentation on the principles and concepts of sound state tax policy.

Ms. Nellen's presentation was based on the AICPA's ten principles of good tax policy and the National Conference of State Legislature's (NCSL) nine principles of a high-quality revenue system. Those principles are summarized in the following table:

AICPA Principles		NCSL Principles	
Equity	Neutrality	Complementary of both state and local government	Efficient and effective administration
Certainty	Economic growth and efficiency	Reliable – stability, certainty and sufficiency	Responsive to interstate and international competition
Convenience to pay	Transparency, visibility and accountability	Balanced variety of sources	Neutrality
Economy of collection	Minimum Tax Gap	Equity & fairness	Accountable
Simplicity	Appropriate Government revenues	Facilitates compliance	

Ms. Nellen also incorporated the perspective of other groups' points on this topic. The Joint Venture: Silicon Valley Network groups the AICPA's ten principles into three categories: fairness, operability and appropriate purpose and goals. The Congressional Joint Committee on Taxation focuses on four questions to evaluate whether proposals represent good tax policy:

- Does the tax system promote or hinder economic efficiency?
- Is the tax system fair?
- Is the tax system simple?
- Is the tax system manageable?

The Government Accountability Office (GAO) adopted three criteria for evaluating tax policy: equity, economic efficiency and a combination of simplicity, transparency and manageability.

Ms. Nellen pointed out that although different tax authorities may use different terminology or have a different focus on their guidance in designing a tax system, the principles are typically the same. By nature, it is difficult for tax rules to meet all principles of good tax policy equally. In reality, a few may not be met in which case it is important to determine if other principles compensate to bring a good balance. The goals of tax reform include enhancing equity and fairness without creating complexity, reducing possibilities of both

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purposeful and inadvertent errors, making sure the public understands the laws and how they operate and ensuring that the system can raise the desired level of revenue.

The Challenged Relationship of California and Its Cities

By: Vuong Luong, *MST Student*

Michael Coleman, creator of CaliforniaCityFinance.com, and a principle fiscal policy advisor for the League of California Cities spoke during lunch. His presentation served to help attendees understand the various constraints that affect California's tax structure and its relationship with local governments. His discussion touched on Proposition 13 (1978), Assembly Bill 8 (1979), the Educational Revenue Augmentation Fund (ERAF) and their effects on California and its local governments.

Californian's opposition to property tax increases led to the passage of Proposition 13 in 1978. The law limits the amount of property tax that can be imposed and requires a two-thirds vote of the legislature for tax increases at the state level as well as a two-thirds vote by voters for special taxes at the local level. Properties were reassessed at 1975 values. The State was given the authority to allocate property tax revenue. This resulted in lower revenues on governments at all levels and restraints on their ability to increase taxes.

The drastic reduction in property tax revenue reduced the ability of local governments to properly fund primary education and resulted in enactment of Assembly Bill 8 (1979). Prior to Proposition 13, the majority of funds allocated to local schools came from property tax collections. To counter the unintended consequence of Proposition 13, AB 8 (1979) was enacted to shift state general funds to the schools.

The shifting of income strained the State's General Fund. In 1992, the Educational Revenue Augmentation Fund (ERAF) was created to earmark a portion of local property taxes to ensure adequate funding for schools. Local governments are required to apportion a larger share of their property taxes to fully fund ERAF.

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Mr. Coleman outlined some of the major changes that have shaped the current relationship between the State and local governments. The ability to generate, allocate, and provide appropriate revenue is essential to a healthy functional government. When the demand for public goods and services increases or when revenue declines due to economic cycles, governments must maintain or increase revenues. Generally, revenues are raised through taxes. Statutes must give authority to entities that can allocate resources more effectively or efficiently. According to Mr. Coleman, governments should have the capability to diversify the mixture of their taxes so they may appropriately predict revenues to ensure liquidity and solvency.

Local governments' rights and authority have shifted to the State. A large portion of their revenue is now collected and reapportioned by the state. Budget problems and a weak economy hinder them from adequately sustaining services for safety, education and welfare. The shift has left many local governments relying heavily on the state's budget, therefore impeding the proper planning and timing of their finances. Frustrated voters have enacted piecemeal reforms through the proposition process, instead of sustainable reforms. The two-thirds vote and limits on increasing property tax have restricted the government's ability to generate revenue to cover shortfalls.

The information and analysis given by Mr. Coleman covered only a small component of a very complex piece of California's tax policy. His presentation slides are located on the conference website at **http://www.tax-institute.com**. Included on the site are links recommended by Mr. Coleman for supplementary information on The Challenged Relationship of California and its Cities. Mr. Coleman's website can be found at http://www.californiacityfinance.com/.

Perspectives on the State of California's Budget, Tax Policy and Fiscal Reform

By: Brian Ross, *MST Student*

Three presenters with diverse background and experiences, but each with many years of devotion to taxation, shared their perspectives on various aspects of California's fiscal system and reform prospects.

Todd Robinson, Partner with Berger Lewis Accountancy Corporation in San Jose, CA and adjunct professor at San Jose State University, spoke about California's conformity with federal tax law as well as the tax burden imposed by California on its residents. On April 12, 2010 Governor Schwarzenegger signed SB 401 into law. This bill changed California's date of conformity with federal tax law from January 1, 2005 to January 1, 2009. Thus, California law conforms to most of the

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changes made during this four-year period. However, California remains two years behind since federal changes for 2009 and 2010 are not included in the conformity law. Some of the more common areas of non-conformity are section 179, bonus depreciation, and capital gains rates.

Mr. Robinson also briefly discussed the tax burden on California residents. The maximum individual income tax rate increased from 9.3% in 2009 to 9.55% in 2010. It is unclear what the rate for 2011 will be. Also, California ranks sixth in tax burden among all states as of 2008. New York, New Jersey and Connecticut are the top three states. The corporate tax rate was unchanged from 2009 to 2010 at 8.84%.

The Honorable Sidney Espinosa, Mayor of Palo Alto, spoke about the state of the City of Palo Alto, California. Palo Alto has a FY2011 budget of $139.4 million and employs about 1,000. Palo Alto is a very wealthy, highly educated, vibrant city. It is home to Hewlett Packard, Tesla, Skype, and many well-known law firms. During the day the city doubles in size due to commuters. The household median income exceeds $100,000. Espinosa mentioned how impressed he was by the high level of knowledge of city issues demonstrated by Palo Alto residents at city council meetings.

Nevertheless, the city is still suffering the effects of the Great Recession. For FY2011 there is an expected deficit of $7.3 million. The two largest sources of revenue are sales and property tax. Together they account for one-third of city's revenue. Both of these taxes are highly cyclical. They go up significantly in boom times and can take a bigger dive in a bust economy. The city has been forced to lay off some full time employees and streamline various departments.

Dean Andal, a former state legislator from Stockton, CA now with PwC, claimed that many people cannot see the connection between the taxes they pay and the services they receive. He also stated that the group with the biggest political impact in the state is the California Teachers Association. They are highly influential in establishing the state budget--42% of the budget is for K thru 12 and another 9% is spent at the collegiate level. Finally, 37% of property taxes are allocated to public school systems. Mr. Andal believes that the state must get wealthier in order to distribute more money to schools.

Relevance of the Feds

By: Zhi Jun Lim, *MST Student*

Amidst a trillion-dollar federal budget deficit and a jobless economic recovery, a panel of three tax experts weighed in on interrelated tax policy issues affecting both the Federal government and states. The highlighted topics included the ideal level of federal tax policy conformity by California legislators, the sufficiency of nexus including the state's authority to tax remote businesses as well as impose sales and use tax (SUT) collection obligations on such businesses,

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and finally, the possibility of a federal level Value-Added Tax (VAT) and how it might impact California.

Federal Tax conformity and California

Oksana G. Jaffe covered conformity, the challenge of achieving conformity and some considerations of how federal tax law and proposals affect California. Ms. Jaffe is the Chief Consultant of the California Assembly Committee on Revenue and Taxation. In her role, she is responsible for analyzing legislation, providing technical assistance on tax law matters, supporting the annual budget process, reviewing tax issues in hearings, and acting as a liaison with state tax agencies.

The right degree of conformity with Federal tax policies was among the highlights in the panel's presentations. It is generally agreed that all states, including California, need to find the right balance between full conformity that promotes uniformity and simplicity, and selective conformity that preserves the state's autonomy over its tax revenues.

As a "selective" conformity state, California has been late in adopting Federal tax policies and provisions. And with the recent enactment of Proposition 26, requiring a two-thirds supermajority vote for any new fees or taxes in California, conformity efforts will be further forestalled. Consequently, this lack of uniformity can present increasing compliance challenges for taxpayers and administrative difficulties for California's Franchise Tax Board (FTB).

Specifically, the widening difference between federal and state tax provisions may lead to increased complexity for taxpayers struggling to comply with two different sets of rules. To further the complications, often the same terms used under the federal and state tax law can be defined very differently. An additional obstacle to setting the correct conformity level is the substantial risk of tax avoidance by taxpayers who may choose to manipulate the difference between the federal and state tax provisions to their advantage.

Even so, full conformity with federal tax policies is not entirely desirable. There are issues such as the loss of legislative autonomy over state tax policies and the potential volatility of state tax revenues that still need to be addressed.

State nexus issues on state sales tax and business activity taxes.

The second topic centered upon two recent federal bills proposed to address nexus requirements and to stem the state tax gap. Carley A. Roberts, a Partner at Morrison & Foerster in Sacramento, CA discussed this topic. Ms. Roberts' practice focuses on tax planning and tax litigation on state and local tax matters. She is also the Chair of the Taxation Section of the California State Bar.

The first bill H.R. 5660 (111th Congress), seeks to expand nexus requirements and impose the obligation on remote businesses such as pure online retailers, to collect state SUT. This bill seeks

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DOI: 10.31979/2381-3679.2011.010206

to preserve a level playing field between traditional brick-and-mortar enterprises and online retailers. It will also serve to close one of California's largest tax gaps, the Use tax. However, recognizing that this compliance burden could significantly hamper inter-state commerce activities, the bill provides for a small seller exception. Additionally, businesses must meet 18 "minimum specification requirements" before the obligation to collect SUT is imposed on them.

The second bill, H.R. 1083 (111th Congress), will clearly delineate whether and when a state can collect "business activity taxes" from a remote business. It begins by modernizing P.L. 86-272, applying the rule to all sales transactions and not merely sale of tangible personal goods. The bill also clearly defines "physical presence" and establishes a "physical presence nexus standard" in an attempt to promote an equitable business environment and reduce disputes that can lead to costly litigation. However, to avoid an excessive compliance burden, certain activities such as solicitation will be exempted and a *de minimis* physical presence safe harbor will be established.

The possibility of a federal VAT

The final issue dealt with the possibility of a federal VAT and its impact on California and other states. This topic was presented by Pat Powers, a Partner and the US Chair of the State and Local Tax Practice at Baker & Mckenzie in Palo Alto, CA. His practice focuses on general tax planning including global tax minimization, tax litigation and state tax planning.

While most other developed nations have adopted some form of VAT, the United States has not caught on with this trend. The prominence of a VAT is attributed to its low administrative cost, efficient revenue collection and high compliance rates. In addition, its credit-invoice mechanism is considered superior to the current sales and use tax regime because a VAT eliminates pyramiding issues and assists auditing and enforcement efforts.

High levels of federal debt and a ballooning budget deficit prompted call for consideration of both cost cutting and tax hikes. However, with the maximum federal income tax rates at 35%, further tax rate increases will find little support. This paves the way for proposals for a new federal level consumption tax regime, such as a VAT.

Despite the strong credentials of the internationally used VAT system, states will face more than mere administrative challenges integrating with a federal VAT. First, the encroachment by the federal VAT into the state sales and use tax base could further strain state tax revenues. Second, removal of the state sales tax regime and piggybacking on the federal VAT base will significantly erode state legislative autonomy. If such a federal VAT were indeed adopted, both issues would need to be addressed by striking the right balance between preserving state fiscal independence and conforming to the federal VAT regime.

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Looking Forward – The Final Session of the Conference

By: Victoria Lau, *MST Student*

Looking Forward was the final session of "The State of Tax Policy in California" Tax Conference. Kim Reeder, Partner with Morgan Lewis in Palo Alto, CA started the session by

recapping key messages from presenters and panelists during the day. This was followed by an open forum for participants to comment and suggest ways to move forward. Lastly, Annette Nellen from San José State University polled the audience again on questions first asked at the beginning of the day to gauge changes in opinions.

The summary of this final session highlights three notable comments made during the open forum and presents the polling questions where audience responses shifted between the beginning and the end of the conference.

The first of the three notable comments was from an attendee question of whether term limits affect the quality and attention of state legislators. In 1990, Californians voted Proposition 140 into law to limit state legislators to serve a maximum of three terms in the Assembly and two terms in the Senate (assembly members have two-year terms and senators have four-year terms). An attendee responded that term limits have hurt the legislative process because key people with knowledge are not there. He believed that the lack of continuity has empowered staff members who may have their own agenda. In addition, it has made lobbyists more powerful as new legislators place more reliance on them to draft bills. He also observed that in 1992, the state experienced a unique economic crisis with a recession compounded by a shrinking defense industry. During that period, the legislators put aside bipartisanship and worked through the issues together. The reason suggested by the attendee as to why such collaboration was feasible in 1992 but not today is that the legislators had long-term relationships with each other. Term limits have reduced the opportunities for legislators across party lines to forge these relationships. Another attendee added that members are commonly perceived to be only effective in forwarding issues during their second term because they need the first term to find their ways in the legislature and their third term is focused on finding new jobs.

The second notable comment was made by an attendee who believed that computerization of redistricting has a more significant impact than term limits. He commented that redistricting is now a science and redistricted seats do not change parties. In the 2010 general election, only one of the eighty contested Assembly Districts changed party. The background to redistricting is that the federal and state governments adjust the boundary lines of districts following each decennial federal census for population change. The use of computerized redistricting software was first

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introduced in the 1960s. However, for the 2010 round of redistricting, the costs of this software has significantly decreased while the technology has advanced such that complex analysis can be performed by users with limited training.

Until 2008, redistricting in California was introduced as bills in the legislature for passage into law. In the 2008 general election, California voters passed Proposition 11 to create the independent Citizens Redistricting Commission to be responsible for drawing district lines for State Senate, Assembly and State Board of Equalization. Voters further approved Proposition 20 in November 2010 to add Congressional districts to the Commission's control. The attendee added that because seats do not change parties, primaries are where the 2012 elections will be decided.

The last of the three notable observations tied into the state nexus issues covered by the Relevance of the Feds panel. In the open forum, one participant noted that it was "ironic" that these bills relating to state taxes are heard by the House and Senate Judiciary Committees and not by the House Ways and Means and Senate Finance Committees that handle federal taxes. The Judiciary Committees have oversight for state compacts, or agreements; so that may be the reason why they have responsibilities for the nexus bills. The concern raised by the participant was that these committees might not have state taxes as their priority.

After the open forum, Ms. Nellen polled the audience with the same questions asked at the beginning of the day to rate participants understanding of California's tax and fiscal system. Responses to two questions significantly shifted in the afternoon. The first was on whether California has a good business climate. In the afternoon polling, 86% of the participants said "no" which was much higher than the morning polling. The second question followed the same dire outlook. In the morning, less than half of the participants placed California's business climate in the bottom quintile amongst the states. In the afternoon polling, almost all participants placed California in the bottom two quintiles and 56% place the State in the bottom 20%.

Ms. Nellen polled one additional question before closing the conference: Who is responsible for solving California's fiscal problems? Of the available options of elected officials, voters, businesses, and all of the above; 80% of the audience chose all of the above. Ms. Nellen and Ms. Reeder reiterated one key purpose of the conference, which is for participants to learn more about the issues so they can educate others and help the State address the problems.