

Tax Reform Proposals Seek to Solve California's Financial Crisis

Summary

Background

One of the recurring criticisms of California's current tax system is its volatility. Critics complain that there is not enough consistency with the amount of revenue generated, which has created and/or contributed to the significant deficit California is facing. On November 10, 2010, the Legislative Analyst's Office (LAO) released a report that stated California will face at least a \$25.4 billion deficit by the time the 2011–2012 budget is passed. The LAO also stated that it anticipates this deficit will continue by approximately \$20 billion each year. On December 6, 2010, the regular session for the Legislature reconvened. Shortly thereafter, Governor Arnold Schwarzenegger declared a fiscal emergency for the State of California and called a special legislative session to deal with the budget deficit pursuant to his authority under Proposition 58. The Legislature has 45 days to act on the budget problem during this special session.

The dismal outlook on California's financial stability may motivate the Legislature to re-evaluate the current tax system during either the special session or regular session, in order to identify ways in which revenue can be increased and maintained at a steadier pace. Below are revenue-generating ideas that have been raised in the past and may appear again as a part of a potential tax reform bill this session.

Business Net Receipts Tax

In October 2008, Governor Schwarzenegger and Assembly Speaker Karen Bass (D-Los Angeles) created the bipartisan Commission on the 21st Century Economy to evaluate the state tax system and provide recommendations for modernizing the system and decreasing volatility. On September 29, 2009, this commission released its final report, which included a proposal to institute the Business Net Receipts Tax (BNRT) while eliminating the corporate income tax and reducing the personal income tax.

The basic way in which the BNRT would work is as follows: the business's gross receipts minus the business's purchases equals net receipts. The net receipts would then be taxed at a set rate, which the commission proposed to not exceed 4 percent. The BNRT would essentially apply to any business entity doing business in California, and would include gross receipts from the sale of any goods, performance of services, or use of property or capital. The corporate tax, which is currently at 8.84 percent, would be eliminated and the personal income tax would be simplified.

Proponents of the BNRT claimed it was a destination-based tax for multi-state businesses and therefore could capture more revenue. Businesses had numerous concerns with BNRT and its application, however.

For example, there were many unanswered questions regarding a rate cap, as well as who would have the authority to set the BNRT rate. There also was a lack of data that the BNRT would be better at minimizing volatility than the current system. Additionally, there were concerns that the BNRT would unfairly impact small businesses and start-up companies that have minimal profits. Moreover, the BNRT would result in a tax on employees, as no deduction was specified for cost of employees.

Given these concerns, the business community urged the commission and the Legislature to conduct a further analysis of the BNRT before moving forward with any recommendations.

Although the recommendations of the commission regarding BNRT ultimately were never adopted by the Legislature, BNRT or a similar tax formula that tries to capture additional revenue from more multi-state businesses may be considered this legislative session. Businesses should be contemplating how to deal with such proposals, like BNRT, in case the Legislature raises this as a revenue solution.

Services Tax

Historically, services generally have not been taxed in California. Yet, the discussion of doing so has been brewing for several years.

During his tenure, Governor Gray Davis created the California Commission on Tax Policy in the New Economy, which issued a final report in December 2003 that included a proposal to expand the sales tax base to certain services, but yet reduce the sales tax rate.

In 2008, Governor Schwarzenegger proposed to tax various services, such as veterinary services, amusement parks, furniture repair, vehicle repair and golf, as a new source for additional revenue in the special budget session.

In 2009, the Commission on the 21st Century Economy proposal for BNRT included taxing services, as discussed above. In 2010, the budget trailer bill, AB 1612 (Committee on Budget; Chapter 725) imposed a tax on in-home supportive services, the proceeds of which will be used to obtain additional federal funding to assist in-home supportive services providers.

Other than AB 1612, however, no proposed legislation has developed yet to impose a tax on services in general, in part due to the business community's voiced concerns to the Legislature about the negative impact a general services tax could have on job growth, economic growth and investment appeal to out-of-state companies. With a new administration and the growing deficit, however, expanding the sales tax to services as a potential new source of revenue may be perceived by some lawmakers as a viable option when trying to deal with the current revenue crisis facing California.

Streamlined Sales and Use Tax Agreement (SSUTA)

The Streamlined Sales and Use Tax Agreement (SSUTA) is a collaborative effort amongst various states to simplify the application and collection of sales and use tax for retailers and the participating states. The need for a uniform, federal solution was due to the fact that traditional brick-and-mortar stores were losing out on a significant amount of sales to Internet retailers because the brick-and-mortar stores had to collect sales tax from their customers, while remote sellers did not.

In order to level the playing field and make it fair for all competitors, various states created the SSUTA. The SSUTA creates a uniform and more simplistic tax system in several ways: 1) uniform definitions that define services and products for all participating states; 2) limit of one state tax rate, except in limited circumstances, and one local tax rate; 3) identification of local tax rates by jurisdiction; 4) uniform sourcing rules so that businesses do not have to fear being taxed twice by two different states for the same sale; 5) uniform tax exemption administration that places the burden on the purchaser who incorrectly claims an exemption; and 6) state funding of all administrative costs incurred by businesses for tax collection.

Twenty-three states have passed legislation to conform to the requirements of the SSUTA. California is not among those 23 states. In 2003, Governor Gray Davis signed legislation to allow California to vote as a member of the Streamlined Sales and Use Tax Project, which contributed to the development of the SSUTA. However, the Commission on Tax Policy in the New Economy, created by Governor Davis, decided that further analysis was needed to determine if joining the SSUTA and introducing conforming legislation was a good idea for California.

One of the commission's main concerns was the ability to obtain a level playing field for all retailers, without obtaining federal reform. Despite such concerns in the past, the idea of participating in the SSUTA has resurfaced. Various organizations are considering the possibility of asking the Legislature to introduce a conforming bill to join the SSUTA as a way of dealing, not only with collecting use tax, but also simplifying the variation of tax rates amongst local jurisdictions so that more individuals and companies can understand and comply with their tax obligations.

Flat Rate Tax System

When recently elected Governor Jerry Brown ran for the presidency in 1992, he proposed a flat rate tax system. A basic flat rate tax system is one in which all income and/or profits are taxed at one rate, with limited deductions or loopholes. In 1992, Brown proposed a flat tax rate at 13 percent for personal income and a 13 percent value-added tax applied at each stage of production and/or distribution of goods, with credits provided for the portion of taxes paid by the prior distributor/producer.

The only deductions under Brown's plan were for mortgage interest, charitable donations and rent (a new deduction). Moreover, there was no payroll tax, no gasoline tax, no estate tax, and a partial abolishment of the capital gains tax. The theory behind such a basic system is it would encourage more compliance and impose less of an administrative burden or cost. Brown commented during this 1992 presidential campaign that personal taxes would be so easy to compute under a flat rate tax system that it could be done on a postcard.

At the time Brown proposed this idea, it did not gain much support from either party. Many complained that it would place too much of the tax burden on the poor and would not generate as

much revenue as the tax system in place. Since Brown's re-election in 2010 as California Governor, this old idea is the subject of new enthusiasm as a potential way to solve California's financial crisis. Many political commentators recently have speculated that Governor Brown will propose a flat rate tax system as a solution for the budget deficit when he takes over California in January 2011.

**CalChamber
Position**

Although the California Chamber of Commerce is not opposed to evaluating tax reform ideas that would simplify the system for taxpayers and create consistent revenue, the CalChamber does not believe this should be the only focal point for trying to solve California's financial problems.

**Reasons for
Position**

- A primary source of California's deficit is due in large part to the government's spending habits, rather than the amount of revenue generated from overburdened taxpayers.
- The Legislature should focus on reining in its spending to reduce the deficit.
- The Legislature should create a more secure rainy day fund for periods of economic downturn.

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