

Continuing Budget Crisis

What Employers Should Expect on Tax Front in 2011

Last October, the California Legislature passed the 2010–11 budget a record 100 days late, but within a matter of weeks, the annual forecast put out by the Legislative Analyst’s Office (LAO) suggested it was already \$6.1 billion out of balance, and predicted lawmakers would need to address a total deficit of \$25.4 billion by the time they enact a budget for 2011–12.

According to Legislative Analyst Mac Taylor, “without immediate action to begin tackling the structural deficit for the long term, the state may not be able in the foreseeable future to move beyond its current stumble from one terrible budget problem to the next.” He also warned that budget solutions in 2011 need to be “real,” not just one-time temporary solutions like those adopted in the 2010 budget. The Department of Finance estimates that in the last three budget rounds, 75-85 percent of each year’s deficit solutions have been either short-term fixes or ones that never materialized.

On December 6, 2010, out-going Governor Arnold Schwarzenegger responded to these dire projections by convening a special session to address the shortfall for the 2010–11 tax year, using his authority under Proposition 58. This initiative allows the Governor to declare a fiscal emergency under certain circumstances, and to propose legislation to address that emergency. The Legislature, in turn, must suspend its other activities and take action on the proposal within 45 days.

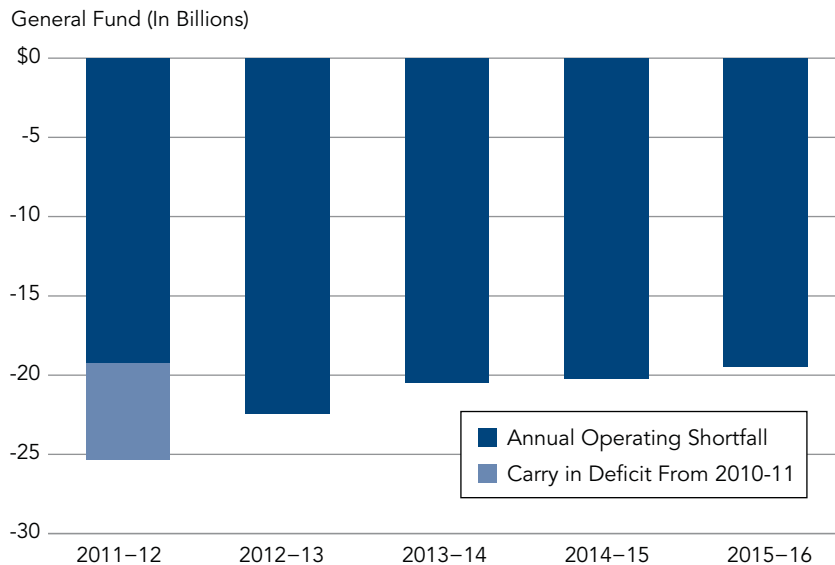
Two days after the start of the special session, Governor-Elect Jerry Brown held the first of several planned budget summits, convening state policy makers to publicly discuss potential budget solutions. During his introduction, he shared updated estimates that showed the two-year deficit could run as high as \$28.1 billion.

Although few are surprised that California’s budget problems are not over, many are wondering where lawmakers will turn in their efforts to close the ongoing budget gap. Over the last three

budget cycles, Californians already have seen an array of tax increases and spending cuts, and California employers alone having sustained more than \$11 billion in tax increases, accelerations and penalties—yet the state continues to face record deficits. In addition, a number of legislative proposals in 2010 would have curbed the availability of business tax incentives in the future, creating even more uncertainty for employers.

Employers’ concerns with the state’s business tax climate also are reinforced by California’s persistent rock-bottom rankings in multiple, well-respected national comparisons. For example, California ranked 49th in the 2010 Tax Foundation State Business Tax Climate Index, 48th in the 2010 Best to

Huge Operating Budget Shortfalls Predicted Throughout Forecast Period



Source: Legislative Analyst’s Office (November 2010)

Worst Tax Systems for Entrepreneurship and Small Business, 39th overall, and 44th for business costs in *Forbes* magazine's 2010 Best States for Business and Careers, and *CEO Magazine's* 2010 Best and Worst States for Business put California at the very bottom. Given this reality, employers are understandably worried they will be targeted with unfavorable tax changes in the coming year.

The California Chamber of Commerce has consistently argued that boosting the economy, rather than trying to squeeze a few more dollars from struggling businesses, is the only way to protect the state's necessary programs and services in the long term. This requires policy makers to work proactively to encourage employers to locate, invest and hire in California by creating a predictable and competitive tax and regulatory environment for businesses.

In addition, there must be a restoration of the public's trust in the state's stewardship of taxpayer dollars through transparency, spending restraint and accountability. Without such action, California will continue to lose jobs and revenue to other states with the foresight to recognize that their citizens are the real winners when businesses thrive.

CalChamber Position

The CalChamber supports sound tax policies that foster investment and respect the proper balance between the need to sustain necessary government programs with the need to maintain and grow a strong economy.

Overview of Major 2010 Legislative Tax Changes

To appreciate what employers can expect to see on the tax front in 2011, it is important to understand what tax developments already have occurred as part of recent budget deals. One significant change is that budget negotiations no longer take place on a predictable, annual timeline, but are re-opened multiple times each year as cash flow issues arise. In fact, in the last three years, budgets and/or budget fixes have been enacted in September 2008, February 2009, July 2009, February 2010 and October 2010, with a special session called in December 2010 to address the shortfalls already arising after the last deal.

While the results of the November 2010 election (discussed below) will make it easier for legislators to pass budgets in the future, this trend of multi-annual budget negotiations is likely to continue into the foreseeable future given the ongoing deficits projected for the state.

In addition, a host of solutions affecting business taxes already have been implemented to plug recent budget gaps, limiting the options that remain for the Legislature to use in balancing future budgets. For a summary of all the business tax changes from recent budget agreements, refer to the chart later in this article. The following is a discussion of the major tax changes adopted in October 2010:

Net Operating Loss Deductions Suspended

In September 2008, the Legislature adopted several significant economic stimulus proposals, including the addition of a net operating loss (NOL) carryback deduction,

California Business Climate Consistently Ranks at Bottom in State Comparisons



and an extension of the NOL carryover deduction from 10 to 20 years. Together, these deductions make it possible for businesses to more evenly distribute their losses, helping to moderate the effect of California's high corporate income tax rate and keep struggling businesses afloat.

In order to give the economy time to recover, these changes were enacted with delayed implementation dates, and were scheduled to apply beginning in tax years 2010 and 2011. This past October, however, faced with a continuing budget crisis and another huge deficit, the Legislature suspended both for two years for businesses with an annual income of \$300,000 or more.

For many employers who already have waited two years to take advantage of these deductions, this suspension is a major blow. It undermines confidence in the state's tax rules and will result in significantly higher tax bills than many had been anticipating or can afford. For some it will even result in the closing of their doors and/or relocation to a neighboring state.

Corporate Understatement Penalty Fix

Also in September 2008, the Legislature adopted a corporate understatement penalty that threatened large employers with a 20 percent strict-liability penalty for miscalculations of tax liability over a certain size. Due to the unforgiving nature of the penalty, employers were forced to overpay their taxes before an "amnesty" deadline to ensure they would not incur the penalty. Although employers are allowed to request refunds for overpayment once their tax liability is settled, the process often can take years due to

Employer Tax Law and Changes of 2008–2010

September 2008 Budget: \$7.4 Billion Over 2 Years

1. **Corporate Understatement Penalty Punishes Reasonable Tax Disputes (SBX1 28):** Estimated to raise more than \$2.5 billion from employers as of June 1, 2009. Effective: Retroactive to 2003, May 31, 2009 “amnesty” deadline, permanently thereafter.
2. **50 Percent Limit on Research and Development Tax Credit and Enterprise Zone Program Credits (AB 1452):** Estimated to raise \$900 million from employers. Effective: Tax years 2008 and 2009.

Offsetting Improvement: **Tax credit sharing (SBX1 28).** Effective: January 2010 and permanently thereafter.

3. **Suspension of Net Operating Loss Deduction (AB 1452):** Estimated to raise \$1.6 billion over two years. Effective date: Tax years 2008 and 2009.
- Offsetting Improvement: **2-year Carryback and Expanded 20-year Carryover (from 10 years)** in partial conformity with federal law. Effective: January 2011 and 2010, respectively, and permanently thereafter.

4. **Accelerated Estimated Tax Payments (SBX1 28):** Estimated to accelerate \$2.3 billion over two years. Effective: January 2009 and permanently thereafter.
5. **Accelerated Limited Liability Company Fee and New Penalties (AB 1452):** Estimated to accelerate \$360 million from employers. Effective: January 2009 and permanently thereafter.

February 2009 Tax Increases—\$12.5 Billion Over 2 Years

1. **Sales and Use Tax Rate Increase of 1 Percent (ABX3 3):** Estimated to raise over \$6 billion (\$2.4 billion coming from employers). Effective: April 1, 2009 for two years.
2. **Vehicle License Fee Increase (ABX3 3):** Estimated to raise \$1.7 billion (\$425 million from employers). Effective: May 19, 2009 for two years.
3. **Personal Income Tax Rate Increase of .25 Percent (ABX3 3):** Estimated to raise \$6 billion (\$2 billion from employers). Effective: January 1, 2009 for two years.
4. **Tax Apportionment Changes (ABX3 15):** Estimated to

raise unspecified sum in \$ millions from employers. Effective: January 1, 2011 and permanently thereafter.

Offsetting Improvements:

- **Elective Single Sales Factor (ABX3 15):** Effective: January 1, 2011 and permanently thereafter.
- **Motion Picture Credit (ABX3 15):** Effective: January 1, 2011, but applies to tax years 2009 through 2013.
- **Small Business Hiring Credit (ABX3 15):** Effective: January 1, 2009 until \$400 million used up.

July 2009 Budget: \$3.5 Billion Over 2 Years

1. **Accelerated Estimated Tax Payments (ABX4 17):** Estimated to accelerate \$700 million. Effective: Tax years 2009 and 2010.
2. **10 Percent Income Tax Withholding Increase (ABX4 17):** Estimated to accelerate \$1.8 billion. Effective: November 1, 2009 and permanently thereafter.
3. **Backup Withholding Mandate (ABX4 18):** Estimated to raise \$64 million. Effective: January 1, 2010 and permanently thereafter.
4. **Use Tax Registration/Reporting (ABX4 18):** Estimated to raise \$149 million. Effective: April 15, 2010 and permanently thereafter.

February 2010: No Additional Tax Revenues From Employers

October 2010: \$1.6 Billion Over 2 Years

1. **Full Suspension of Net Operating Loss Deduction (AB 1618):** Estimated to raise \$1.2 billion over two years. Effective date: Tax years 2010 and 2011.

Offsetting Improvement: **Safe Harbor for Corporate Understatement Penalty (AB 1618):** Estimated to save taxpayers \$130 million over two years. Effective: Taxable years beginning on or after January 1, 2010.

Offsetting Improvement: **Fix for Sourcing of Intangible Goods (AB 1618):** Estimated to save taxpayers \$123 million over two years.

2. **Board of Equalization Cost Recovery Fees (AB 1618):** Estimated to raise \$4.8 million–\$5.9 million in 2011 if implemented in April, and \$18 million–\$20.6 million annually starting in 2012.

more equitable tax rate, and to mitigate the unintended disincentive created for some employers by use of the four-factor apportionment formula.

These two proposals were adopted in September 2008 and February 2009 respectively, to help offset large tax increases on employers, but did not take effect immediately, and, like the NOL deductions, were both threatened with further implementation delays in 2010. Fortunately, the business community was able to convince the Legislature to allow the proposals to take effect on schedule, providing

the certainty and fair tax treatment necessary to encourage employers to bring more jobs to California and aid the state’s economic recovery.

Fix for Sourcing of Sales of Intangible Goods

When the Legislature drafted the language and approved elective single sales factor in 2009, it inadvertently changed the method the state uses to calculate which of a business’ sales of intangible goods are taxable in California for all businesses, regardless of which apportionment formula they used going forward. While it was necessary to use

a different formula for businesses making the election, changing the formula for businesses continuing to use the four-factor apportionment formula in effect resulted in a tax increase. The October 2010 budget agreement included several provisions correcting this error, clarifying that the old sourcing method will be applied to businesses that use the traditional four-factor apportionment formula, and the new method will be applied only to businesses electing the single sales factor apportionment formula.

November 2010 Election Results Affecting Tax/Budget Issues

The November 2010 election brought a host of changes that will likely have a significant impact on future legislative and budget proposals. For the first time in seven years, both houses of the state Legislature and the Governor's office are controlled by one party, meaning some proposals that have not been politically viable in recent years may receive a more welcome reception in 2011. In addition, several propositions passed that will have an impact on the ability of future legislatures to borrow from local governments (Proposition 22), approve budgets (Proposition 25), and increase taxes and fees (Proposition 26).

Voters also sent a powerful message with what they did not pass at the ballot box, voting down efforts to raise funds for state parks (Proposition 21) and repeal tax changes that help businesses provide jobs (Proposition 24). For California employers, these changes mean there will be a new dynamic, but one that ultimately may prove to protect jobs and prevent a worsening of the business tax climate.

No More Local Borrowing

The CalChamber supported Proposition 22, which prohibits state legislators from "seizing, diverting, shifting, borrowing, transferring, suspending, or otherwise taking or interfering with" local government revenues used to provide local services and fund transportation projects.

In recent years, legislators have increasingly relied on maneuvers including local borrowing to avoid having to make cuts to state programs and services. With the passage of this measure, the Legislature will now be forced to either find another way to pay for existing state programs and services, or make the cuts necessary to ensure that the state lives within its means.

Majority-Vote Budgets

At the same time, voters approved Proposition 25, putting sole responsibility for the passage of future state budgets in the hands of the majority party by reducing the vote requirement for budgets from two-thirds to a simple majority. The measure also contains a provision prohibiting the state from paying legislators if they have not passed a budget by the July 15 deadline. This should make it easier for the Legislature to come to agreement on budgets in the future and prevent long delays like ones in recent years, which only worsen the state's cash-flow problems and hurt individuals and local communities.

One concern that arose with Proposition 25 during the campaign was that it might allow the Legislature to pass tax increases as part of a budget trailer bill without a two-thirds vote. The CalChamber filed a court challenge arguing that the title was misleading to voters because it did not clearly indicate taxes could, in some cases, be increased by a simple majority vote. The 3rd Circuit Court of Appeals, however, held in a recently published decision that the language of the initiative clearly shows that "Proposition 25 will not change the present vote requirement for raising taxes. To attempt at some point in the future to take a different tack would perpetrate a gross fraud on the voters of this state." While it is still possible that someone could try to argue otherwise, the court's decision makes the success of such an argument very unlikely.

Given the current lack of agreement between legislators on either side of the aisle about how best to address revenue shortfalls, passage of Proposition 25 likely means that any mid-year budget fixes will be characterized almost entirely by cuts to state programs and services. In recent years, the vast majority of state Republican legislators have pledged not to vote for tax increases. With taxpayers having shown a recent distaste for tax increases, and the majority party now empowered to unilaterally pass a budget, it is unclear whether there will be any tax increases in 2011–2012, making large cuts to state programs and services more likely.

An End to Hidden Taxes

The CalChamber also supported Proposition 26, which clarifies the definition of a tax. The initiative prohibits the practices of disguising tax increases as majority-vote fees and of passing revenue-neutral tax increases by majority vote. Both tactics have become increasingly popular in recent years due to budget shortfalls, partisan gridlock, and ambiguity created by the *Sinclair Paint* decision, which further blurred the boundary between certain types of taxes and fees.

Proposition 26 will help protect employers from burdensome tax increases and elimination of important tax incentives. Under normal circumstances, elimination or reduction of a tax incentive is scored as a tax increase and requires a two-thirds vote to pass. Because many Republican legislators have been unwilling to vote for tax increases of any kind, legislators have changed tactics, placing such proposals in revenue-neutral bills that could be passed, at least theoretically, by a majority vote. Because Proposition 26 explicitly disallows this practice, it will provide greater protection for existing business tax incentives.

In addition, it will prevent the state government from evading the Proposition 13 constitutional protections for taxpayers by inappropriately labeling taxes as fees to allow them to pass without the required two-thirds vote.

The changes made by Proposition 26 apply retroactively to any state tax adopted after January 1, 2010, and will result in the repeal of any state tax increase passed by a majority vote unless the Legislature re-approves it by a

two-thirds vote 12 months after the effective date of the ballot measure. One law that could be affected is the revenue-neutral federal tax conformity measure, SB 401, approved in February 2010, which the CalChamber and business coalition members supported for its broader tax benefits. According to the terms of Proposition 26, SB 401 will need to be re-approved by a two-thirds vote in the coming months or it will be automatically repealed, at least in part.

Voters Send a Message: No New Taxes!

Not only did voters approve measures to limit the ability of the Legislature to raise revenue through traditional channels, they also voted down two measures that would have increased state revenue and helped prevent future cuts. Proposition 21 would have helped fund state parks by increasing the vehicle license fee, and Proposition 24 would have repealed several recently enacted business tax changes to grow the General Fund. The message all these outcomes send is clear—voters want legislators to balance the state budget on time without new revenues from anyone, be they individuals, local governments or private employers.

CalChamber Position

Whether tax increases are warranted at times of fiscal crisis is a case-by-case determination. Generally, if tax increases are warranted, the least harmful to the economy are those that are temporary, have low rates and are broad-based. The CalChamber opposes targeted tax increases.

Top Tax Threats for 2011

While the election did provide some good news for employers looking ahead to 2011, there still are substantial threats on the tax front. There is no doubt that trying to resolve a multibillion-dollar deficit within the new constraints set by voters will be difficult, and the Legislature is likely to look for some new revenue to help minimize the cuts that will need to be made.

In addition, as the state welcomes a new Governor, and for the first time in seven years, one from the same party as the legislative majority, many issues that have been politically off the table in recent years may get re-examined in 2011, creating some uncertainty for employers. Governor Jerry Brown stated throughout his campaign, however, that he would not raise taxes without voter approval, which suggests any tax increases proposed by the Legislature will meet with his disapproval.

Ballot Measures Proposing Business Tax Increases

It is possible that voters will balk when legislators make more cuts to the programs and services they use, spurring interest groups to turn to the ballot box to help protect popular programs and services, and ballot measures that increase taxes require only majority approval by voters. While this approach is expensive, it can be effective when there is sufficient funding for a campaign, and with so much at stake, many groups could be willing to come forward to fund campaigns to protect their constituents. Businesses

and high-income earners tend to make more popular targets for ballot-measure tax increases, and it may be possible to convince voters to pass a tax increase on employers once legislators start cutting programs and services.

The good news for employers is that voters have recently shown themselves to be in no mood for this sort of “ballot-box budgeting,” even when the measures were marketed as protection for schools, health and human services, public safety and state parks.

In addition, the Governor would have to call a special election in order for any initiatives to be considered before 2012. Not only are special elections expensive, but there also is little for the Legislature to gain out of calling one unless it can pull together enough votes to put up its own proposals, because these require a two-thirds vote of the Legislature to qualify. There currently is little, if any, bipartisan agreement on ways to increase revenue, making approval of such a proposal less likely.

Accelerated Revenues

The 2008 and 2009 budgets included numerous tax acceleration devices: the understatement penalty, accelerated estimated tax payments, accelerated limited liability fees, and increased income tax withholding.

In July 2010, legislators again considered an amnesty proposal, first as part of AB 2498, and later as part of the budget deal, which would have retroactively changed the definition of an “abusive tax avoidance transaction,” forcing law-abiding taxpayers to overpay their taxes during a short amnesty window to avoid harsh penalties for past conduct that was appropriate when engaged in, and forbidding them from subsequently requesting a refund for any overpayment.

Because so-called amnesty proposals raise revenue by forcing taxpayers to overpay their taxes to avoid penalties, they don’t actually increase taxes and so can be passed by majority vote. There could be grounds to challenge such a proposal, however, if it denies taxpayers the right to request a refund for taxes everyone subsequently agrees it did not owe.

Another burdensome proposal considered in 2010 was an onerous and costly majority-vote independent contractor withholding mandate, which also had been proposed and vetoed in 2009. Although the CalChamber successfully organized nearly a thousand individuals, businesses and other organizations to challenge the proposal, it remains a significant threat going forward, especially now that voters have taken so many other revenue options off the table.

All these devices have the common goal of requiring taxpayers to pay taxes they would pay anyway, but sooner than normal, so the state may use the funds at an earlier date. Acceleration devices borrow from tomorrow’s revenues to solve today’s budget problems, which is problematic for several reasons:

- They create budget problems for future years by creating holes where there otherwise would have been revenue.

- They impose unexpected cash shortages on taxpayers by depriving them of money they would otherwise have been able to access and sometimes forces them to pay taxes on income they have not yet earned.

- They often result in overpayments of taxes that have to be refunded. This means that taxpayers have been forced to give the government an interest-free or low-interest loan, and this money has been pulled out of the economy.

CalChamber Position

The CalChamber believes tax revenue accelerations are short-term fixes that create instability and generally are poor fiscal policy. CalChamber opposes tax measures that pull money out of the economy, discourage investment, and create cash shortages and hardship for companies and individuals, particularly when the economy is suffering. The CalChamber opposes tax penalty and amnesty programs that trap law-abiding taxpayers into overpayments into the tax system and impinge on their rights.

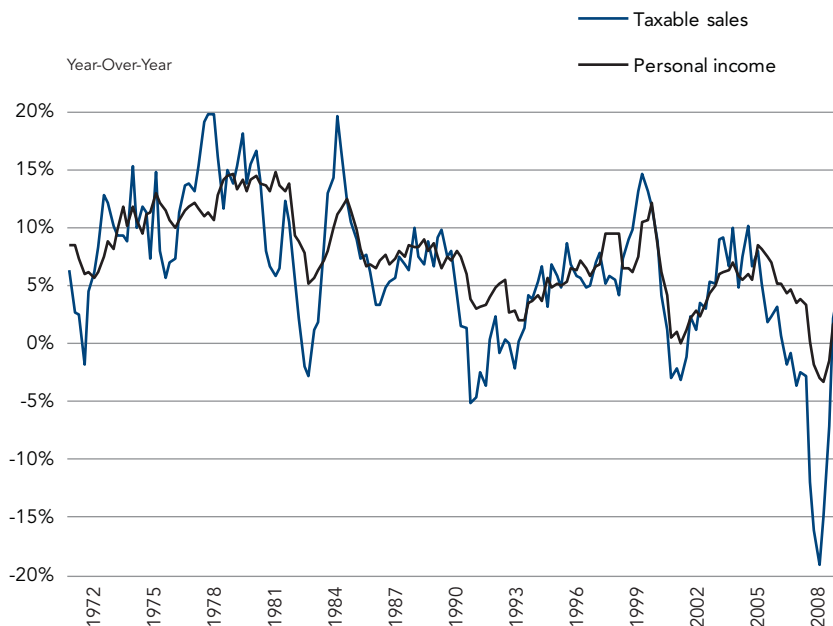
Targeting Business Tax Incentives

In 2010 the Legislature considered several measures that would have limited tax incentives designed to lure and keep employers in California. One approach taken by several bills was to propose automatic sunsets for all business tax credits after a specific number of years. Tax credits are mechanisms purposefully created by the Legislature to encourage certain behaviors by employers and otherwise offset the state's above-average corporate tax rate. In recent years, however, skeptics have become more aggressive about characterizing these credits as inadvertent "loopholes," and have sought to reduce and/or eliminate many of them to help fund other programs.

Although the CalChamber agrees wholeheartedly that the Legislature should take time to periodically review the effectiveness of all the state's tax provisions and incentives, the CalChamber has consistently opposed automatic sunsets on tax credits. Automatic sunset provisions undermine the very purpose of tax credits because they allow those credits to automatically expire unless the Legislature acts by the sunset date, making them unpredictable for employers, discouraging investment.

Including sunset provisions also makes California less competitive as a place to locate future employees because many other states offer similar incentives without the same unpredictability. Now more than ever, the CalChamber

Quarterly California Income and Sales Trends



Source: California Foundation for Commerce and Education

believes that California's best hope for economic recovery is through growth in the private sector, and providing reliable tax credits is one important way the state can help stimulate that growth.

Significantly, one of these bills, SB 1272 (Wolk; D-Davis), made it through the Legislature in 2010 with strong support, only to be vetoed by the Governor. It is possible that the new Governor will feel differently about these provisions, making bills like this one a very real concern for employers in 2011.

Another group of bills sought to create a publicly searchable database with information about companies and the various tax incentives they utilize. Although the CalChamber supports the goal of increasing transparency for all government programs and expenditures, most of the information these bills sought to provide is already available to the public and/or the Legislature through annual reports published by the Department of Finance and the Franchise Tax Board. In addition, the new database the bills proposed to create would have provided the required information without any context, stigmatizing California employers who make legitimate use of tax incentives to provide jobs and revenue to the state.

One of these bills, AB 2666 (Skinner; D-Berkeley), also made it easily through the Legislature only to be vetoed. It is anticipated that there will be renewed attempts to create such a database in 2011, given the possibility that such a measure could receive different treatment from the new Governor.

CalChamber Position

The CalChamber opposes any attempt to limit the availability and predictability of business tax incentives, which are necessary to keep the state's tax climate competitive. The CalChamber also opposes using a one-size-fits-all approach to evaluating the effectiveness of business tax incentives.

Tax Collection and Enforcement Measures

In recent years the Legislature has considered a number of proposals, all of which require a majority vote, that have the goal of improving collection of taxes owed on purchases made from out-of-state retailers, so-called use tax. Use tax is the equivalent of sales tax for out-of-state purchases, but responsibility for its collection is imposed on individual purchasers rather than retailers because of federal constitutional requirements governing taxation of interstate commerce. Californians are notoriously bad about reporting use taxes in their annual tax returns, and the result is that most of that revenue is never realized by the state.

In 2010, several states adopted laws that sought to either force out-of-state retailers to collect sales and use tax on behalf of individual purchasers, or to require those retailers to report information about those purchases to the state to help it enforce and collect the tax from individuals. Legislators in California responded by introducing several proposals modeled on the approaches taken in these other states.

In addition to acting out of a desire to collect more of the taxes the state is owed, legislators also acted out of sympathy for in-state retailers, who have become increasingly vocal about the competitive disadvantage use tax collection rules can create for in-state retailers as e-commerce becomes more popular. These California employers have long argued that some Internet retailers purposefully design their business models to take advantage of federal limits on state tax collection requirements, making their goods appear cheaper than those sold in-state that have sales tax automatically imposed at the register.

The CalChamber is sympathetic to both concerns, recognizing that California has one of the lowest compliance rates for use-tax reporting by individuals, and that many of those individuals have bought into the incorrect notion that online purchases are "tax free." As a threshold issue, however, the CalChamber continues to oppose measures focused on out-of-state retailers. Such measures are likely unconstitutional, and almost certainly will be litigated if adopted here, as every other state with a related proposal has found itself the subject of costly and protracted litigation, none of which will be resolved in the near future.

In addition, a number of the proposals actually would create a competitive disadvantage for other California businesses, forcing legislators to pick winners and losers among in-state employers, potentially eliminating thousands of California jobs.

As an alternative, the CalChamber does not oppose

approaches that focus on enforcement of the individual obligation to report use taxes to the state, such as the use-tax registration requirement for businesses passed in 2009, which the Board of Equalization (BOE) expects to raise approximately \$600 million annually by 2013. The CalChamber encouraged attempts to reinstate the use-tax reporting line on the personal income tax form, made permanent in 2010, and continues to be optimistic about legislation that would make the line mandatory, while supplying individuals with an estimate table and a safe harbor to encourage and simplify compliance, vetoed in 2009. The CalChamber also believes more can be done to educate individuals about their obligation to remit this tax, and to provide the BOE with more resources to aid its tax collection efforts.

CalChamber Position

The CalChamber is generally opposed to tax proposals that could stifle California's national and global competitiveness and its leadership role in e-commerce. In addition, the CalChamber opposes proposals that are likely unconstitutional, as they result in costly, time-consuming litigation.

Taxation of Services

Another tax proposal frequently raised in budgetary discussions in 2008, 2009 and 2010 was expansion of the sales tax base to include services. Historically, California's sales tax has applied only to goods, not services.

On repeated occasions, Governor Schwarzenegger's budget proposals have suggested expanding the sales tax to a small group of services, including appliance and furniture repair, vehicle repair, golf, veterinarian services, amusement parks and sporting events. This past summer, he broadened his proposal, suggesting that the Legislature consider expanding the tax to include all services.

The business net receipts tax (BNRT) proposed by the Tax Commission in 2009 also was intended to expand the tax base to include services by taxing "business activities" rather than income or sales transactions, as under the current tax regime.

One of the common justifications proponents of a services tax give for such a change is that it would more appropriately reflect the current economy, which they argue is now services-based. This has led to the misconception that taxable sales have eroded significantly when compared with personal income. To the contrary, over the last 30 years, taxable sales have closely tracked personal income (see chart on previous page).

The CalChamber believes it is appropriate for the state to consider broad changes to the tax system, including a tax on services, as one possible way of addressing the budget crisis. However, such a dramatic change to the tax system must be very carefully crafted to avoid certain detrimental outcomes, including:

- Creating a competitive disadvantage for in-state businesses.

- Increasing the state's overall taxation of California employers.
- Carving out large numbers of services such that a few business sectors end up with the bulk of the tax burden.

CalChamber Position

The CalChamber opposes targeting specific businesses, industries and professions with a sales tax on services. Such a tax would impede economic recovery, punish California companies and discriminate against small businesses. The CalChamber considers service tax proposals on a case-by-case basis, however, as the terms and potential consequences for employers can vary dramatically from bill to bill.

Other Persistent Tax Legislation

There are a host of other tax bill ideas that are re-introduced each year. While the CalChamber expects reiterations of these proposals in 2011, and that they will continue to serve as talking points for legislators and the media, all require significant buy-in from legislators on both sides of the aisle to present real threats to the employer community, something the CalChamber does not anticipate happening in 2011. These proposals include:

- Taxes targeting a specific industry;
- Taxation of high-income earners;
- Taxation of digital downloads;
- Split-roll property taxation;
- Repeal or reduction of business tax incentives.

CalChamber Position

The CalChamber opposes targeting specific industries and tax brackets with new or increased taxes because it is bad tax policy to place the burden of funding programs with a general benefit on a narrow class of taxpayers. The CalChamber generally is opposed to tax proposals that could stifle California's national and global competitiveness.

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