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TO: Democratic Lawmakers and Staff

FROM: David Kersten, Tax Analyst

RE: Why State Republican Lawmakers Are Wrong On Taxes

State Republican lawmakers are just plain wrong when it comes to talking about and debating taxes. Some of the arguments they raise border on the absurd and make one wonder if they even believe them themselves.

Generally speaking, nobody likes taxes but there is a broad consensus, dating back to at least the 1950's, that a healthy public sector is a critical part of California's long-term success story. To maintain a high productivity economy and society, California must have a tax system that provides sufficient revenues for education, infrastructure and vital public services.

Given this fact of life, the state's tax system should raise revenues in a manner that is as efficient, effective and equitable as possible.

The failure of Republican lawmakers to engage the tax issue in an open, honest, and forthright way has prevented the Legislature from doing anything to fix the state's outdated and loophole-ridden tax system.

The Republican mantra goes something like this; "all tax increases are bad, will lead to job losses and devastate the California economy." Governor Arnold Schwarzenegger shared this belief until earlier this year when he proposed a temporary sales tax increase to help close the budget deficit.

The truth is that an excessive tax burden is bad for the economy. But closing tax loopholes should be one of the highest priorities of the Legislature.

There is much disagreement on what a tax loophole is, but it could be argued that a true tax loophole exists where a select group of taxpayers avoids paying taxes that another group of taxpayers in the same tax position pay. Furthermore, the tax system should not discriminate against select classes of taxpayers and grant special treatment to others in the same tax position.

The purpose of this paper is to debunk the Republican stance and arguments on taxes and briefly examine eight true tax loopholes in the state's tax system that should be closed.

Debunking the Republican Stance on Taxes

It could be argued that the two biggest votes on taxes last year were for the closure of the yacht tax loophole and the enactment of an oil severance tax and windfall profits tax on oil.

Senators Jeff Denham, Abel Maldonado, and Roy Ashburn were the only Republican lawmakers to vote for the closure of the yacht tax loophole when this proposed law change was voted on in February of this year (the proposal ended up getting incorporated into the final 2008-09 budget deal and was the only loophole closure that was passed into law in 2008).

The purchasers of yachts or other recreational vehicles such as private jets and airplanes can currently avoid paying sales tax on their purchases by buying it either in state or out of state and parking it offshore for 90 days before bringing it into the state.

Current law states that there is a rebuttable presumption that any vehicle, vessel or aircraft purchased by a California resident is subject to sales tax if brought into the state within 90 days of the purchase.

SB X3 8 would have extended the rebuttable presumption from 90 days to 12-months. It was estimated to increase revenues by $21 million in 2008-09. The 12-month rebuttable presumption had been in effect for the two fiscal years prior to June 30, 2007. The bill passed the Senate but failed on the Assembly floor in February of 2008.

In a 2006 report, the Legislative Analyst's Office (LAO) found that the law change resulted in a sharp decline in the practice of parking recreational vehicles out-of-state for the 90 days in order to avoid paying the state sales tax.

According to an Assembly Budget Committee Analysis, "the LAO found little evidence that the change from a 90-day presumption to the 12-month presumption had depressed the sales of yachts or recreational vehicles or had adversely affected related economic activity such as marinas and repair and maintenance. The LAO recommended making the 12-month presumption permanent."

Based on the facts and research, it appears that there is no public policy justification for keeping this tax loophole open. But Republican lawmakers had plenty of arguments against SB X3 8.

In reviewing Republican arguments against SB X3 8, it is tough to find much substance.

The California Progress Report reports that Sen. Dick Ackerman has concluded, "First of all, it is a tax increase. Unfortunately, it follows the trend of some of our colleagues who want to tax the rich. As we found, taxing the right in California does not work—they have many other alternatives. The LAO has not completed all of her research, but I'm pretty sure that we've lost a lot of jobs, we've lost a lot of working class jobs in ship yards, maintenance, rehabilitation—all of those things that generally occur when someone buys a boat. So it does have a significant impact on the state of California."

One must wonder if Sen. Ackerman even reviewed the LAO report because the LAO issued a detailed report that found little evidence of any adverse economic impacts.

Sen. Dennis Hollingsworth similarly concluded, "it's going to mean an actual loss of revenues to the state of California. If that doesn't concern you, because it means an actual loss of income—because it ought to—it's going to mean a loss of jobs for the working people that we represent. Not the rich people, they'll find a way around it. The working people, the immigrant who sprays fiberglass on a boat will lose his job…Those are the people who are going to be affected by this not the right. This is going to hurt the families and working people that all of you say you're representing."

Again, the evidence shows that the 12-month rebuttable presumption works and the rich do not avoid it because they do not want to buy a yacht or jet and leave it out of state for one year. The evidence shows that the yacht industry did not come crashing down when the 12-month rule was in effect for the two years prior to June 30, 2007.

Another bill brought up during the February special session was AB X3 9, which would have imposed a 6% tax on oil production and a 2% windfall profits surcharge on oil companies. The bill, authored by then-Assembly Speaker Fabian Nunez, stalled on the Assembly floor on a 45-30 vote. The bill did not garner a single Republican vote.

AB X3 9 would impose a 6% severance, or production tax, on the value of each barrel of oil that is extracted from California soil. With the price of oil at $85 per barrel, the tax would impose an estimated $5.10 per barrel, on the production of 190 million barrels annually—for a revenue gain of $970 million in the budget year.

The windfall profits surcharge on oil companies was estimated to raise approximately $250 million annually, and was structured as a 2% surcharge on profits in excess of $10 million a year. The bill was estimated to raise a total of $1.2 billion in 2008-09.

"This tax would raise taxes by $1.2 billion…This is bad tax policy and bad energy policy," said Assemblymember Chuck DeVore (R), who noted that California oil commands a lower price per barrel because it is thicker and this bill will make foreign oil less expensive relative to California oil, leading to a decline in California oil production.

Assemblymember Roger Neillo (R) said he opposes the bill because "tax increases don't work" because they alter behavior and are "bad for the economy."

Assemblymember John Benoit (R) has stated that local governments will lose property tax dollars, noting that Kern County would stand to lose as much as $70 million from a reduction in oil production. "This will make the budget problem even worse," Benoit went on to say.

According to the California Tax Reform Association, California is the only oil producing state without an oil severance tax and appears to be the only place in the world that does not collect taxes or royalties on oil production. The market for oil is a global market, which means that California oil producers cannot pass the tax onto consumers at the pump because refineries always have the alternative of buying from another company.

The Rand Corporation conducted a study on the impact of a 6% oil severance tax in California and found that it cannot be passed on to consumers and would not affect production. "The study was done when oil prices were far lower, but virtually all economists agree that the world market sets the price of oil and that underlying taxes, whether from Texas, Kuwait or California, are not passed through at the pump," states an analysis of AB X3 9 by the California Tax Reform Association.

"Oil companies have had record making profits for the past three years and it's on the backs of consumers…Don't hide behind the oil companies and say that this is going to be passed on to consumers. I don't buy that," said Speaker Nunez, noting that the tax vote coincides with thousands of layoff notices being sent out to California teachers.

According to the California Tax Reform Association, California's total taxes on oil are the lowest of any state. Other states' oil severance tax rates are as follows: Alaska 12.25%, Louisiana 12.5%, Oklahoma 7%, Kansas 8%, Colorado 5% over a minimum payment, Texas 4.6%, Wyoming 6%, New Mexico 3.75% plus 3.15% for schools.

Speaker Nunez has argued that it is unconsciousable to lay off teachers when California is the only state which fails to tax the production of oil.

Republican lawmakers blind insistence that all tax changes that increase revenues are bad for the economy and jobs plays out year after year on the hundreds of tax bills that are introduced in the Legislature each year.

Take the Republican opposition to AB 1840 (Calderon), for example. The bill, which was introduced in 2008, would clarify that a retailer is deemed to be engaged in business in this state if a retailer has substantial nexus in this state, as provided by applicable federal and state law.

The bill would enable California to enforce California's use tax law to the fullest extent allowed under the federal constitution.

The bill is necessary because many California-based "brick-and-mortar stores," such as Barnes and Noble and Borders, have online affiliates that should be collecting sales tax on their sales to California residents but have managed to skirt the law as it is currently

written. This also puts the California-based competitors of online and mail order retailers at a competitive disadvantage because these traditional retailers are required by law to collect sales tax.

Specifically, the language of this measure would essentially require the State Board of Equalization to decide the meaning of “substantial nexus” as it applies to California’s use tax provisions and extend the obligation to collect the use tax to those retailers that are deemed to be engaged in business in this state as provided by federal law.

Under constitutional law, states lack jurisdiction to require out-of-state retailers to collect a sales or use tax when the retailer has no “physical presence.” In this state, different courts have reached divergent conclusions about what constitutes physical presence in cases with similar facts. The ambiguity created by these court decisions and California statutes and regulations have allowed many online and mail order companies to sell to California customers and not collect sales tax even though they have a substantial physical presence in the state.

The tax gap between what should be owed and what is collected in this area is estimated to cost the state of California $1.1 billion a year. In summary, the Calderon bill would help the state of California collect a portion of this lost revenue by clarifying the law to the extent allowed under the federal constitution.

Republicans claim to be the party of jobs and the economy but not collecting taxes where they should be collected is both unfair to California-based retail stores and to state taxpayers.

Eight Tax Loopholes That Should Be Closed

Here are eight common sense tax loophole closures that are estimated to raise $6.2 billion a year towards closing California’s $22 billion a year long term structural budget deficit.

1. Commercial Property Tax: More Loophole Than Tax

If you can sail a yacht through the yacht tax loophole, you could put a whole block of downtown Los Angeles through this one on any given day and nobody would know about it. This is the biggest loophole in the tax system (several billion dollars depending on how it is scored).

In short, the state’s methods and laws for assessing commercial property are loophole-ridden and subject to endless manipulation. Current law requires reassessment when 51% of a property’s ownership shares change hands. The system makes sense for homeowners but not for commercial property owners because current law cannot be enforced.

The complex manner in which investment property is held and sold make "change of ownership" rules difficult to apply on any rational basis. Current law is extremely narrow in the transactions that generate reassessment, such that properties routinely change ownership without reassessment. For example, in one transaction in Napa County in 2001, 12 shareholders of E & J Gallo Winery acquired the shares owned by approximately 20 shareholders of the Martini Winery, with the name changing and the deed changing, but since no shareholder bought over 50%, no reassessment took place.

According to the California Tax Reform Association, the system is indefensible from any economic perspective. The state currently taxes new investment heavily, at full market value plus fees and mitigations, and imposes property and sales taxes on investment goods, while letting windfalls ("economic rents") go entirely untaxed—the opposite of what any economist would recommend as tax policy. Similarly situated competitors pay widely differing tax burdens, violating basic principles of horizontal equity. For example, IBM Silicon Valley Laboratory is paying $0.004/square foot of land in property taxes compared to many other companies in the area which are paying roughly $0.60 a square foot—a disparity of 150 times.

The Legislature could explore a two-step solution: 1) Tighten change of ownership law, which can be done by statute, as proposed in a Senator Escutia bill (SB 17), so that cumulative and partial transfers of investment property can be reassessed, and 2) Place a constitutional amendment on the ballot that would require the periodic reassessment of non-residential property at market value.

The California Tax Reform Association estimates that the state could raise $1 billion annually by tightening the change of ownership rules and statutes, and $3-4 billion annually by assessing nonresidential property at market value each year. This tax policy is commonplace in other states and makes sense from a sound tax policy perspective.

A negotiated solution in the legislature would most likely include some business tax changes that would lower the net revenues, such as a personal property tax exemption for small businesses, or a reduction in overall rates.

2. **Require Withholding on Independent Contractors/Penalize Failure To Issue Form 1099's ($100 million in 2008-09, $270 million in 2009-10, $400 million in 2010-11 and a $3.6 billion revenue acceleration in 2008-09.):**

The underground economy is a significant drain on revenue, and efforts to address it, such as amnesty in income tax payments and offers in compromise on child support payments, have been proposed but are only piecemeal fixes.

This revenue is already due to the state, and the state has strengthened reporting for new hires of independent contractors. The state has not moved forward on a real enforcement program on independent contractors since the Wilson Administration proposed withholding of tax on payments to independent contractors in 1991. The proposal was later withdrawn.

Requiring withholding on independent contractors and increasing penalties for failure to file payments to independent contractors (Form 1099) would raise several hundred million dollars a year.

The ongoing revenue estimate could be higher if parts of the $6 billion of untaxed revenue in the underground economy is captured. This is money that is just lost to the state unless it is withheld.

These estimates reflect the money that would be raise if a 5% income withholding rate were implemented.

3. **Disallow 1031 Exchanges on Out-of-State Property ($30 million/yr.):**

Real estate investors can currently exchange one commercial property for another without paying any capital gains taxes on the exchanged asset. The system allows real estate investors to avoid paying taxes on most of their gains, which are contained within the capital gains on the sale of their property.

The theory behind this is that they roll their initial real estate investment over into subsequent properties, and are finally paid when those properties are sold. However, in the absence of both an estate tax and a stepped-up basis rule (as well as the ability to transfer to family trusts without reassessment), billions of dollars in gains from investment property may go untaxed forever.

This exemption may make sense for instate property exchanges but not for out-of-state property exchanges because the state has no way of recovering the capital gains tax when the asset is finally sold.

Disallowing "like-kind" exchanges (section 1031 exchanges) on California property that is exchanged for out-of-state property is estimated to raise more than $30 million a year.

4. **Limit the Excessive Use of Corporate Tax Credits ($585 million/yr. in 2008-09, $535 million/yr. in 2009-10, and $560 million/yr. in 2010-11):**

A total of 3,622 profitable corporations in California paid no corporate taxes on their income in 2001, as the result of the use of the many credits and incentive programs available under California law. These major corporations make substantial use of the state's infrastructure, education system, and services, but fail to contribute through the corporation tax, unlike the many thousands of other companies who are unable to use these special credit and incentive programs.

The solution is to prohibit businesses from using tax credits to erase more than 50% of their tax liability in a given year. (SB 1354 (Escutia) in the 2003-04 regular session proposed this limitation for the 2004 and 2005 tax years only). Credits should be allowed to be carried forward but should not be permitted to eliminate a profitable business' entire tax liability.

Prohibiting businesses from using tax credits to erase more than 50% of their tax liability in any year would raise more than $500 million annually. Some companies have such a store of credits built up that they would not have to pay taxes for more than 20 years.

The limitation would only effect a narrow class of businesses—less than 1% of the state's profitable businesses—who pay little or no corporate taxes every year. The Franchise Tax Board Estimates that only 4,520—out of more than 520,000 corporation filing returns in 2001—used tax credits to erase more than 50% of their tax liability.

5. **Prevent Corporations from Parking Income in Tax Haven Countries ($60 million/yr.):**

Corporations are currently allowed to attribute income, for tax purposes, to tax haven countries even though they conduct no business in those countries.

For example, more than a dozen corporations that are headquartered in California have set up a post office box in Bermuda or the Cayman Islands and have begun claiming that location as their new headquarters.

The solution, as contained in AB 34 (Ruskin—2005-06), would be to treat income that is attributed to tax haven countries such as Bermuda and the Cayman Islands as though it were in the "water's edge" for tax purposes.

6. **Use Book Income as the Measure of Corporate Income (estimated to be as much as $1 billion/yr.):**

Corporations currently report relatively high earnings to their shareholders to maintain their stock prices but then find ways to avoid reporting those earnings to tax authorities. Using a business' book income (that is, the income reported to shareholders), as opposed to the federal taxable income base calculation, would reduce the potential for sheltering income from state taxation.

7. **Close the "Nowhere Income" Loophole ($30 million):**

Current law allows multi-state corporations who are based in California to sell out-of-state subsidiaries or assets without paying taxes. The solution would be to require companies to make the same Section 338 election (IRS Code Section) for state tax purposes as they do for federal purposes.

8. **Overhaul the State's Enterprise Zone Program ($50-100 million/yr.):**

The State Enterprise Zone Program is a popular program but is full of loopholes and abuse. The cost of the program has increased nineteen-fold between 1993 and 2003—from $15.6 million to $299.3 million, according to the California Budget Project.

The enterprise zone program is intended to aid economically depressed areas by providing a series of tax incentives to businesses located in designated enterprise zones.

According to the California Budget Project, the program fails to effectively target the areas most in need of assistance. For example, large tracks of San Francisco are in an enterprise zone including portions of North Beach and Nob Hill in San Francisco. The program allows big hotels, gourmet supermarkets, and upscale restaurants to claim tax incentives that they do not need. Current state law allows enterprise zones to expand into areas that are not economically distressed.

The enterprise zone hiring tax credit rewards businesses that do not hire workers with barriers to employment or create new jobs. Nearly two-thirds (64.8%) of hiring credit vouchers approved by EZs in 2004 were for workers who merely happened to living in the right neighborhood, not on the basis of employment. Only 2.7 percent of approved hiring credits were for workers who were either participants in or eligible for income support programs, according to the California Budget Project.

There is also evidence that enterprise zone businesses seek approval for hiring credit vouchers from the enterprise zones that are most willing to approve them. A recent audit found that more than half (61 percent) of vouchers approved by the Oakland enterprise zone were for companies located in other enterprise zones, according to the California Budget Project.

The state needs to reexamine each of the 39 enterprise zones throughout California to ensure that the zone boundaries only include truly economically depressed areas. Eligibility criteria for the payroll credit needs to be rewritten to ensure that businesses only receive credits for truly qualified individuals and controls need to be put into place to safeguard the program from abuse.

Conclusion

The failure of Republican lawmakers to debate taxes in an open and honest manner, together with the 2/3 vote requirement for tax increases, has created a situation where it is impossible to raise revenues by closing even the most egregious tax loopholes.

Republicans blind insistence that all tax increases are bad defies rational logic and responsible policy making The expenditure side of the budget is given a lot of close attention by lawmakers and advocates but the revenue side has been largely ignored.

An open and honest examination of the tax system would inevitably show that there are large loopholes and inequalities that cannot be defended from any rational tax policy or economic perspective. It is the duty of all state lawmakers to engage on this important issue.

The Legislature's failure to address tax loopholes and a tax system that is outdated and inequitable is also bad for the economy and job creation.

The ability to raise revenues in an equitable and efficient manner is essential to California's long term economic prosperity. The state needs to invest in an education system that can produce a highly skill workforce that will fill the jobs of tomorrow.

We need a health care system that can care for those workers, adequate resources for public safety, and enough money to pay for the infrastructure that will maintain and promote future economic growth.

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