ASSEMBLY COMMITTEE ON REVENUE AND TAXATION

"Overview of the Tax Recommendations Proposed by
the Commission on the 21st Century Economy"

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Mr. Chairman and Members:

Thank you for the invitation to testify today on the important subject of the Tax Recommendations of the "Commission on the 21st Century Economy" ("COTCE").

By way of a brief background, I have been involved with California tax policy and administration for almost 30 years, working for both the public and private sectors. In my public career, I had the opportunity to help formulate tax policy at both the legislative and administrative levels. In my private career, I have represented clients, large and small, with their issues before the major state and local tax agencies. From this latter perspective in particular, I have seen how the decisions that are made by California's policymakers play out in the lives of the people they govern, both for good and for ill.

I only mention this because there is a danger when reviewing the COTCE proposal of focusing on sweeping generalizations about tax policy without regard to the "details." In taxation, as Commissioner Pringle noted in his testimony, the devil is always in the details and this is especially true in the California tax system, which is highly integrated with the local taxation system, and which is partially regulated by the

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California and United States Constitutions. Hopefully, the Legislature will investigate "both ends of the pipeline": the explicit and implicit policy in the COTCE proposal and how those policies would play out in the lives of individual taxpayers. I say this because ultimately, "quintiles" do not pay taxes—individuals do.

To assist the Committee, I have some observations at the policy level, and offer a few case studies that will make some of these issues come into sharper focus at the implementation level.

Recommendation One: Question the Assumptions.

Last year I appeared before this Committee and took the position that the existing tax system, far from being in a state of crisis, is in relatively good shape. I was reassured when the Legislative Analyst appeared early in these proceedings and continued to share a similar view for similar reasons. Mr. Taylor and I both see a system which is broad-based and robust, relies on a portfolio of taxes that reach income, wealth and consumption, is well administered by a dedicated and experienced workforce and which is generally progressive. Clearly, whether there is or isn't a crisis in the tax system is a fairly fundamental difference of opinion. For that reason I would counsel now, as I did then, that the Legislature move cautiously and not take anyone's assumptions (mine or the COTCE's) as the gospel.

What are the key COTCE assumptions that should be scrutinized? The COTCE assumes that the state's fiscal woes can be blamed on volatility, and further assumes that the volatility problem is a structural one in the entire tax system, and answers with a rather radical solution---a wholesale reduction in the reliance on the personal income tax, and the substitution of, in essence, a consumption tax that if fully implemented would

constitute about 45% of the state's general fund revenue. But have those assumptions been proven to be true?

First, the state and the nation are currently in the grasp of the most severe economic downturn since the Great Depression. This came on the heels of a prolonged period of economic expansion and a real estate bubble that was the most extreme in California. This period of prosperity came after the 1998-2001 dot-come boom and bust cycle. More attention needs to be paid to separating the impact of this atypical economic turmoil from the impact specifically caused by the tax system.

The Legislature should fundamentally question whether volatility is a good thing or a bad thing, and should also revisit the philosophical debate over whether volatility is a tax system problem or a spending problem. It might help to couch this debate in terms of an example. If I am paid a salary, and my firm has a good year and I am given a $10,000 bonus, my income for that year is volatile---it just shot up from the year before and may very well drop drastically back down to my regular salary the following year. But this doesn't mean I should simply refuse the bonus because it makes my income volatile, which is what the Commission's proposal to cut the volatile Personal Income Tax seems to suggest; rather, it suggests that I should use the "volatile" portion of my income for non-recurring expenditures. Maybe I choose to pay off some old debts, or even save some of it as a hedge against the possibility that my firm next year has a terrible year and has to reduce my base salary. What I should *not* do is use the bonus to put a down payment on a bigger house with a bigger mortgage that I can only afford if I get a $10,000 bonus *every year*.

But assuming volatility is deemed to be a concern, there are at least two alternatives to the COTCE proposal for managing the volatility of the Personal Income Tax that should be examined. First, the Legislature could estimate the portion of the Personal Income Tax revenue that is attributable to "volatile" capital gains (i.e., that above some normalized percentage of revenue), and segregate and limit spending of that revenue to one-time expenditures, debt relief and for future economic uncertainties.

If one is dubious of government's ability to forbear from spending one-time revenues on ongoing programs, another option arises by altering the current Personal Income Tax system. Instead of recognizing 100% of capital gain or loss in the year of "realization" (i.e., when the property is disposed of at a gain or loss), those gains or losses can be averaged into income over a longer period of time (2-5 years). In my bonus example, it would be the equivalent of taking my $10,000 as a $2,500 payment per year for the next 4 years.[2] I believe this second solution was suggested by Professor Kirk Stark at UCLA. Either alternative could possibly work, and neither would require a sweeping change to the Personal Income Tax system. Both deserve your consideration, in addition the remedy proposed by the COTCE.

Recommendation Two: Recognize that the COTCE Proposal is a Fundamental Doctrinal Shift from Taxing Income to Taxing Consumption

The current California tax system draws a large part of its revenue from income taxes—the Personal Income Tax and the Bank and Corporation Tax. Inherent in the system's reliance on income taxes is the notion of "ability to pay"—the more profit a person or business has, the higher his or her or its tax liability will be. Conversely, to the

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[2] It also bears noting at this juncture that my firm chose to pay me a one-time bonus of $10,000 when our firm's "economy" was doing well. They did not choose to raise my base salary by the equivalent of $10,000 per year on the assumption that the firm would do as well every year.

degree a person or corporation has no income or has a loss, the person or business may have no liability at all. They may even have a refund coming to the extent that California has now conformed to federal law and has adopted a Net Operating Loss (NOL) "carry back" provision.

Reduced to its simplest elements, the COTCE proposal recommends a major change in past doctrine away from reliance on income taxes in favor of taxes on consumption. The cornerstone of the COTCE proposal is the complete replacement of the corporate income tax, the state portion of the sales and use tax and a significant portion of the Personal Income Tax with a new Business Net Receipts Tax ("BNRT") that, while possessing some elements of an income tax, is really more like a consumption tax[3].

The Committee should be aware of several aspects of consumption taxes in evaluating whether to adopt some or all of the COTCE proposal. Consumption taxes tend to be less volatile on the downside, but less volatile as well on the upside. The Committee should closely evaluate the projected growth rates of the current revenue system compared to projected growth rate of the system as envisioned by the COTCE under various changing assumptions. I suspect that less volatility comes at the price of growth rate, but more study will determine whether this is so.

Second, a doctrinal shift away from income taxes towards consumption taxes will mean that an individual taxpayer with no income or a loss will still be paying a significant amount of tax. While the current sales tax applies whether a purchaser has net income or not, the sales tax exempts the three largest necessities (food, utilities and

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[3]However, most consumption taxes tax true "consumption", in other words, they differentiate between spending and savings. The BNRT treats savings the same as all other nondeductible "purchases."

prescription medicines), minimizing the impact on the poor. Again, the Committee may decide that tax liability with no "income" is a price worth paying to achieve less revenue volatility, but at least they should do so consciously and carefully.

Third, as suggested above, consumption taxes tend to be regressive. I strongly suggest that the Legislature request any data prepared by the COTCE which analyzes who actually would pay the BNRT. This will include reviewing their assumptions about how much of the tax would be passed along to others in the form of higher prices or lower wages. Understand that the BNRT does not exist anywhere in the world—so assumptions about who will ultimately pay will be based on educated guesses rather than hard data. But I suspect that if the BNRT follows the pattern most consumption taxes follow (including California's excise taxes on fuel, alcohol and tobacco), lower income Californians will ultimately be paying proportionally more of their incomes on BNRT than those with arguably more of an ability to pay.

Finally, consumption taxes tend to be "nontransparent" or "hidden" taxes. With the exception of the sales tax which usually, though not always,[4] is a line item on a sales receipt, other California consumption taxes (fuel taxes, alcohol taxes and tobacco taxes) tend to be buried in the sales price of the item rather than separately stated. Transparency is generally thought of as a desirable attribute of a tax system. Here, the COTCE proposal's recommended transition from reliance on income and sales taxes which are transparent, to a BNRT which is not is also a major doctrinal shift.

[4] Retailers have the option of selling at a "tax-included" price, but have to disclose that fact to purchasers. Regulation 1700(a)(2).

Recommendation Three: Consider the Merits of Each Component of the Package, and Not the Package as a Whole.

The Legislature should not feel bound to accept the Commission's proposal as a whole, but should break it down into its component parts. When one does so, additional issues emerge.

If one takes a step back, the Commission's proposal can really be broken down into several subcomponents or tradeoffs. There is one "revenue raiser" (The Business Net Receipts Tax) and three revenue losers—reduction and flattening of the personal income tax, reduction of a portion of the state sales tax rate, and replacement of the Bank and Corporation Tax. In even greater detail, a portion of the total BNRT rate one can be viewed as necessary to cover the revenue loss associated with each of these subproposals. To the degree the Legislature decides that the particular revenue loser is not good policy, one can eliminate the associated part of the BNRT rate.[5]

The BNRT versus the Bank and Corporation Tax

As an initial matter, the Committee has already heard testimony that no one spoke in support of the BNRT during the course of the Commission's deliberations. The corollary to that is that the corporate community also never testified that the Bank and Corporation Tax needed drastic reform or replacement. However, since it is part of the Commission's proposal, some comparisons between the two programs is appropriate.

The BNRT apportions net receipts based on a single sales factor, and on a combined group basis limited to those companies within the "water's edge." As of 2011, Bank and Corporation Tax taxpayers have an election to use either a double-weighted sales factor or a single sales factor to apportion their net business income. Moreover, for

[5] This is important because the 4% BNRT rate on which the proposal relies to be revenue neutral is extraordinarily high. By comparison, Michigan's modified gross receipts tax rate is .8%.

many years, taxpayers have had the option to combine their corporate groups on either a water's edge or a worldwide basis. The Legislature presumably adopted an elective single sales factor approach because some taxpayers would be adversely affected by a mandatory change. The move to a mandatory SSF to apportion net receipts under the BNRT will undoubtedly have a profound impact on some taxpayers with a large market presence in California, but a small "footprint" of property and payroll.

It is also fair to say that while the Bank and Corporation Tax is neutral, or perhaps slightly biased in favor of substituting labor for capital,[6] the BNRT is biased, perhaps strongly so, in favor of the substitution of capital for labor. This is simply because the purchase of a machine (from a third party) and the associated property taxes are deductions from gross receipts in the year incurred, while wages, benefits and payroll taxes are not deductions from gross receipts. In a state where the unemployment rate is in the double-digits, a situation which will carry on for some time, the Legislature should weigh the policy implications carefully.

There has been significant testimony before the Committee on the related issues of outsourcing and misclassification of workers as independent contractors. The current Bank and Corporation Tax is neutral on whether work is done by a corporation's own employees or by the employees of another firm or an independent contractor. Both wages and benefits, or payments for third party labor are ordinary and necessary business expenses and are deductable under the Bank and Corporation Tax. Under the proposed BNRT, however, amounts paid to either a third party labor provider or directly to an independent contractor are deductions from gross receipts, while wages and benefits paid

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[6] Because wages and benefits are current deductions, while capital equipment, except that equipment eligible for IRC section 179 treatment, must be capitalized and depreciated over a period of years.

to employees are not. Thus, the move from the Bank and Corporation Tax to the BNRT creates an incentive to incur a labor expense through an independent contractor or third party labor provider rather than through a BNRT taxpayer's own employees. The higher the BNRT rate, the greater the incentive to change the employer-employee relationship. All parties, both proponents and opponents of the COTCE proposal, acknowledge that this is an issue that needs to be resolved.

I do want to comment, however, on the characterizations by some that the "solution" to this problem of outsourcing or deliberate misclassification of workers will be easily obtained. Trying to address the issue by simply limiting a BNRT taxpayer's deduction to those payments made to an independent contractor who also is paying BNRT itself raises new issues. First, to the degree the alleged independent contractor has gross receipts of less than $500,000, the independent contractor has no tax liability and indeed, no obligation to file a return. The suggested "simple" solution means that larger labor suppliers would be favored by the new tax system over smaller businesses, even those following the law.

Moreover, if the independent contractor is located in another state, there is a significant question of 1) whether the independent contractor meets the dollar thresholds for "economic nexus" in the proposed BNRT legislation; and 2) whether the U.S. Constitution allows California to impose its BNRT on that independent contractor if the services are rendered outside California. And indeed, if the independent contractor is located outside the water's edge (i.e."offshore"), the BNRT's own provisions would prevent those payments from being subject to tax.

The Committee needs to spend a great deal of time considering the extent and the severity of this problem, but what is clear is that there are no easy solutions that actually work.

There are other issues as well, some of which you have heard about, and some you have not. The only tax credit from the Bank and Corporation Tax the Commission decided to retain was the Research and Development Tax Credit. If you view a tax credit is simply another form of state appropriation for a program, the Commission proposal amounts to the elimination of several programs, including the credits for establishing or contributing to a child care plan, the enterprise zone credits for hiring disadvantaged workers, the low income housing credit, and the low emission vehicle credit. Maybe this is a way for the Legislature to essentially sunset these programs and re-enact those still found worthy, but I would suspect you will hear from those aggrieved by their elimination shortly.

And finally, not to belabor the point discussed earlier, but by shifting from a net income tax to what can be viewed as a consumption tax, some companies will, at least as an initial matter, be paying BNRT when they have incurred a loss.

This is just a quick overview of some of the comparisons between the Bank and Corporation Tax and the proposed BNRT. Many other comparisons need to be researched.

<u>The BNRT versus the Sales Tax</u>

The Commission proposal would eliminate the General Fund portion of the sales and use tax rate, with a portion of the BNRT rate used to reimburse the General Fund for the revenue loss.

At the outset, the Committee should be questioning whether partial replacement of the sales and use tax system with the BNRT is warranted. My colleague Greg Turner and I presented a paper[7] to the Commission which challenged the assumption that transitions in the California economy from the production of goods to services have been manifested as a weakening of the sales and use tax base. Although this too was a core assumption of the COTCE (that the transition from a goods to a services economy mandates a fundamental change in the California tax system), there was never any evidence presented to the COTCE that our scholarship was incorrect. The Legislature should carefully consider the evidence and make its own decision.

Although replacement of the sales tax with the BNRT became a central part of the COTCE proposal, very little attention was paid to the issues arising from the transition from the sales tax to the BNRT. In many ways, these changes are the most profound.

First and foremost, the tax base is significantly broadened in two ways: 1) by subjecting to BNRT sales transactions that are currently not within the sales tax base; and 2) by effectively removing the exemptions in the sales tax base.

There are several examples of both of these, some obvious, some not so obvious. For example, the BNRT would apply to all for-profit sellers of services, ranging from legal, accounting, educational, and medical services to the more mundane landscaping, dry cleaning, domestic housekeeping and nanny services. But the base is also expanded

[7] http://www.cotce.ca.gov/meetings/testimony/documents/8-ERIC%20MIETHKE%20-%20PPT%20-%20Final%20-%20Tax%20Commission%20Testimony.pdf

in ways that are not immediately obvious such as to sales and leases of real property,[8] rental housing or hotel rooms, or licensing of intangible rights. All of these are outside of the current sales tax base, and each have issues too numerous to cover here.

But the BNRT would also effectively eliminate exemptions from the sales and use tax law that were placed there to address the regressive nature of consumption taxes: 1) food; 2) utilities; and 3) prescription medicines. The gross receipts from the sale of these items would be subject to BNRT, at least as an initial matter.[9]

There is also a doctrinal shift at work here as well. The sales and use tax currently has very few provisions within it that are based on the status of the buyer or seller. That it, the taxability of the sales does not hinge (except in a few cases) on whether the buyer or seller is a business or an individual, a profit or nonprofit entity, or a private sector or public sector entity. There are issues associated with this attribute of the sales and use tax law (such as pyramiding of tax for manufacturers). The BNRT, however, applies only to sales by private, for profit entities as sellers, and does not apply to public sector or nonprofits sellers. Also, to the extent BNRT is passed along in the form of higher prices a purchaser who is also a BNRT taxpayer is able to deduct that "passed along" tax from their own gross receipts, while an individual, government or nonprofit consumer will not be able to do so. Some thought needs to be given to whether this is a concern or not.

There are a few other subtle questions that arise in the transition from a sales tax to the BNRT. The current sales tax applies to sales by state and local government and by

[8] Although litigation could almost certainly be expected on the issue of whether the BNRT is tantamount to a "sales or transactions tax" on the sale of real property prohibited by Cal. Const art XIIIA, sec. 3.
[9] A question would arise as to whether a seller of food could be reached under the BNRT given the current constitutional prohibition in Cal. Const. art XIII, sec. 34.

most nonprofit entities. As noted above, the BNRT completely exempts nonprofits and government from the BNRT. To the degree that current sales tax revenue emanating from these sellers would have to be made up by a higher BNRT rate, it constitutes a shift of tax liability amongst competitors, and from the public sector to the private sector.

Second, because of concerns about the failure of Proposition 42 to apply to the BNRT, the decision was made to keep the full sales tax rate on sales of gasoline. The Committee needs to consider whether sales of gasoline will also be subject to BNRT. If it is, and that tax is passed along in the form of a higher price for the gas, the sales tax on gasoline will also rise as a result.

Here is where the "transparency" rubber hits the metaphoric road, however. Sales tax, BNRT (to the degree it is passed along in price), state excise tax and federal excise tax will all be buried in the price paid by consumers for a gallon of gas, yet they will have no idea of what they are paying for taxes as opposed to the actual price for the gas. The Legislature has to decide whether this is, in fact, a good thing or a bad thing. The COTCE Commissioners who have already testified before you conceded that the lack of transparency of the BNRT makes it politically possible to tax services, whereas prior efforts to impose a transparent sales tax on selected services have failed. One assumes that the COTCE members supporting the proposal believe nontransparency is a good thing.[10]

Next, there would be a change in how California taxes sales in interstate or foreign commerce. Under the current sales and use tax, a California retailer who makes a sale to an –out-of-state customer, and ships the property via common carrier or the U.S.

[10] If transparency is not deemed to be an attribute of a good tax system worth protecting, however, one could simply *require* all retailers to sell at a sales tax included price, and remove the words "tangible personal property" from the Sales and Use Tax Law, and achieve roughly the same effect as the BNRT.

mail does not add the California sales tax to the sales price. The same is true of most VATs—it is not imposed on so-called "export" sales. With the BNRT, however, to the degree the tax is passed along in the form of a higher price, there is no mechanism for "backing out" the tax, or selling in a "two-tier" pricing system (one price for in-state sales, one for out-of-state sales). The Committee should study what effect this change would have on such interstate and international sales.

Finally, the Board of Equalization has already mentioned the issue of administrative costs associated with both the BNRT and the sales tax. The state will not be able to reduce the number of personnel associated with the sales and use tax program, since a significant portion of the state rate (that for "realignment" of state/local services and that for Prop. 172's funding of local police and fire services) and the entire local rate will continue to be imposed on the existing sales tax base. The vast majority of the administrative cost of that program, however, will be shifted to local government.[11] This too is an issue that will not be easily resolved.

BNRT versus the Personal Income Tax

The Committee has heard significant testimony already on the use of revenue generated by the BNRT to pay for the reduction in revenue generated by the Personal Income Tax ("PIT"). I want to briefly focus on two issues, and show you an example that will bring many of these doctrinal shifts and collateral issues to light from a small taxpayer perspective.

[11] Indeed, local government might also be concerned how long the state would be willing to continue to fund the sales and use tax program at all. They should also be concerned to the degree would be willing to commit audit and collection resources to the sales tax if it becomes the diminished General Fund revenue source anticipated by the COTCE proposal. Enforcement efforts that were economical to the state when the state sales tax was at 7 percent may not be economically viable when the tax rate drops to 2 percent.

First, the BNRT exempts taxpayers with less than $500,000 of gross receipts from even filing a return. Some of the issues in connection with that decision were discussed earlier. However, the way the proposed statutory language is currently constructed, some issues of horizontality equity may arise. For example, if I am a sole proprietor with $400,000 of gross receipts and $100,000 of allowable BNRT "purchases" (deductions), I have $300,000 in net business receipts. But, because I have less than $500,000 of gross receipts, I do not even file a BNRT return. If, however, another taxpayer has $600,000 of gross receipts, and $300,000 of allowable "purchases," he or she has the same $300,000 of net business receipts that I do; however, they will owe BNRT tax. The ultimate amount of the tax owed is a function of what kind of purchases they have and the relationship of those purchases to their gross receipts. These are the inputs to the so-called small business tax credit (section 27801, page 271 of the draft legislation)(Attachment 1). But on these facts, the point I am trying to make is that unlike the current system, which at least on its face will treat taxpayers with the same taxable income the same, you may get a different answer with the BNRT taxpayers with the same net receipts.

The final few points I would like to make come about by way of an actual example. Attachment 2 is an actual financial statement for an S-Corporation that operates two daycare centers in the greater Sacramento area[12]. Because S-Corps are treated as a pass-through entity under current law, the income that the centers generate is taxed at the interest-holder level under the Personal Income Tax regime. As you can see in the left hand column, that amounted to taxable income of about $61,000. Under the PIT tables in effect for 2008, that would generate PIT of about $1,800. The right hand

[12] This particular taxpayers was featured in the Sacramento *Bee* on Sunday, October 11, 2009, page E1

column shows the computation of tax under the proposed BNRT regime. Even applying the so-called small business credit, this taxpayer would see their tax increase to just over $26,000 per year.[13] Moreover, although we have not computed it here, they are taxed again on this income under the PIT regime, albeit at a slightly reduced rate under the Commission's plan.

But what else does this tell us from the view of a small business person?

1. This taxpayer's chief competitor is a major corporate provider of day care. Because the competitor operates as a C-Corp, and the Commission's proposal completely eliminates the Bank and Corporation Tax, the Commission proposal would apply two levels of tax (the BNRT and the PIT) to the S-Corp daycare provider, but only the BNRT to his major corporate competitor.

2. What are the S-Corp. day care provider's options?

a. Increase Prices

This particular daycare provider noted that daycare that offers a safe and educational environment is something that is highly price sensitive. In a down economy, if quality daycare gets too expensive, parents opt for less desirable "warehousing" options, such as leaving their child with babysitters. The Legislature should spend a good deal of time examining the COTCE's assumptions on how much of the BNRT ultimately could be passed along as a price increase, and to the degree it can, is that a desirable outcome?

[13] Looked at in another way, the daycare operator is facing an effective tax rate of about 43% ($16,000/$61,000).

Labor-intensive, low-margin businesses with inconsistent cash flow and little price leverage in the marketplace[14] such as day care, in-home support services, restaurants, and agriculture just to name a few, will likely be greatly concerned about the transition from the PIT (and the bank and Corporation Tax for that matter) to the BNRT.

b. Decrease labor costs

When a business' tax increases, it can only do one of three things: pass it along in the form of higher prices, pass it along in the form of reduced wages and benefits or have it reduce returns on capital investment. Because the BNRT does not allow a deduction from gross receipts for wages and benefits, the most tempting place for the tax to be passed along is in the form of reduced wages and benefits.

We can generalize to some degree, and anticipate that industries which rely on unskilled or semi-skilled labor, or where there is an abundant supply of labor, will be most vulnerable to having the BNRT passed along to some degree in the form of lower wages and benefits. This would seem to coincide with many of the labor-intensive, low-margin industries described above. The Committee should focus some appreciable amount of time studying the impact the BNRT would have on labor economics in California.

When all of the tax policy talk ends, this is the reality that taxpayers at the other end of the policy pipeline will face. I encourage the Committee not to lose track of how the COTCE proposal would actually manifest itself in these types of individual cases for the nominal taxpayer, their customers and their workers.

Recommendation Four: Question whether the proposal's price for reducing volatility is worth it.

[14] These are referred to by economists as industries with a "high price elasticity of demand."

As mentioned above, there are many ways to address volatility, if volatility is ultimately determined to be a problem worth addressing in the tax system. The Commission's proposal addresses volatility by transitioning from a system that taxes income to one which taxes something else ("value-added," "consumption," or "business activity"). As discussed above, that means that people who have no or even negative income will be BNRT taxpayers, and that is a profound policy change.

At its August 26, 2009 hearing in San Francisco, the Commission heard testimony on just that point. A CPA named Joseph Greenstreet presented another actual case study of a well established local fine dining restaurant. He presented a spreadsheet (Attachment 3) showing the actual financial data for the restaurant. He showed that under the current income tax regime, the restaurant has a net loss of $58,619. Under the BNRT regime, the restaurant owner would owe $17,419.

I would add two caveats to this example, however. First, Mr. Greenstreet computed that BNRT liability using a 3% rate. The Commission did all of its calculations using a 4% rate. At a 4% rate, the BNRT liability jumps to $23,220. The second caveat is that Mr. Greenstreet's calculation did not factor in the so-called small business credit I mentioned earlier which is part of the final COTCE proposal. I did a rough calculation today, and found that credit to be about $3,500 dollars. This would mean that this restaurant, which had a loss and is currently not paying any more than the $800 minimum franchise tax, would now owe just under $20,000 in BNRT.[15]

Because this taxpayer also had a federal loss, if California adopted the BNRT there would be no "reduction" in his federal tax liability, only an increase in his NOL.

[15] Unlike the daycare center operator, the restaurant operator has an infinite effective tax rate.

Like the daycare operator, the restaurant owner would face some tough choices about whether to try and increase his prices, reduce wages and benefits to his workers, reduce his own standard of living, or simply close his restaurant. The Committee may well ask for modeling of how many business enterprises at the margin would be expected to close if the COTCE proposal were adopted.

And so, Mr. Chairman and members, as the Committee continues to study the COTCE proposal, it should rightly ask if these types of case studies, replicated thousands of times across California, would truly be better for California's 21st Century Economy than the tax system which serves it now.

I am pleased to answer the Committee's questions.

Final 10/14/09

Attachment 1

Taxpayer 1	Item	Taxpayer 2
$400,000	Gross Receipts	$600,000
$100,000	Purchases	$300,000
$300,000	Net Receipts	$300,000
-0[1]-	BNRT	$ 2,800

Computation of Taxpayer 2's BNRT

Initial Tax @ 4% $12,000 ($300,000 x .04)

Small Business Credit:

Section 27801(b)(2) (Purchases equal net receipts)

(A) 1-300,000/600,000= 1- (.5)= .5
(B) $250,000/ .5 = $500,000
(C) ($600,000-$500,000) x .008= $100,000 x .008= $800
(D) Credit= $10,000-$800= $9200

Final BNRT Liability = $12,000 - $9,200= $2,800

[1] Gross receipts under $500,000—no filing requirement [Section 18611(b)]

Ordinary Income/Expense

	Jan - Dec 08	BNRT	
Receipts from Services	1,272,694	1,272,694	
Total Income	$ 1,272,694	$ 1,272,694	Total Receipts
Expense			
Advertising	18,536	18,536	
Amortization Expense	11,486	-	
Automobile Expense	6,525	6,525	
Bank Service Charges	193	193	
Depreciation Expense	32,185	23,568	
Dues and Subscriptions	827	827	
Salaries and Wages	637,992	-	
Employee Benefit Programs	35,808	-	
Equipment Rental	170	170	
Insurance	36,999	36,999	
Total Interest Expense	3,795	-	
Janitorial Services	34,200	34,200	
Licenses and Permits	2,088	2,088	
Meals and Entertainment (net)	19	19	
Office Expense	5,334	5,334	
Outside Services	13,134	13,134	
Postage and Delivery	294	294	
Printing and Reproduction	296	296	
Professional Fees	300	300	
Rents	189,551	189,551	
Repairs and Maintenance	5,599	5,599	
Security	1,417	1,417	
Supplies	61,775	61,775	
Taxes			
Property	31,470	31,470	
Employer	53,801	-	
Total Taxes	85,271	31,470	
Telephone	3,554	3,554	
Training and Education	570	570	
Utilities	23,716	23,716	
Total Expense	$ 1,211,634	460,135	
Net Income	**$ 61,060**	**$ 812,559**	Net Receipts
Std Deductions Fam4	9,174	4.0%	BNRT Tax Rate
Taxable Income	51,886	$ 32,502	Gross BNRT
2009 PIT Rate	4.25%	$ (6,588)	Small Bus. Credit
Exemption CR	392		
PIT Tax	**1,813**	**$ 25,915**	**BNRT**

Small Business Credit

460,135	purchases		
$ 812,558.72	net receipts		
$ 1,272,694.00	gross receipts	0.638455685	net receipts/gross receipts
		$ 20,000	multiply by
		$ 12,769.11	Sub A (gross credit)
credit reduction		6,181.55	credit reduction
($ 500,000.00)	subtract	6,587.56	Credit Allowed
$ 772,694.00			
0.008	multiply	32,502.35	BNRT gross
$ 6,181.55	credit reduct.	**25,914.79**	**BNRT net (after credit)**

Case Study One - Closely-held C Corporation, fine dining establishment 30-years in business, incurred a Net Operating Loss in 2008, paid no income taxes.

		2008		BNRT	
Gross Receipts	$	**1,423,137.00**	$	**1,423,137.00**	
Purchases:					
Food, Beer, Wine, Liquor	$	498,726.00	$	494,026.00	
Salaries and Wages	$	546,138.00	$	-	
Repair and Maintenance	$	22,053.00	$	22,053.00	
Rent	$	99,643.00	$	99,643.00	
Payroll Taxes	$	70,734.00	$	-	Assumption: Not a purchase
Interest	$	7,906.00	$	-	
Depreciation	$	8,731.00	$	904.00	Current year purchase only
Advertising	$	7,054.00	$	7,054.00	
Employee Benefit Programs	$	1,945.00	$	-	Assumption: Not a purchase
Accounting	$	2,650.00	$	2,650.00	
Auto and Truck	$	377.00	$	377.00	
Credit Card Processing	$	31,329.00	$	31,329.00	
Dues and Subs	$	970.00	$	970.00	
Glassware/Disher	$	9,772.00	$	9,772.00	
Insurance	$	17,288.00	$	17,288.00	
Interior Decorating	$	128.00	$	128.00	
Janitorial	$	26,277.00	$	26,277.00	
Laundry and Cleaning	$	404.00	$	404.00	
Meals and Entertainment	$	1,816.00	$	1,816.00	
Music Services	$	1,826.00	$	1,826.00	
Musicians	$	28,130.00	$	28,130.00	
Office Expense	$	6,044.00	$	6,044.00	
Outside Services	$	351.00	$	351.00	
Parking and Tolls	$	840.00	$	840.00	
Promotional Expense	$	549.00	$	549.00	
Seminars/Education	$	423.00	$	423.00	
Supplies	$	36,705.00	$	36,705.00	
Telephone	$	3,103.00	$	3,103.00	
Travel	$	2,102.00	$	2,102.00	
Utilities	$	47,742.00	$	47,742.00	
Total Purchases	**$**	**1,481,756.00**	**$**	**842,506.00**	
	$	(58,619.00)	$	580,631.00	
BNRT Tax Rate				**3%**	
Tax Liability	**$**	**-**	**$**	**17,419.00**	