GENERAL DYNAMICS
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Memo

October 8, 2009

The Honorable Charles Calderon
Chair
Assembly Committee on Revenue and Taxation
Room 2117
State Capitol
Sacramento, CA. 95814

RE: Commission Tax Proposal 9/29/2009

Dear Chairman Calderon:

My name is Jim Euphrat, and I am the Tax Manager at General Dynamics National Steel and Shipbuilding Company, also referred to as NASSCO. I have been an employee at NASSCO for 30 years, almost all of which have been in my current role of dealing with tax matters. I am a CPA, and I have a Master's Degree in Business as well as a degree in Economics.

NASSCO is located in San Diego, and is the only remaining full service shipyard on the West Coast of the United States capable of building U.S. Navy ships. We also design and build all commercial vessel types. We are also the prime contractor and a strategic partner for the U.S. Navy for repair of multiple ship classes. We consistently deliver vessels to our customers that are superb in fit and finish, ahead of schedule and below budget. We also face a near-term business challenge: our order book currently reflects no commercial work after 2010 and no U.S. Navy work after 2012. In order to attract new business in the immediate future, we must remain competitive.

NASSCO is the largest manufacturing company in the San Diego region. NASSCO employees 4500 people in the San Diego area, plus an additional 1000 long-term subcontractors. NASSCO provides a critical employment niche between San Diego's high-technology industries and the service-based tourist industry. We provide above-average hourly wages, with benefits, to skilled tradesmen and women, along with extensive training and education programs. Many NASSCO employees are represented by the Boilermakers and Machinists unions. We rely on a stable, well trained, local workforce to meet the needs of our customers.

NASSCO provides significant economic benefit to California. In 2008, we spent over $500M in payroll for employees and over 370 suppliers, generating approximately $1.25B in the California economy. In addition, we spent an additional $80M on facilities improvements since the Fall of 2007, including a Blast & Paint facility that is beyond environmental compliance.

Today I would like to provide you a real-world indication of what the proposed Business Net Receipts Tax structure could mean to manufacturers in California, using NASSCO as an example. I would like to address three points:

- Job creation incentives vs. dis-incentives
- Competitiveness in the national marketplace
- NOL carry-forwards which encourages business risk-taking

First, in my reading of the BNRT proposal, it appears that a deduction is permitted for payments to subcontracts and suppliers; however there is no similar deduction for labor costs. Therefore, since labor costs are included in the "net" amount that is taxed, it appears to discourage needed job creation in California. Manufacturing jobs have a higher economic multiplier effect (2.5) than most service jobs. Manufacturing companies are heavily dependent on the retention of skilled employees. The BNRT discourages just this type of job creation, and has the unintended consequence of providing an incentive for manufacturing companies to relocate jobs elsewhere. Further, since manufacturing businesses regularly contract with subcontractors or suppliers that operate nationally or globally, again this BNRT appears to unintentionally encourage sourcing jobs outside of California.

Second, based upon the September 29 Commission Proposal, my preliminary estimates strongly suggest that NASSCO would pay significantly more tax under the proposed BNRT than under the current system. There may be a perception that large businesses, or the California market, can bear a higher price with low risk to the underlying business or related jobs. However, NASSCO competes in a national marketplace. The price of an ocean-going ship is determined by markets much broader than just the state of California. In order to protect the competitiveness of companies that employ thousands of people, this type of major tax policy shift must be viewed in the context of national and international markets. NASSCO is already subject to a higher tax rate than our Gulf and East-coast competitors. A shift such as the one proposed could make NASSCO less competitive in the market place, resulting in business conditions that lead to job reduction.

Finally, shipbuilding does have a history of cyclical business periods, and losses have occurred in some years. The current tax system can be helpful in a loss year, as the net operating loss can be carried forward to offset future profits necessary to sustaining, and hopefully, growing the business. This tax convention has the effect of encouraging business risk-taking, thereby creating jobs, with the state benefiting in the long-run from taxes paid in sustainable years. The BNRT again has the unintended consequence of penalizing business risk-taking by levying a tax regardless of whether the company has any profits from which to pay that tax.

<u>Business Net Receipts Tax (BNRT) recap of issues and concerns:</u>

1. BNRT is essentially a tax on jobs; labor is by far the largest cost component on which the tax would be levied, and this could therefore be adverse to long term job creation in California.

2. The proposal includes the reduction of marginal personal income tax rates to 6.5% from the highest rate of 10.55%. The BNRT will indirectly significantly raise taxes and related costs on goods and services to lower and middle income California residents. Therefore, the proposed BNRT would impose a significantly higher tax burden on our employees and make it even more difficult for us to recruit trained ship builders.

3. Lower profit margin businesses that currently pay a modest corporate income tax would generally see a huge tax increase. This would exacerbate the already negative environment that California faces with regard to new and existing businesses. This in turn is likely to be adverse to the long-term fiscal health of California. This would have a negative effect on many of our suppliers.

4. Complex transition issues with regard to existing credits and NOLs and other tax attributes are either ignored or not dealt with fairly in the proposal. For example, under current law credits that were awarded to companies for actions in accordance with state policy objectives may currently offset up to 50% of corporate income tax. Under the BNRT, such existing credits could only offset at most 5% of the tax (over a 20 year period); the BNRT thus effectively eliminates the cash value of earned credits. The current tax system can be helpful in a loss year, as the net operating loss can be carried forward to offset future profits necessary to sustaining, and hopefully, growing the business.

5. The BNRT prospectively provides no NOL provisions or relief for a start-up company. Thus a new business, which might have losses initially, would still be subject to full BNRT at a time when cash flow is especially tight. The BNRT could then be seen as discouraging creation of new businesses in California. Under federal contracting regulations we are required to work with a variety of small business suppliers. Therefore, this would have a negative effect on our ability to secure the needed suppliers and in turn this may negatively affect our ability to meet production schedules.

6. The BNRT indirectly encourages the outsourcing of jobs to subcontractors or consultants. This in turn may encourage us to outsource jobs outside the state.

7. The authors of the BNRT are presuming that the tax will be levied against companies in other states or countries that provide goods or services to California residents or businesses. The tax would be apportioned based upon sales in California. However, there are numerous legal issues that are uncertain in this regard. A legal challenge from the perspective of the U.S. Constitution Commerce clause (essentially a fair trade issue) is highly likely.

8. The proposed tax rate of around 4% for the California BNRT is much higher than a sort of similar tax that has just been implemented in Michigan. (The Michigan rate is less than 1%.) (The Michigan tax is too new to have been studied with regard to economic impact, but the rate is so much lower that this is not a fair comparison.) The proposed California BNRT tax rate is high enough that the BNRT could easily become a key factor in forcing marginally profitable California businesses to close or relocate to another jurisdiction with a more business friendly environment. This could therefore be detrimental to reducing the current high unemployment rate in California.

9. Dynamic modeling (vs. static modeling) has not been performed to evaluate potential adverse consequences to the overall fiscal health of California—there are no extensive studies on BNRT. This proposal is essentially an economics experiment with unknown consequences, and therefore any such changes need to be carefully studied prior to implementation. The Tax Commission was

not given sufficient time or resources to adequately analyze the impacts of such a massive change in tax policy.

The Commission's Tax Court Proposal Would Make it More Difficult and More Costly for the Individual Taxpayers and Businesses to Represent Themselves

Appendix D in the September 29, 2009 Commission report proposes a new "independent tax forum" to resolve tax disputes between the taxpayer and the state. In my view this proposal has not been adequately researched and is of questionable value. The elected members of the Board of Equalization provide a forum that appears in general to work well; the current system provides taxpayers with a venue to appeal tax matters at a cost that is lower than would be the case in a more formal tax court. From the NASSCO shipyard perspective, the current California tax dispute resolution system is perceived positively [based upon actual tax issues spanning several years] in comparison with approaches taken by other states. Further, the current system permits numerous administrative appeals and informal discussions with the various tax agencies that may resolve tax issues in a reasonable and efficient manner. The additional cost of setting up a new state tax court would seem to be a very questionable use of scarce state resources; there would seem to be many higher state budget priorities. In my view, this is a case of the current system is not broken, so no fix is needed.

The replacement of an elected body with appointed members of the Tax Court removes citizens from their elected representatives, and results in a less responsive government.

The success of the Board of Equalization stems in large measure from the fact that it is an elected body, not an appointed one. Because they are elected, Members of the Board of Equalization have the responsibility of acting in the people's interest, but not according to their wishes, but with enough authority to exercise swift and resolute initiative in the face of changing circumstances. The Commission's Tax Court Proposal would grant the power for hearing and determining tax appeals to non-elected judges, rather than elected officials who are directly accountable to voters.

Conclusion

In conclusion, I respectfully encourage the panel to reject a plan that relies on BNRT as the tax standard in California. It is my opinion that BNRT will serve to negatively impact industrial manufacturing growth in this state, discouraging creation of middle class jobs and prolonging the economic downturn. Representing just one of the manufacturers that will be harmed, the BNRT would encourage outsourcing jobs out of California, limit competitiveness in the global marketplace, and eliminate the net operating loss carry forward to the detriment of business risk taking.

NASSCO is committed to growth and maintaining our position as an economic engine in the San Diego region. BNRT jeopardizes our company's competitive position, and California's competitiveness, in the marketplace.

If you have any questions in this regard, please do not hesitate to call me at (619) 544-7907.

Sincerely,

Jim Euphrat
NASSCO Tax Manager

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Proposed Business Net Receipts Tax (BNRT)--sample

Sales	1,000,000,000	
Purchases	600,000,000	
Net Receipts	400,000,000	conceptually, primarily labor costs: value added concept *presume here $300M labor + $100M profit*
Estimated Tax Rate	4.00%	estimate based upon various Commission documents--see www.cotce.ca.gov
prelim. est BNRT	***16,000,000***	
credit carryforward	800,000	limited to 5% of tax, with credits expiring after 20 years--theoretical maximum
est. net receipts tax	***15,200,000***	

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Current California Corporate Income Tax--sample

Sales	1,000,000,000	
Est tax profit @ 10%	100,000,000	
Tax Rate	8.84%	
est preliminary tax	8,840,000	
credits--R&D, hiring	4,420,000	limited to 50% of tax per current California tax law--theoretical maximum in 2009
est corporate tax	***4,420,000***	based upon current law

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Comparison of effective net California tax rates

Current Corporate Income Tax	**4.42%**	(= est tax of $4,420,000 / est profit of $100,000,000)
Proposed BNRT	**15.20%**	(= est tax of $15,200,000 / est profit of $100,000,000)

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Notes:

1. The above numbers will not be representative for all businesses. The actual taxes will vary primarily with profits and labor costs.
2. Net receipts tax conceptually taxes value added or labor; this is not helpful for encouraging jobs and related economic growth.
3. Current corporate income tax also provides some recognition of risk and business losses with net operating loss offsets; net receipts tax appears to discourage business growth and risk taking.
4. The BNRT represents a huge tax increase for businesses; this will discourage future business activity in California. This in turn will very likely make current budget challenges worse on a long-term basis.