

# WILL THE NET BUSINESS RECEIPTS TAX END UP AS AN INCOME TAX? AND WHY I CANNOT VOTE TO SEND THIS TAX FORWARD

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## I. Introduction

I am sorry that I could not make last Monday's meeting of the Commission. I did have someone try to make a transcript, and I have talked with some Commissioners about what transpired. I am now more concerned than ever that the net business receipts tax (NBRT) will end up moving in the direction of an income tax. That move obviously will undercut the ostensible goal of the tax, which is to tax personal consumption (value added), not income. We might very well end up eliminating the existing corporate income tax and after much wasted effort, adopt a new tax that is tantamount to the corporate income tax we just eliminated. A much greater risk looms, however. The risk is that NBRT, as it moves closer to an income tax, will be held by a court to be subject to Public Law 86-272.

Under Public Law 86-272, a state cannot levy an income tax on out-of-state persons if their only activities within the state consist of: the solicitation of orders for the sale of tangible personal property; such orders are sent outside the state for acceptance or rejection, and if accepted, the order is filled by shipment from outside the state. If Public Law 86-272 applies, one of the heralded features of the NBRT, its ability to tax out-of-state vendors, would dissipate (regardless of whether economic nexus was the governing standard).

When I combine these concerns with those raised in my earlier memo, "Why I Fear We are Heading in the Wrong Direction," I cannot vote to send this tax forward. It will consume legislative resources, divert attention from more promising approaches to eliminate waste and inefficiency in the State's tax structure, and from proposals to actually deal with the challenges of the 21<sup>st</sup> Century, such as the Internet and the digitalization of goods and services.

## II. The Proper Differences between a VAT and an Income Tax, and why those Differences are Likely to Diminish Significantly and be Blurred

A pure NBRT would differ from an income tax in four key ways: no deduction would be allowed for wages, no deduction would be allowed for interest, the cost of capital goods would be expensed, that is, fully deducted in the year of purchase, and the tax would be paid whether a business was profitable or not. All these of these differences are likely to make the NBRT appear less favorable to job retention, growth, and innovation than an income tax and have been the object of intense business criticism. I claim no special expertise on California politics. But I have been around the block enough times to expect that a legislator is unlikely to sit idly by when jobs are at stake. Some Commissioners might want to wait for studies that show the NBRT is causing a significant substitution of capital for jobs or a shift of jobs out-of-state. Legislators, however, are unlikely to wait.

And the barrage of letters we have received raising these concerns indicate the pressure that will be brought on Legislators demanding relief.

The lack of a deduction for of wages, which is entirely appropriate in the context of a value-added tax, may be difficult for the California legislature to accept in the context of a tax presented to the public as a business tax. A Legislator will certainly fear that the combination of no deduction for wages with the expensing of capital goods will encourage a substitution of the latter for the former, such as replacing humans with machines. My earlier memo, "Why I Think We are Heading in the Wrong Direction," sets forth other reasons why the NBRT might well encourage the substitution of exempt California independent contractors for California employees, as well as encouraging the use of out-of-state labor over California labor. Under the slogan of "protect our jobs," friends of labor are likely to press with success either for wages to be made deductible in computing the base of the NBRT or to obtain some job credits or other special provisions designed to encourage California employment.

The lack of a deduction for interest also is likely to prove controversial. A firm that has to borrow to stay afloat and preserve jobs may be able to make a case for relief that the Legislature will find compelling. Firms wanting to expand and hire more workers also are likely to make a strong case for relief.

Any relief granted for wages and interest will be costly in terms of lost revenue to the State, thereby putting pressure for an increase in the NBRT tax rate. One way to finance relief for wages and interest will be to deny the expensing of capital goods and allow only a deduction for depreciation. I certainly can imagine that such a change would have some appeal to a legislative body.

Moreover, California is an incubator for innovative, high-tech businesses. One characteristic of these start-ups is some initial period of losses. Unlike an income tax, the NBRT will be paid by businesses under a cash-flow crunch, with no profits, but wages to be paid and debt to be serviced. I predict Legislators will be concerned about the NBRT's impact on new ventures.

Quite aside from the changes that the California legislature might make to the staff draft of the NBRT provided to the Commission, the draft itself incorporates provisions that are features of the existing corporate income tax but are inconsistent with the normative structure of a VAT. For example, the draft would allow a deduction for NOLs and a generous credit for R&D costs. It would provide an exemption for non-profit organizations, even though goods and services acquired by Californians from a non-profit organization are just as much personal consumption as the same or similar goods and services obtained from a for-profit company.

The more the Legislature moves to grant relief for wages and interest, limit the costly deduction for capital costs, and carries over other features of the existing corporate income tax, the more the NBRT is likely to look like an income tax. Indeed, as I reviewed the transcript of our most recent meetings, I am struck by how often Commissioners

talked about the NBRT using concepts and terms that were lifted from the income tax literature. If we are inclined to talk about the NBRT in income tax terms, we ought to be concerned that the Legislature and a court will do the same. If a court does, Public Law 86-272 comes into play, and the revenue projections from the NBRT will disappear.

Part of the problem in keeping the Legislature from converting the NBRT into some version of an income tax is that the NBRT is not the type of value-added tax used elsewhere in the world. At our last meeting, at least one Commissioner seemed sympathetic to the NBRT because California would be getting in line with the tax practices of the rest of the world. That understanding is manifestly incorrect. The NBRT is exactly opposite the value added taxes used elsewhere in the world. We have set sail alone is designing the NBRT, with only the low-rate, Michigan modified gross receipts tax, as precedent. That Michigan tax is so new, however, that that State's tax administration does not even know how much revenue it has generated in its first full year of operation.

I have suggested in my earlier memo that a legislator will have trouble understanding the theory and concept of the NBRT and what its normative structure should look like. We have helped confuse that issue through our draft of the tax. By incorporating into the draft of the NBRT provisions that are not an inherent part of a value added tax, we have helped blur the conceptual purity of the tax, and confused its core concept. By giving away so much in our draft, we have squandered an opportunity to educate the Legislature and public about the goals and structure of a value-added tax. This compromised tax will now be the starting point for more concessions by the Legislature. The bottom line, I fear, will be something that will resemble an income tax more than a value-added tax. To a court, the similarity of the tax to a traditional income tax may be compelling, which means that the expected exception of the NBRT from Public Law 86-272 will not come to fruition.

If Public Law 86-272 is held to be applicable to the NBRT, that law will supersede any economic nexus standard adopted by California. The revenue consequences would be severe. Out-of-state vendors that have a pattern of continuously soliciting sales in California might satisfy an economic nexus standard (assuming that would be the applicable nexus test), but they would be protected from the tax if they satisfied the requirements of Public Law 86-272.

### III. Why I Cannot Vote to Send the NBRT Forward to the Legislature

When I combine my concerns about how the NBRT is likely to devolve into an income tax, or at least be set adrift without a rudder, with the issues raised in my earlier memo, I cannot in good faith send this proposal forward, especially when some Commissioners want the tax described as “promising.” I think it is anything but “promising.” I realize that we can drop the “promising” language and attach all the caveats we want, but the bottom line is that anything we send forward will have our imprimatur, consume legislative resources, time, and energy with hearings, studies, testimony, drafts and so forth. I believe that those resources are better devoted elsewhere, as I suggested in my Red, White, and Blue Plan. I also think that the Legislature needs to take seriously the

challenges presented to the State's tax system by the 21<sup>st</sup> Century, including the Internet and the digitalization of goods and services, which we have essentially ignored.