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SheppardMullin



Controller Betty T. Yee  
California State Controller's Office

# Inside Sacramento

WHAT MUST BE DONE, WHAT MIGHT GET DONE!?

TEI-SJSU Tax Policy Conference: Tax Reform – Getting Ready for Action in 2017

John Paek – Baker & McKenzie  
Oksana Jaffe - KPMG  
Nikki Dobay – COST

Tracey Grose – Council of Economic Advisors  
David Ruff – Assembly Revenue & Taxation  
Greg Turner – Sheppard Mullin

## Agenda

1. Back to the Future
2. Can The Tax Structure Drive Economic Vitality?
3. What Other States are Doing
4. CA Tax Reform and Making Sausage
5. Hot Topics in Sacramento
6. Helping or Hurting Business?

# Back to the Future

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1. The Riley-Stewart Plan (1932)
2. Proposition 13 (1978)
3. Tax Advisory Commission (1985)
4. Constitution Revision Commission (1993)
5. Commission on Tax Policy in the New Economy (2000)  
(Aka The Vasconcellos Commission)
6. Commission on the 21st Century Economy (2009)  
(Aka The Parsky Commission)



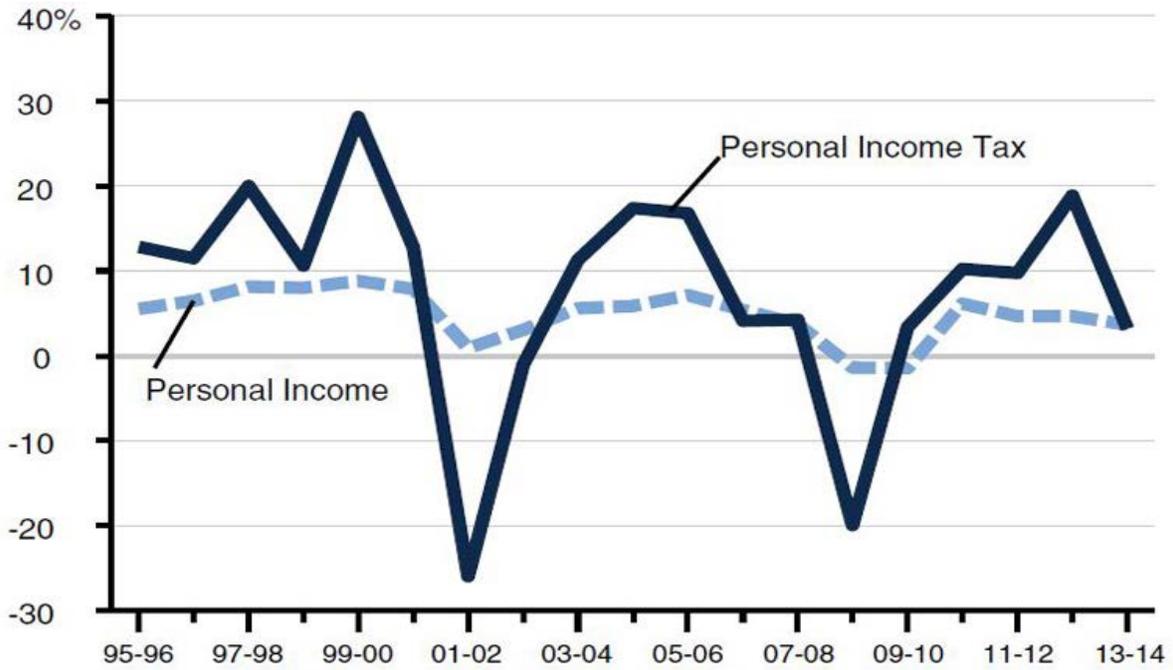
## What Shapes CA Tax Policy?

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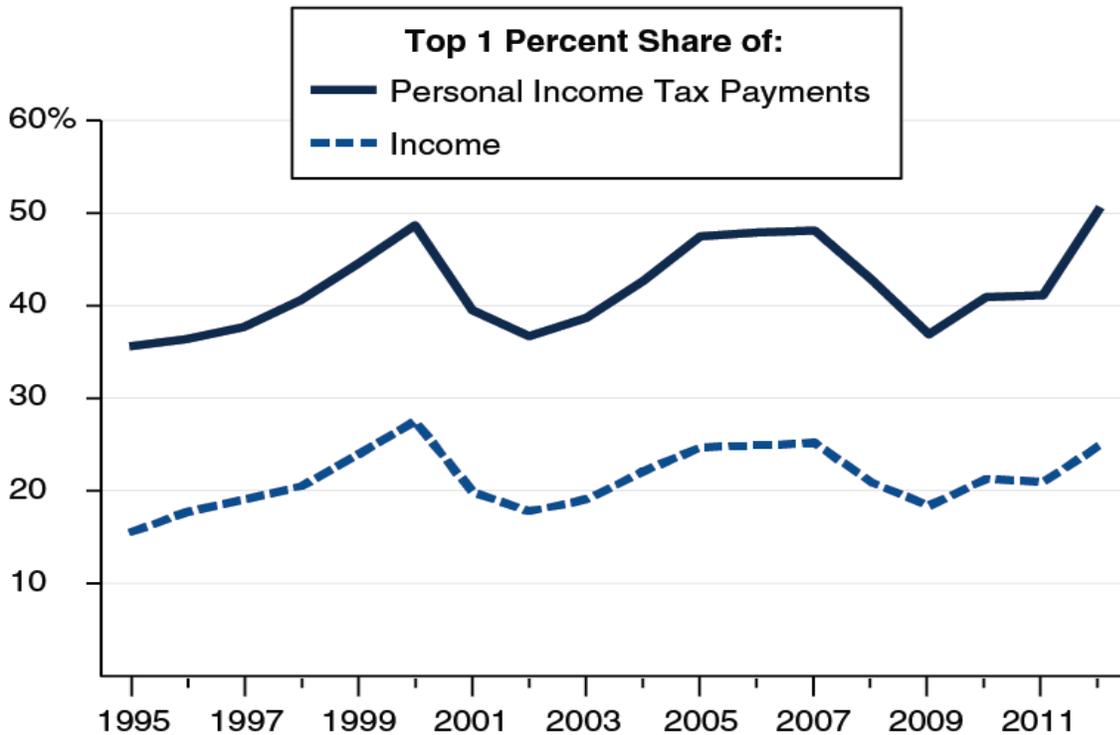
1. Don't Tax You, Don't Tax Me, Tax the Fellow Under the Tree.
  2. The Initiative Process  
(Direct Democracy or Shackling Government?)
    - a. Proposition 13 (Property Tax Reform) (1978)
    - b. Proposition 98 (Minimum School Funding)(1988)
    - c. Proposition 218 (Local Special Tax Reform) (1996)
    - d. Proposition 26 (Fee Reform) (2010)
    - e. Proposition 30 ("Temporary" Tax Increases) (2010)
    - f. Proposition 39 (Clean Energy Jobs Act– Single Sales Factor)
  3. The State and Local Fiscal ~~Co-dependency~~ Relationship
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# Personal Income Tax Much More Volatile Than Economy

*Percent Change From Prior Year*

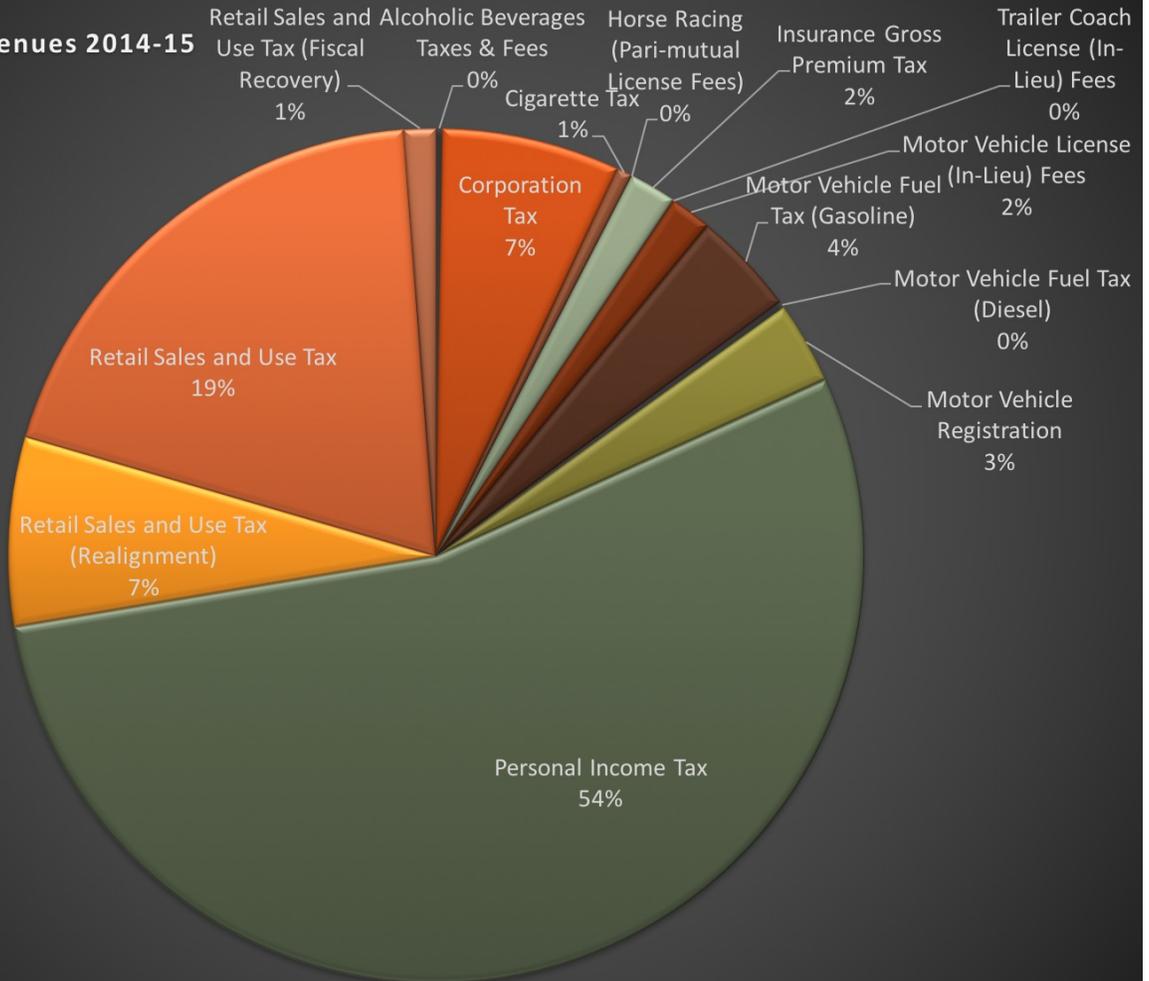


## Top 1 Percent of Income Earners Paid Half of Income Taxes in 2012

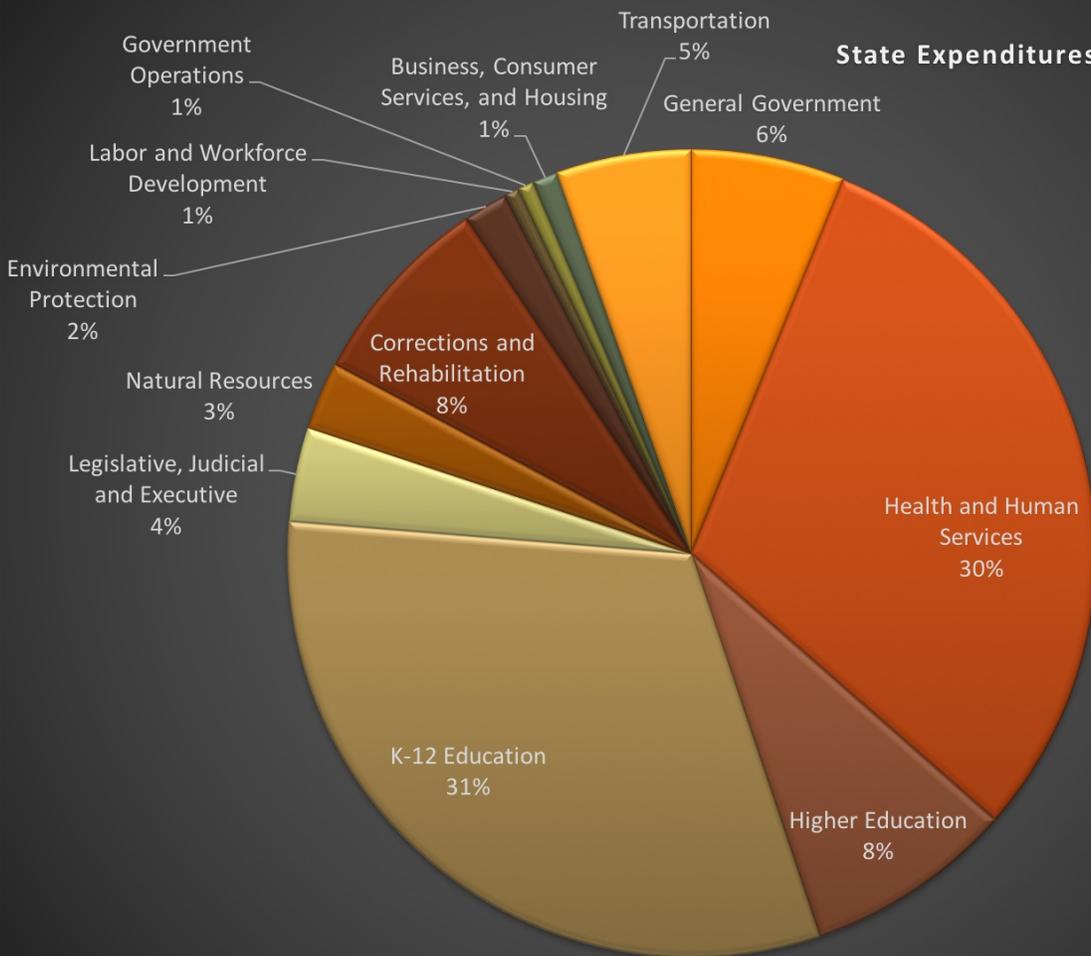


Source: Franchise Tax Board

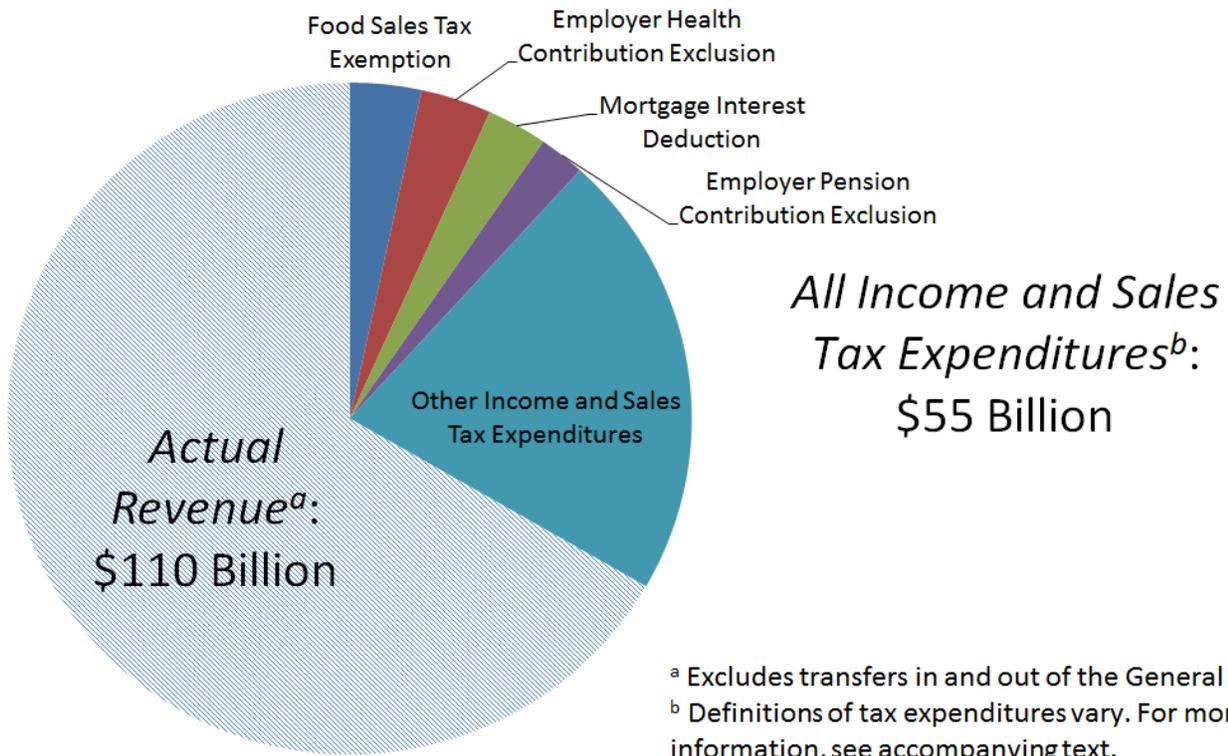
### State Revenues 2014-15



### State Expenditures 2015-16



# How Much More General Fund Revenue If There Were No Tax Expenditures? (2014-15, Static Estimates)



## TAX REFORM IN THE GOLDEN STATE

**Tracey Grose**  
Chair, Council of Economic Advisors, California State  
Controller Betty Yee  
TEI-SJSU Tax Policy Conference - August 2, 2016

# OVERVIEW

1. California's tax structure is outdated— It's time to consider comprehensive reform.
2. How do we adapt to the changing economy and drive economic vitality and competitiveness?
3. Next steps



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## CA Controller Launches Expert Panel To Analyze Tax Reform Proposals from Varied Perspectives

SACRAMENTO—With momentum building for comprehensive tax reform in California, State Controller Betty T. Yee today appointed a Council of Economic Advisors to assess the impact of proposals across the spectrum of taxpayer constituencies.

The nine-member council will include experts from a variety of backgrounds including academia, economics, business, and government. The group's core objective is to review and comment on the potential impacts of numerous tax reform proposals. Working with data from the California Board of Equalization, California Franchise Tax Board, and State Controller's Office, the council members will assess the workability of proposals including practical effects, unintended consequences, and prospective alternatives.

"California needs a tax system that reflects the 21<sup>st</sup> century economy, is less vulnerable during economic downturns, and is more sustainable, providing greater certainty from year to year," said Controller Yee, the state's chief fiscal officer. "While multiple reform proposals have merit, they must be examined within the context of comprehensive tax reform with a focus on fairness to all taxpayers. My Council of Economic Advisors will serve as the singular nonpartisan source of perspectives for tax reform proposals. With 10 years of experience serving on the State Board of Equalization, I believe the workability of tax proposals must be evaluated prior to their enactment such that application of the enacted provisions is clear."

The includes:

- **Dr. Alan Auerbach** – Professor of Economics and Law at University of California, Berkeley, and Director of the Robert D. Burch Center for Tax Policy and Public Finance
- **Dr. Imran Angelov Farooq** – Director of Center for Economic Development & Innovation at University of California, Riverside, and Partner at The Omnibus Group
- **David Gamage** – Assistant Professor of Law at University of California, Berkeley
- **Ruben Gonzalez** – Senior Vice President of Public Policy and Political Affairs at Los Angeles Area Chamber of Commerce
- **Tracey Grose** – Vice President of Bay Area Council Economic Institute
- **Jennifer Ito** – Project Manager at University of Southern California Program for Environmental and Regional Equity
- **Hon. Mike Machado** – State Senator (Retired) and Farmer/Business Owner
- **Kim Rueben** – Senior Fellow at Urban-Brookings Tax Policy Center and Affiliated Scholar at Public Policy Institute of California
- **Kim Walsh** – Director of Economic Development and Deputy City Manager for City of San Jose

Ms. Grose will serve as chair of the council. Controller Yee will convene the first meeting of the council in Sacramento in May.

###

# Comprehensive Tax Reform in California: A Contextual Framework

June 2016



California State Controller Betty T. Yee  
& the Controller's Council of  
Economic Advisors on Tax Reform

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# SOME GUIDING PRINCIPLES

## ***Effects on People***

- Promote tax fairness and equity

## ***Budgetary and Fiscal Policy***

- Encourage revenue sustainability
- Enhance comprehensive taxation
- Promote revenue stability
- Encourage systemic flexibility and adaptability
- Adjust state-local alignment

## ***Economy***

- Promote economic vitality
- Encourage revenue sustainability
- Address infrastructure, housing, and transportation needs

## ***Compliance and Administration***

- Make it easier for taxpayers to comply
- Ease tax administration
- Ease regulatory requirements

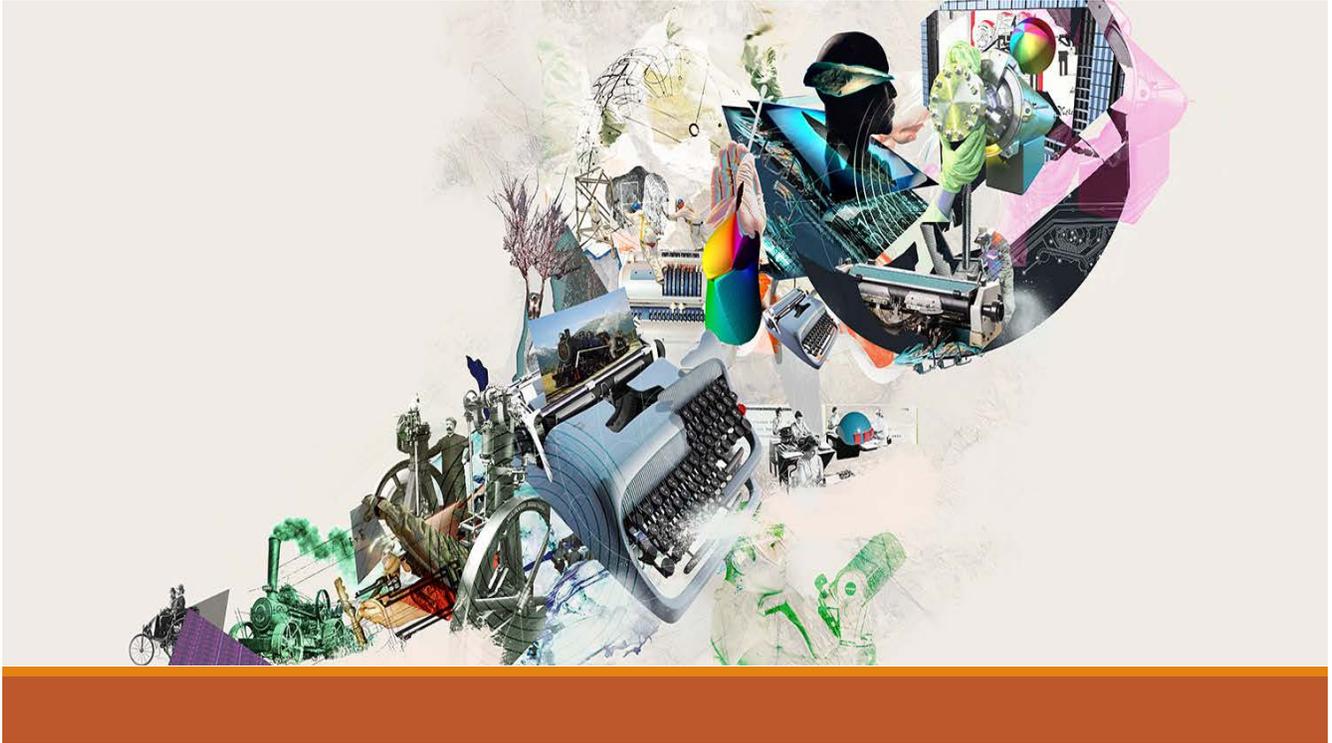


## BALANCING TRADEOFFS

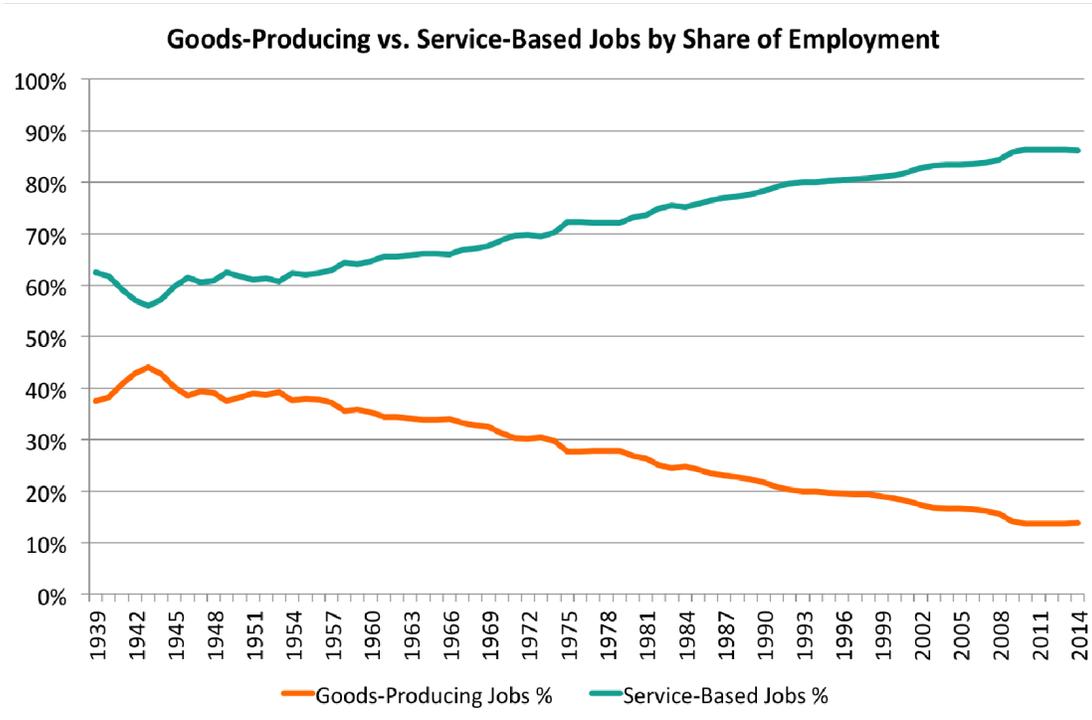
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- ***Local Fiscal Discretion***
  - ***Changes for the Tax on Capital Gains***
  - ***Financing an Increase in Critical Infrastructure like roads***
  - ***Improving Government Performance***
  - ***Fostering an Improved Business Climate***
  - ***Who Bears What Burden?***
- 

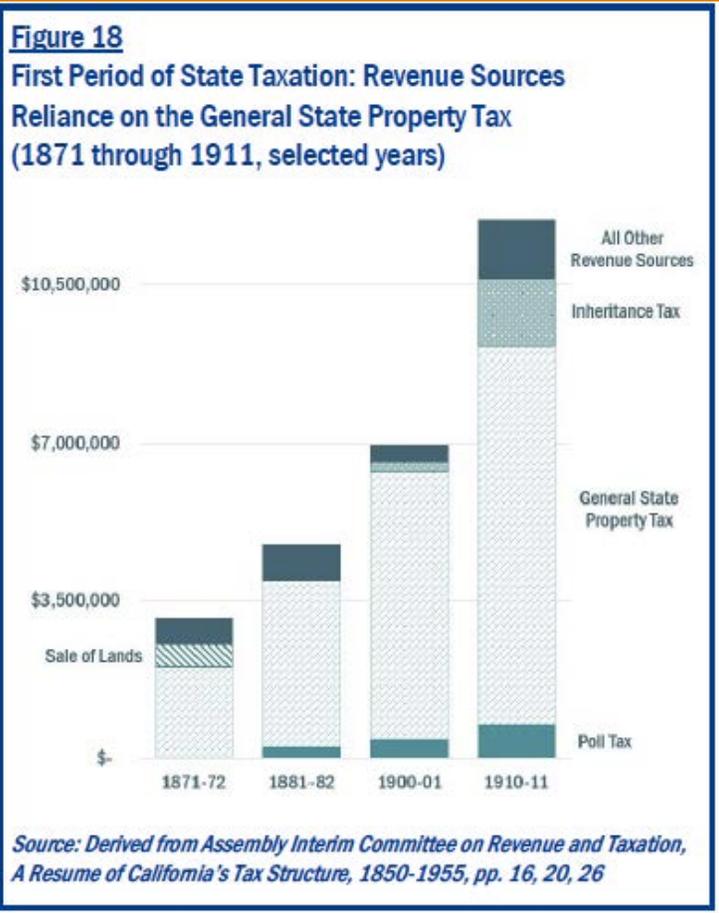
# As the economy evolves, how do we adapt our tax structure? How do we drive economic vitality?



## SHIFT FROM GOODS PRODUCING TO SERVICE-BASED ECONOMY



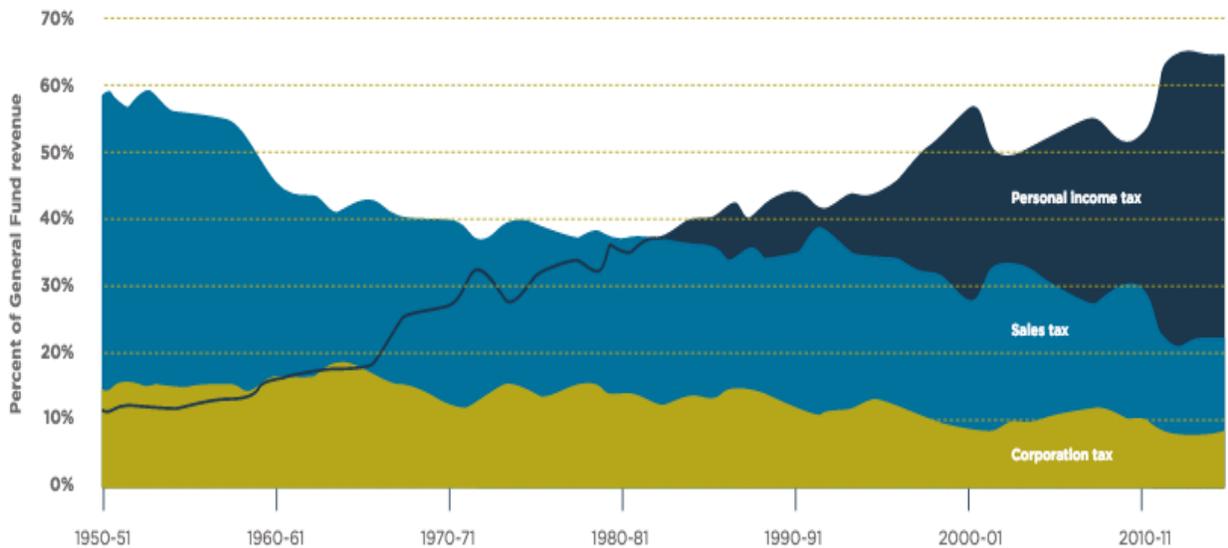
Source: U.S. Bureau of Labor Statistics, Current Employment Statistics  
Analysis: Bay Area Council Economic Institute



# GROWING RELIANCE ON PERSONAL INCOME TAX

## THE BIG PICTURE

Increasing reliance on income taxes



**Note:** Excludes transfers and bond proceeds  
**Data source:** Legislative Analyst's Office

# Addressing growing volatility and income disparity

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Taxing income AND wealth

Harnessing volatility

Investing in personal outcomes



## INCENTIVIZING VIRTUOUS CYCLES OF ECONOMIC GROWTH

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Address the State-Local Relationship

Simplify Regulatory Requirements

Facilitate Investment in Critical Infrastructure

Incent Business Investment



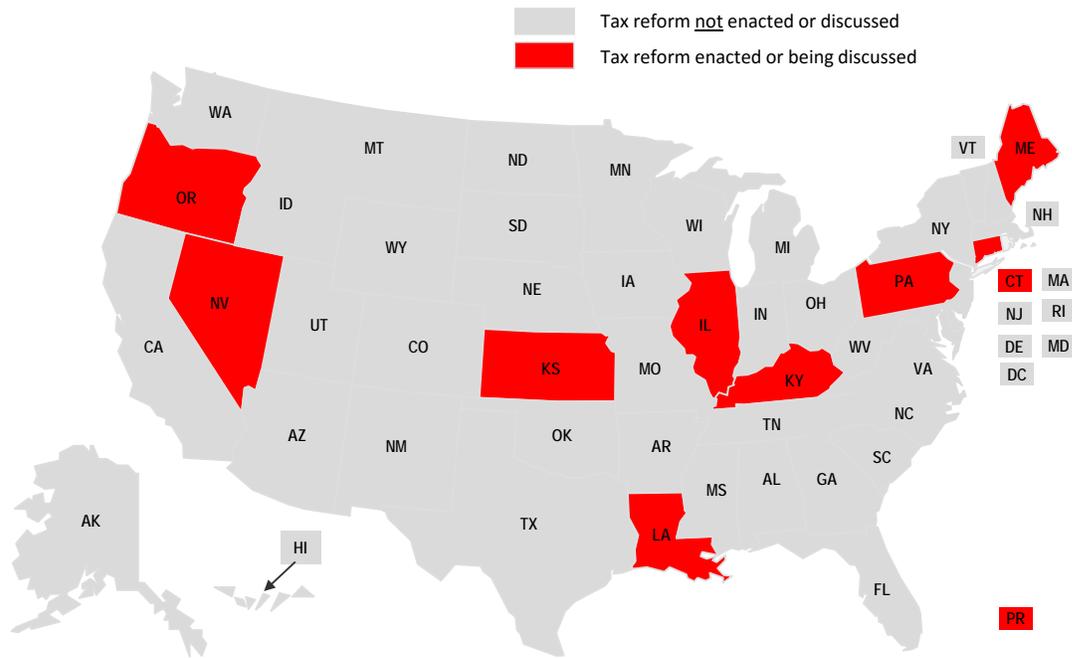


LOOKING AHEAD

**State Tax Reform**



## State Tax Reform: Where It Happened



## 2015 State Tax Reform: Why It Happened

- Puerto Rico – significant budget shortfalls, taxpayer non-compliance with the SUT system, need for a more stable revenue source
- Illinois and Pennsylvania – a tale of two states facing very similar issues
  - ✓ New governors with opposite party controlling the legislature
  - ✓ Severe budget shortfalls
  - ✓ Need to reform their tax codes and pension systems , fund education
- Nevada – a need to fund education led to the enactment of the new Commerce Tax
- Kansas – 2012 tax relief that exempted income from a pass-through entity from individual income tax is causing significant budget shortfalls; governor and both houses of the legislature at odds on fix
- Connecticut and Louisiana – both states faced significant budget shortfalls; tax increases appear insufficient

## 2016 State Tax Reform: Where It Could Happen

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- Will Oregon voters pass a GRT? If not, will the Oregon legislature adopt a CAT?
  - Will Connecticut adopt a tax similar to a VAT, CAT or Margin tax?
  - Louisiana's new governor faces significant budget shortfalls due to decreasing oil revenues, insufficient revenues from the 2015 tax changes. Is tax reform in the future?
  - Illinois and Pennsylvania on repeat...both states are still facing budget shortfalls, both states still need to fix their pension systems and both states need to enact budgets
  - Will continued revenue shortfalls and the need to adequately fund education cause Kansas to reconsider rolling-back some of the 2012 tax relief?
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## Tax Haven Legislation

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## Existing “Tax Haven” Provisions

Six states (Alaska, Connecticut, Montana, Oregon, Rhode Island, and West Virginia) plus D.C. currently have some form of a “tax haven” provision that seeks to include certain foreign entities in a state’s unitary combined return.

Only two states (Montana and Oregon) define a “tax haven” on the basis of a list of foreign jurisdictions (commonly referred to as a “blacklist” approach). The other five jurisdictions employ a facts and circumstances test modeled after the MTC’s “tax haven” criteria definition.

The states that have tax haven legislation collectively make up less than 4 percent of the U.S. population.

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## Recent Legislative Activity—2015/2016

In 2015, at least 12 states considered tax haven legislation; however, only one (Connecticut) enacted it.

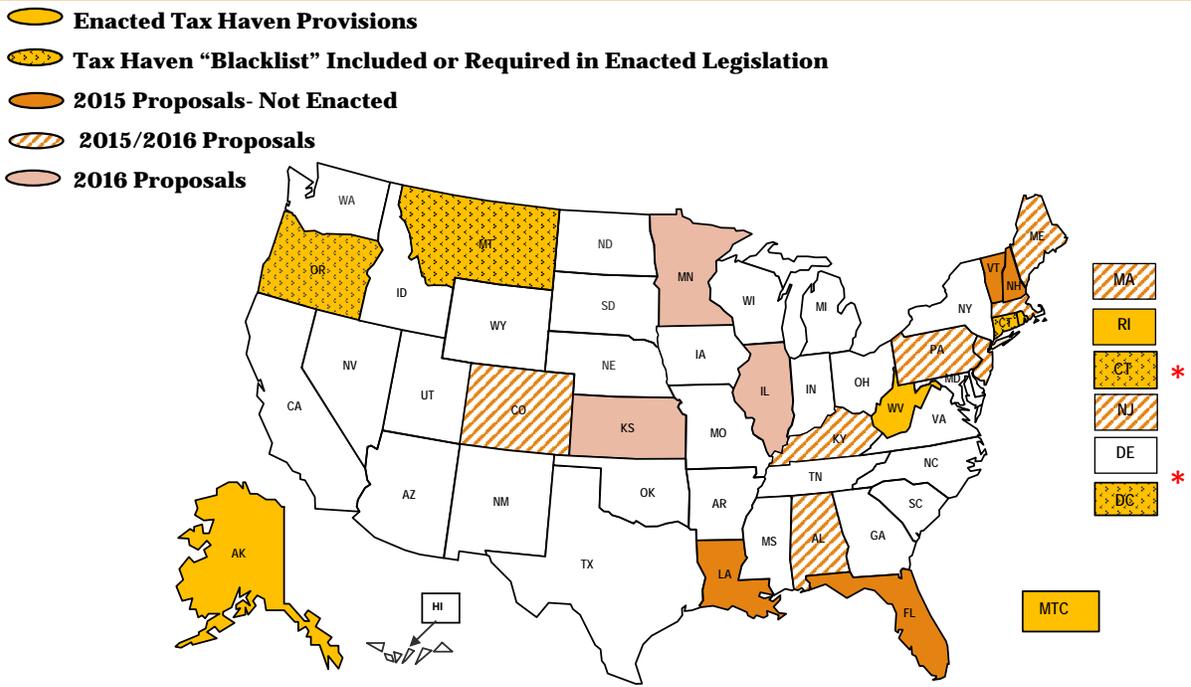
- Montana and Oregon updated their current “blacklists”.
- D.C. adopted a “blacklist”, but then repealed it.
- States typically considered adding tax haven provisions to existing combined reporting statutes or including tax haven provisions with new combined reporting bills.
- Most of these proposals followed the “blacklist” approach.

So far in 2016, eight states have considered tax haven legislation—Alabama, Colorado, Indiana, Kansas, Kentucky, Maine, Minnesota, and New Jersey – but none have enacted it.

Democrats and Republicans typically vote along party lines for and against these proposals.

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# “Tax Haven” State Enactment Status and 2015/2016 Proposals



\* DC and Connecticut have subsequently repealed or removed the “blacklist” requirement in favor of “indicia” of tax havens.

## What’s Wrong with this Picture

The effort to impose state taxation on foreign source income is not likely to abate.

In our State Tax Research Institute report, we draw the following key conclusions about tax haven legislation:

- There is no clear evidence that profit shifting to tax havens is eroding the state corporate tax base.
- State tax haven blacklists are arbitrary and unmanageable.
- Tax haven legislation represents a partial return to the discarded mandatory worldwide combination method.
- States adopting tax haven legislation risk losing investment and jobs and face constitutional challenges.
- The tax haven approach is completely out of sync with the global approach to BEPS.



## Inside Sacramento – What Must Be Done, What Might Get Done

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M. DAVID RUFF, CHIEF CONSULTANT  
CALIFORNIA ASSEMBLY COMMITTEE ON REVENUE AND TAXATION

## What is happening in the Legislature?

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In the current Legislative Sessions, 305 bills have been introduced either amending or adding provisions to California's Revenue and Taxation Code.

What kinds of bills get introduced?

- One of these bills pertained to comprehensive federal conformity. (AB 154 (Ting).)
- At least 9 of these bills pertained to Voluntary Contribution Funds on the PIT return.
- At least 19 of these bills pertained to a sales and use tax exemption.
- At least 64 of these bills pertained to tax credit programs.

# Hot Legislative Topics in the Last Year?

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Managed Care Organization (MCO) Tax Changes

The Regulation and Taxation of Medical Marijuana

The Taxation of Certificated Aircraft



# Hot Legislative Topics in the Last Year?

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## MCO Tax Changes

On March 1, 2016, Governor Brown signed legislation restructuring the MCO tax. Starting July 1, 2016, a new MCO provider tax is imposed on health care service plans, along with other entities.

The MCO tax package also reduced the gross premiums tax rate to zero percent for health care insurers affiliated with a health care service plan subject to the new tax.



# Hot Legislative Topics in the Last Year?

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## The Regulation and Taxation of Medical Marijuana

- We have seen the introduction of numerous bills seeking to build upon the regulatory framework adopted last year:
- **AB 2243 (Wood)**: Imposes a tax in specified amounts upon the distribution of medical cannabis flowers, immature medical cannabis plants, and medical cannabis products. (Pending in Senate Appropriations)
- **SB 987 (McGuire)**: Imposes a fee, on and after January 1, 2018, on the consumption or other use in this state of "medical marijuana" purchased from any "retailer" for the consumption or other use in this state at the rate of 10% of the sales price of the "medical marijuana". (Failed passage in Assembly Revenue & Taxation)



# Hot Legislative Topics in the Last Year?

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## The Taxation of Certificated Aircraft

- **AB 2622 (Nazarian)**: Extends the Centralized Fleet Calculation Program for statewide assessment of certificated aircraft for property tax purposes until fiscal year (FY) 2019-20. Contains other more substantive provisions.
  - **SB 1329 (Hertzberg)**: Extends the Centralized Fleet Calculation Program for statewide assessment of certificated aircraft for property tax purposes for one year, until FY 2017-18.
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# What's on the Horizon?

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## Direct Democracy

- **Prop. 55:** Extends by twelve years the temporary PIT increases enacted in 2012 on earnings over \$250,000 (for single filers; over \$500,000 for joint filers; over \$340,000 for heads of household).
  - Allocates these tax revenues 89% to K-12 schools and 11% to California Community Colleges. Allocates up to \$2 billion per year in certain years for healthcare programs.
- 

# What's on the Horizon?

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## Direct Democracy

- **Prop. 56:** Increases cigarette tax by \$2.00 per pack, with equivalent increase on other tobacco products and electronic cigarettes containing nicotine.
  - Allocates revenues primarily to increase funding for existing healthcare programs; also for tobacco use prevention/control programs, tobacco-related disease research and law enforcement, University of California physician training, dental disease prevention programs, and administration.
- 

# What's on the Horizon?

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## Direct Democracy

- **Prop. 64:** Legalizes marijuana and hemp under state law for recreational use. Designates state agencies to license and regulate marijuana industry. Imposes state excise tax on retail sales of marijuana equal to 15% of sales price, and state cultivation taxes on marijuana of \$9.25 per ounce of flowers and \$2.75 per ounce of leaves.
- Net additional state and local tax revenues potentially ranging from the high hundreds of millions of dollars to over \$1 billion annually related to the production and sale of marijuana. Most of these funds would be required to be spent for specific purposes such as substance use disorder education, prevention, and treatment.



## Tax Reform: Accountability for Tax Expenditures

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In 2014, Governor Brown signed **SB 1335 (Leno)**, which added R&TC Section 41. SB 1335 recognized that the Legislature should apply the same level of review used for government spending programs to tax expenditure programs.

Thus, Section 41 requires any bill allowing a new income tax credit to articulate specific goals and objectives that the tax credit will achieve. In addition, Section 41 requires detailed performance indicators for the Legislature to use when measuring whether the tax credit meets the goals, purposes, and objectives so-identified.



# Tax Reform: Accountability for Tax Expenditures

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## What has been the result?

- Too soon to tell. Last year, the Governor vetoed most tax expenditure bills, including:
  - **AB 428 (Nazarian)**: Income taxes: credit: seismic retrofits.
    - Contained performance metrics per Section 41.
  - **SB 251 (Roth)**: Disability access: civil rights: income tax credit.
    - Provided that, “It is the intent of the Legislature to make the findings required by Section 41 of the Revenue and Taxation Code with respect to the tax credits allowed by Sections 10 and 11 of this act.”



# Tax Reform: Accountability for Tax Expenditures

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## What has been the result?

- We have also seen the introduction of several bills with “notwithstanding” clauses.
  - “Section 41 does not apply to the credit allowed by this section.”
  - And why not? See e.g., United Milk Producers of California v. Cecil (1941) 47 Cal.App.2d 758, 764-65, noting that the Legislature cannot declare in advance the intent of a future Legislature.
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# Administrative Tax Reform

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Largely focused on the State Board of Equalization:

- **AB 1828 (Dodd):** Under existing law, a member is prohibited from making a decision in an adjudicatory proceeding if the member knows he or she received contributions aggregating \$250 or more from a party to the proceeding, as specified.

This bill would have removed the \$250 limitation and instead applied the disqualification provisions if a board member receives any contribution or has behested a payment that is reportable under the Political Reform Act from a party, as provided.



# Administrative Tax Reform

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Largely focused on the State Board of Equalization:

- **SB 816 (Hill):** Would reduce the \$250 contribution limitation to \$100.

## Comprehensive Tax Reform?

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SB 8 (Hertzberg) sought to make three broad changes to the tax code:

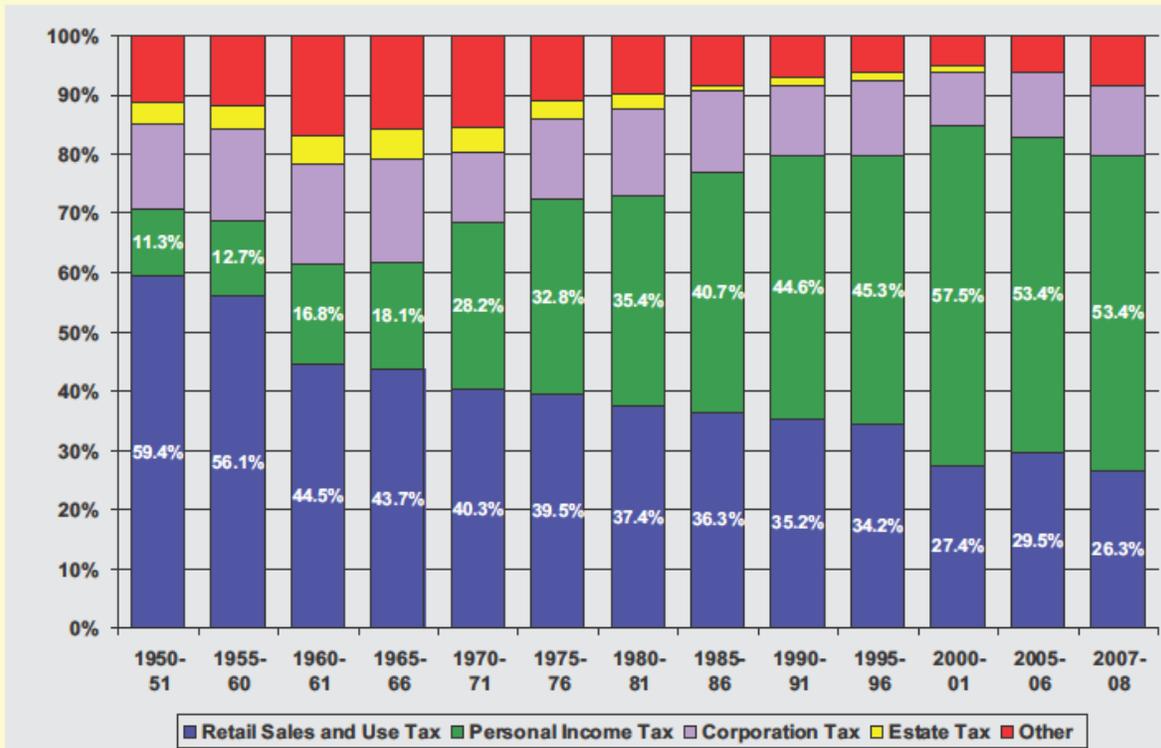
- Broaden the tax base by imposing a sales tax on services to increase revenues. (Health care and education services would be exempt.)
  - Enhance the state's business climate by "evaluating" the corporate income tax.
  - Examine the impacts of lowering and simplifying the personal income tax "while maintaining progressivity."
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## Comprehensive Tax Reform

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- The SUT represents the state's second largest source of General Fund (GF) revenues.
  - Nevertheless, the past 60 years have seen a dramatic reduction in the state's reliance on the SUT and a corresponding increase in its reliance on personal income tax revenues.
  - In FY 2014-15, SUT revenues comprised 23% of the state's GF revenues, down from nearly 60% in FY 1950-51.
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# California State Revenues by Source



Source: Commission on the 21st Century Economy, 2009 Report

## Conformity (AB 154 (2015))

- First conformity update since SB 401 (2010): Changes California's specified date of conformity to federal income tax law from January 1, 2009 to January 1, 2015, and, therefore, generally conforms to numerous changes made to federal income tax law during the six-year period.
- Takes effect immediately as an urgency statute, but is operative for taxable years beginning on or after January 1, 2015, except as otherwise provided.
- Required a 2/3 vote of the Legislature for passage.
- Select Conformity to the Affordable Care Act (ACA):
  - Denial of deductions for annual fee on branded prescription pharmaceutical manufacturers and importers. [Patient Protection and Affordable Care Act (P. L. 111-148)]
  - Increase in additional tax on distributions from Archer MSAs (Medical Savings Accounts) not used for qualified medical expenses. [Patient Protection and Affordable Care Act (P.L. 111-148)]
  - What about Section 9013 of the ACA? No conformity.

## Conformity (AB 154 (2015))

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Conformity to the federal Net Operating Loss (NOL) rules that allow corporations expecting an NOL carryback to extend the time for payment of taxes for the preceding taxable year.

Amends the Large Corporate Understatement Penalty (LCUP) provisions by excluding from its application:

- Underpayments resulting from proper elections under Internal Revenue Code (IRC) Section 338, as reported on the first amended return; and,
- An understatement attributable to either of the following:
  - The FTB's imposition of an alternative apportionment or allocation method under the authority of Revenue and Taxation Code (R&TC) Section 25137; or,
  - A change in the taxpayer's federal method of accounting, provided that the due date of the return is prior to the date on which the Secretary of the Treasury approves the change in the accounting method.



## Conformity (AB 154 (2015))

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States legislative intent to confirm the validity and ongoing effect of SB 401.

- Section 355 conformity
  - Other sections?
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# Concerns of the Business Community

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## Concerns of the Business Community

- Economic Nexus & Market-Based Sourcing
  - Default Worldwide Combined Reporting
- Alternative Apportionment Process
- Penalty Regime

## Effect of Federal Reforms

- Corporate Integration
- Inversions
- Repatriation Holiday

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## Economic Nexus & Market-Based Sourcing Concerns

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Under California's factor presence nexus standard, a taxpayer is considered doing business in the state if:

- Its California sales exceed the lesser of \$536,446\* or 25% of its total sales;
- Its California real and tangible personal property exceed the lesser of \$53,644\* or 25% of its total real and tangible personal property; or
- Its California payroll exceeds the lesser of \$53,644\* or 25% of its total payroll. CRTC 23101(b)(2)–(4).

The sales, property, and payroll of the taxpayer include the taxpayer's pro rata or distributive share of pass-through entities. CRTC 23101(d).

California sales are determined using the rules for assigning sales for apportionment purposes. CRTC 25135 & 25136.

# Economic Nexus & Market-Based Sourcing Concerns

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## Market-Based Sourcing:

- For taxable years beginning on or after January 1, 2013, receipts from sales other than sales of tangible personal property are sourced using a market-based approach that looks to where the customer received the benefit of the transaction.

The combination of California's factor presence nexus standard with its market-based sourcing regime could potentially cause certain taxpayers to have a taxable presence in California, even if such taxpayers' connection with California is tenuous.

Does this satisfy the Commerce Clause substantial nexus requirement?

When combined with the default worldwide combined reporting requirement, is this a fair standard for foreign corporations?

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# Alternative Apportionment Process

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## Petition for Alternative Apportionment (CRTC 25137)

- Background facts
- Application of standard formula and the resulting distortion
  - Compare California activities against standard formula results
- Alternative formula explanation and comparison to California activities

## "Distortion Board" Review

- Determination on the Petition

## Right to Appeal to the Franchise Tax Board

- Public Hearing

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# Penalty Regime

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## Large Corporate Understatement Penalty (LCUP)

- Strict liability with no protest or appeal rights
- AB 154 exceptions a positive step
  - IRC 338 Election on First Amended Return
  - CRTIC 25137 Alternative Apportionment Imposition
  - Certain Federal Accounting Method Changes

## Non-Economic Substance Transaction (NEST) Penalty

- Strict liability with only appeal to Chief Counsel

## Interest-Based Penalty

- Strict liability with no protest or appeal rights

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# Questions?

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