California Commission on Tax Policy in the New Economy

Sacramento
April 21, 2003

Proceedings

APRIL 21, 2003: SACRAMENTO

√Policy Approach to Analyzing Tax Systems
Annette Nellen - Joint Venture: Silicon Valley Network

√The Taxation of Telecommunications in California in the Information Age
Terri Sexton - Center for State & Local Taxation, UC Davis

√Perspectives on Structural Fiscal Reform
Fred Silva - Senior Advisor, Public Policy Institute of California

√Civic Entrepreneur Summit 2003
Nick Bollman - California Center for Regional Leadership

MEETING OF THE

CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY

www.caneweconomy.ca.gov

California State Capitol Building
Assembly Room 317
Sacramento, CA 95814

April 21, 2003
AGENDA

10:30 AM	Chairman Bill Rosendahl Meeting called to order Announcements Roll Call and Introductions (as appropriate)
10:40 AM	Annette Nellen, Joint Venture: Silicon Valley Network Terri Sexton, Center for State and Local Taxation, UC Davis
11:30 AM	Commission Discussions Workplan for 2003 Meeting dates and locations Resource allocation Structural reform options Analyses of tax options
12:30 PM	Working Lunch
12:50 PM	Commission Discussions (continued)
3:15 PM	Chairman Bill Rosendahl Public commentary Closing remarks Adjournment

Agendas for public bodies supported by the California Technology, Trade and Commerce Agency, are available at http://commerce.ca.gov. For additional information regarding this notice, please contact Marshall Graves, California Technology, Trade and Commerce Agency, 1102 Q Street, Suite 6000, Sacramento, CA, 95814, (916) 445-7654, mgraves@commerce.ca.gov

Perspectives on Structural Fiscal Reform

California Commission on Tax Policy and the New Economy

April 21, 2002

Discussion Outline

1. Spending Limitation
2. Revenue Volatility
3. Balanced Budget Requirement

Fred Silva
Senior Advisor
Governmental Relations
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The purpose of this paper is to provide perspective on the issue of state fiscal reform and an outline for the discussion by the Commission. The statute creating the Commission provides a guide to the commission's consideration of fiscal issues beyond the specific tax policy issues identified in the statute. As stated in the first section, the purpose of the Commission, among other things is to create a process to develop a long-term strategy for revising the state and local tax structure for California. That policy is to balance tax restructuring with the "…generation of sufficient resources to continuously improve California's education system, quality of life and promote shared prosperity."

This paper includes observation on three aspects of state's fiscal structure. First, the state spending limit; second methods for dealing with revenue volatility; and third, methods for insuring balanced budgets

1. Spending Limitations

It has been argued that there is insufficient fiscal discipline in the legislature or executive branch to maintain a balance between spending and revenues and that a revision to the current constitutional spending limitation is in order. The following is a discussion of three approaches to spending limitations.

The current spending limit- using a calculated spending limit that grows by an index. Following the enactment of Proposition 13 there was a debate about limiting state and local government spending. The legislature debated the issue and came to no resolution. Paul Gann, co-author of Proposition 13 authored an initiative (Proposition 4) that set up a spending limit that grew by population and inflation and provided that the expenditure of state tax revenue was subject to the spending limit. If revenues from taxes exceeded the limit the excess had to be rebated to the taxpayers. By the late 1980s there was general agreement that the limit should grow with the economy and that infrastructure spending should be exempt from the limit. In 1990, the legislature placed a revision of the spending limit on the ballot changing the growth index to per capita personal income (Proposition 111).

Since the limit grows year to year, in a booming economy the limit indexed by per capita personal income growth will move up rapidly and when the economy slows there is not sufficient revenue to get close to the limit. Hence, a spending limit that grows over time is probably not effective in limiting spending.

Using a procedural approach – a spending limit tied to a vote requirement. In 1933 the voters approved a constitutional amendment (Riley-Stewart Act) that, among other things required a two-thirds vote on the budget if non-school spending exceeded the prior year by 5%. If expenditure growth was less than 5% the budget was passed by as majority vote. This system remained in effect until 1962 when the legislature placed a constitutional amendment before the voters asking, among other things that the 5% limit be repealed and the two-thirds vote requirement remain. During the time that this provision was in effect most state budgets grew by more than 5 per cent and were approved by more that a two-thirds vote of the legislature.

Using a year-to-year spending limit. In this option state spending would be limited year to year by the prior year plus the index used to allow for spending increases. The growth in state spending would always be based on the prior year and would be adjusted by an index such as population and inflation or growth in the economy as measured by personal income. This approach is the most limiting. It will keep spending growth relatively slow depending on the index used. If the objective is to have state spending follow economic growth, per capita personal income would be the index that would more closely mirror the economy. The pitfall in either approach is that basic state programs in education, health and social services as currently constructed tend to grow faster than inflation.

2. Revenue Volatility

The basic problem of volatility of tax revenue is that either economic forces or policy changes made by others often cause it. Over the last two decades California has experienced revenue volatility due to the actions of others. For example, federal tax law changes in 1986 caused a one-year spike in personal income tax caused the state spending limit to be exceeded. In the late 1990's the economy grew rapidly producing major increases in tax revenue from capital gains and stock options. State fiscal offices, including the Department of Finance and the Office of the Legislative Analyst acknowledged that a substantial amount of this revenue would be one time in nature. This did not prevent the legislature and the governor from increasing ongoing obligations of the state using these one-time revenues.

It can be argued that the problem of revenue volatility is not in the revenue structure but in the way the state treats revenue from sources that can change quickly. The Commission may want to consider two approaches to dealing with the problem of revenue volatility that focus on the spending side of the equation.

Budgetary reserves – constitutional requirement for a budgetary reserve. The state does not have an effective reserve requirement. The current requirement simply indicates that there should be a "prudent" one. The California Constitution Revision Commission and the Citizens Budget Commission as well as other groups have recommended that the state maintain a reserve of from 2 to 3 percent of state general fund spending. The design of a reserve requirement should consider a phase in period as well as a system for replenishment.

During each fiscal year there are unanticipated expenditures and minor changes in revenues unforeseen when the budget was passed. Reserve requirements should handle these circumstances. A budget reserve requirement will not protect against major economic down turns or natural disasters. Reserves may be sufficient for minor changes in tax revenues (usually brought about by an external event like a federal tax change) or minor spending changes. On the spending side a reserve should also be used for deficiency bills and related expenses not foreseen when the budget was adopted.
One time spending with one time revenue. An additional option for dealing with major infusion of nonrecurring revenue would be to set it aside for one-time purposes. This could be used for expenditures such as infrastructure or one-time tax rebates. For

example, Assembly Constitutional Amendment #11, which will be on the March, 2004 ballot provides that a portion of the growth in general fund revenue be dedicated to infrastructure.

3. Balanced budget requirements

There is no balance budget requirement. The constitution requires the Governor introduce a balanced budget. Article VI, Section 8 (a) requires the governor submit a budget to the legislature on January 10 each year including recommended expenditures and estimated revenues. "If recommended expenditures exceed estimated revenues, the Governor shall recommend sources from which the additional revenues should be provided." From that point on the legislature does not have to pass a balanced budget, the governor need not sign one and the state is not obligated by the constitution to maintain one. When the books are closed at the end of the fiscal year state spending and revenues need not balance.

Our budgetary history is replete with unbalanced budgets. Most budgets adopted during recessions have some form of deficit spending to get them through the year without crippling major state programs, particularly education and health and human services. During an economic slowdown it is easy to spend more than the state takes in.

During the 1930s the state ran deficits for ten years. Looking at the last 25 years, 15 budgets spent more than revenues available to support the level of spending in the budget. In 8 of those years the state simply used surpluses from the year before to finance the spending. In 7 (including the current year budget) state budgets ended in deficits.

It may be time to consider a requirement that expenditures not exceed revenues.

Multiyear budget process. If the state considers a balanced budget requirement it may need to institute a longer fiscal period over which the budget must balance, since a 12 month period is probably too short for a balance test to be made for state expenditures and revenues. For example, the annual budget process would continue but require the budget to be balanced at the end of the two-year fiscal cycle. The two-year fiscal cycle would begin in an odd numbered year following an election end at an even numbered year. For example, the next the biennial fiscal period could be include budgets adopted for 2005-06 and 2006-07. The legislature and the governor would enact a statute along with the first budget in the biennium that would set the ground rules for the second budget.

Dear Members of the Commission on Tax Policy in the New Economy:

I'm pleased to have been asked by Bill Rosendahl and the Governor's office to volunteer to assist with the work of the Commission, and I continue to believe that your work is among the most important "civic" policy efforts currently underway in California. Unfortunately, I won't be able to be with you on Monday the 21st, but I've pledged to Bill and the staff whatever help I can give, following the meeting, to help you carry out your important mission.

As I indicated at both my presentations to the Commission, the California Center for Regional Leadership is committed to helping you also to reach out broadly to the civic, business, local government and community leadership across the state to ensure that your work becomes a focal point for civic dialogue. We believe that such dialogue is an essential ingredient for sustaining fundamental policy reform through successive, incremental steps. I have offered to work with our regional civic partners (see information on this network of 22 regional civic organizations at http://www.calregions.org/civic/index.php) to organize such dialogues this summer and fall in several regions of the state. At these dialogues Commission members would have an opportunity first-hand to share the Commission's reform ideas and to get direct feedback and potentially support.

To help stimulate interest in these outreach dialogues and to help launch the Commission's May 15 report into the public debate, we've invited Bill Rosendahl to come present the draft interim report at our annual Civic Entrepreneur Summit, to be held June 1-3 in Sacramento. Specifically, we are delighted that Bill has agreed to present the draft report at our opening plenary on Monday, June 2, from 8:45 to 10:15 A.M. Bill will be joined on the podium by Mark Baldassare of the Public Policy Institute of California, who will share with the audience the results of his surveys of Californians on their attitudes toward tax policy reform.

We would very much like to invite any and all Commission members (including ex officio members) to join us for this session. I've attached our confirmation letter to Bill that tells more about the session and about the overall event. The Summit is an invitation-only event, but we would be very pleased for you to attend the session on tax policy. Please let us know at your earliest convenience whether or not you will be able to attend the tax policy session. In addition, please let me know if you might be interested in attending the entire event and we will send you a registration form and the full agenda.

Thanks again for all the good, hard work you are doing for the people of California.

Regards,

Nick Bollman

April 14, 2003

Mr. William J. Rosendahl
Regional Vice President of Operations
Adelphia Communications
2939 Nebraska Avenue
Santa Monica, CA 90404-4108

Re: June 2 Participation at the CCRL Civic Entrepreneur Summit in Sacramento

Dear Bill:

I am writing to confirm your participation at the Civic Entrepreneur Summit on June 2, 2003, at the Sheraton Grand Hotel in Sacramento. As one of California's most involved civic leaders and leading communicators, we are honored that you will take a leading role at the Summit. Thank you so much for agreeing to participate as follows:

- The opening plenary session, *The State Fiscal Crisis—a "Terrible" Opportunity for Fiscal Reform,* from 8:45 a.m. to 10:15 a.m. on Monday, June 2, will launch the first full day of the Summit. We ask that you open the meeting and speak for about 15 minutes, bringing an update from the Commission on Tax Policy and the New Economy (the Commission) on the ideas that the Commission believes (and will have produced in a May 15 draft or interim report) are worthy of serious consideration. We'll follow this with a few minutes of questions and answers, then ask the conference participants to discuss these ideas at their at their tables. You would then moderate a lively dialogue, as attendees give feedback to the Commission from their "regional perspectives." (We would also ask you to identify Commissioners that may be interested in serving on the panel.) We are also exploring the possibility of using electronic decision technology to enable participants to actually "vote" on the proposals, and Mark Baldassare has agreed to participate to see how participant views compare to his public opinion poll results on these same ideas. Sounds a bit complicated, I know, but we'll have time to discuss the process thoroughly before the event itself. We would like as many members and ex-officio members of the Commission to attend this opening plenary as well, and we'll be following up directly with them.

- We have invited Governor Davis to be our special guest at the Summit dinner that evening, from 7:00 p.m. His scheduling office has not yet agreed that he will participate (though Daniel Zingale indicated to me that he would recommend the Governor's participation). Frankly, I'm hoping that the opportunity to have a "Bill Rosendahl-type" interview in front of the assembled crowd would be of interest to him. Subject matters: the current and long-term policy challenges, including especially fiscal reform and infrastructure planning and investment, but we'd like for you to "do your thing," and pose questions that would be of greatest interest to you and the Governor at the time of the Summit. We'd also like to explore with you the possibility of taping the conversation for your later use on

your talk show. We would of course cover any out-of-pocket costs to make the taping possible. Attendance at the dinner is expected to be in the 175-200 person range.

The Civic Entrepreneur Summit will take place at the Sheraton Grand Hotel in Sacramento. This event is the annual statewide convening of more than 200 of California's business and civic leaders. This dynamic and committed network of regional leaders is working to address California's most pressing economic, environmental, and social equity challenges, and they come from a variety of backgrounds--from the business, policy advocacy, planning, grassroots, and government sectors. Also in attendance at the Summit will be invited leaders of various statewide organizations interested in the issues facing the regions and state government. The Summit is sponsored by the California Center for Regional Leadership, our statewide nonprofit organization that supports the state's existing and emerging network of regional civic organizations and informs state policy and practice in support of innovative regional strategies.

This year's Summit over-all will have a special policy focus, and address strategies on topics including: economic and workforce strategies to create more jobs for trained Californians, improving the quality of our communities through long-term and comprehensive growth planning, and continuing to create greater social and economic opportunity for disadvantaged Californians. I hope you will be our guest and attend as much of the Summit as your own schedule permits (see enclosed Draft Agenda).

Thanks again for agreeing to participate, Bill, and helping to make this an important and productive event. I'll be following up with you in the next couple of weeks to discuss the exact logistics of the two sessions in which you'll participate. I look forward to speaking with you.

Warmest regards,

Nick Bollman
President, California Center for Regional Leadership

Cc: Members of the Commission on Tax Policy in the New Economy

Enclosures: Civic Entrepreneur Summit – Draft Agenda
List of 22 regional civic organizations

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The Taxation of Telecommunications in California in the Information Age

James E. Prieger, Terri A. Sexton, and Annette Nellen

The telecommunications industry is undergoing rapid change due to technological advances and deregulation. The industry that began with the telephone now includes cable, wireless and satellite communications, and the Internet.

California's tax system has not kept pace with the telecommunications industry. The myriad taxes and charges on telecommunications in California were established for an industry that was legally, technologically, and structurally very different than it is today. Many taxes remain targeted to a specific technology (e.g., telephone taxes or cable franchise fees), despite the blurring of distinctions between technologies that provide similar services (e.g., the telephone and Internet telephony). The convergence of formerly distinct communications technologies renders the existing tax structure difficult to justify in terms of economic efficiency or equity.

This Brief summarizes our review and analysis of telecommunications taxes and fees in California. The primary objectives of our research were (1) to provide a comprehensive overview of the telecommunications tax system in the state, including all taxes, fees, and surcharges paid by telecommunications service providers and their customers; and (2) to examine the economic consequences of current tax policy, including inequity, inefficiency, and administrative complexity.

As policymakers at all levels of government confront the challenge of reforming our tax system to encourage new technology and broad access to various telecommunications services, including Internet access, while at the same time addressing the needs of tax equity and revenue sufficiency, they must first have a clear understanding of the current tax system and the incentives it creates.

Tax Rates

We find that the cumulative tax rates (including all taxes, fees, and surcharges) are higher for telecommunications services than other goods and services. The total tax rate on intrastate services (e.g., within-state long-distance) ranges from 7.83 to 18.83% and comprises the federal excise tax of 3%, various statewide taxes and surcharges totaling 4.83%, and a local tax that varies across cities from zero to 11%.

The total tax rate on interstate services (e.g., long-distance calls to other states) is even higher, ranging from 10.28 to 21.28% or higher. This rate consists of the 3% federal excise tax, a 7.28% federal universal-service charge (which is sometimes passed on to consumers at a higher rate), and the zero to 11% local tax.

Equity
The distribution of the burden of current telecommunications taxes is not equitable according to any accepted equity principle. According to the benefit principle, the burden of a tax should be distributed according to the benefits received from the governmental activities financed by the tax. Many of the taxes imposed on telecommunications are revenue-based, and companies pass them along to consumers in proportion to their expenditure. However, the benefit these taxpayers receive from goods and services financed by these taxes is not linked to their tax burden in any way, as would be required by the benefit principle.

Furthermore, since the share of household income spent on telecommunications decreases as household income increases, the telecommunications tax burden is distributed regressively with respect to income. This violates the ability-to-pay principle, which holds that tax burdens should be distributed among taxpayers according to their ability to pay, typically as measured by income.

Finally, horizontal equity requires that taxpayers of equal ability to pay bear equal tax burdens, which is impossible with revenue taxation because taxpayers with similar incomes may spend differing amounts on telecommunications.

Taxation Differences Across Technologies
Today there are many alternatives to the traditional wire line telephone call, including wireless service and voice communication over the Internet (Internet telephony). Our research shows that the tax burden varies across technologies. For example, traditional telephone companies are subject to a much broader range of federal, state, and local taxes than are some of their new competitors (e.g., cable or satellite providers).

Consumers of cable or satellite services do not pay the federal excise tax or federal and state taxes and charges to support universal service. The largest potential "leakage" with respect to voice communications is Internet telephony, which escapes federal and state universal-service taxes, the federal excise tax, and the local utility tax.

Other potential sources of discriminatory tax treatment are local franchise fees, which cable companies pay and local exchange carriers do not, and property-tax laws. The property of most telephone carriers is state-assessed annually at market value, while cable television companies are locally assessed with annual increases in assessed value limited to 2%.

There is little economic justification for these differences in treatment across technologies, because efficient taxes (which introduce the least distortion in consumer and producer decisions) depend on the demand for the final service produced, not on the technology underlying the service. Favoring one technology over another may reduce consumer and producer welfare over time.

Efficiency
Efficient economic outcomes maximize the total economic benefits received by consumers and firms. Excess burden, the term for the inefficiency caused by a tax, is the

loss in a taxpayer's well-being above and beyond the tax revenue collected. Taxation of revenue causes excess burden because the higher prices that result decrease consumption of telecommunications services. The decrease in consumption and subsequent excess burden will be greater when taxing services such as cellular as compared to local-access service because cellular consumers are more sensitive to price changes. Excess burden is a pure efficiency loss in the economy, reducing the consumers' economic benefits by more than the amount of tax revenue that the taxing authority gains.

We estimate, very conservatively, that the current set of telecommunications taxes leads to at least a 4% efficiency loss, or excess burden, in California. We show that the efficiency loss can be reduced without affecting tax collections by raising the tax rate on revenue from local-exchange access (whose demand is relatively insensitive to price) and lowering the rates on other services, such as long-distance and wireless communication.

The existing tax structure may also result in efficiency losses that compound over time—dynamic efficiency losses. Discrimination among telecommunications firms or between telecommunications companies and other companies distorts the rates of return on investment across companies, thereby reducing the economic benefits realized from the growth of the telecommunications industry and its various components.

Consumption Distortions

Consumers' choices between competing telecommunications services are affected by differences in taxes on these services. Consumers today have many avenues to avoid the taxes on traditional service. For example, Internet telephony services escape all telecommunications taxes, and consumers consequently have an added incentive to switch to Internet-based telephony. As consumers switch from taxed to untaxed services, federal, state, and local governments will see their tax revenues decline.

Differences Across Locations

Telecommunication costs vary among cities and counties in California due to variations in the local utility user tax (UUT) and local franchise fees. The UUT rate ranges from zero to 11% across cities; the UUT tax base also varies.

Our comparison to neighboring and other large states shows that California has a greater number of state telecommunications taxes, which raises administrative and compliance costs for telecommunications companies doing business in the state. California, however, does not impose relatively higher tax rates on telecommunications. Telecommunications taxes, therefore, probably play a negligible role in business or household decisions to locate in California, but may influence the siting choices of some heavy users of telecommunications within the state.

Conclusions and Recommendations

Telecommunications represents a major path by which future economic growth will continue to travel. Although the telecommunications industry is currently a relatively small part of California's overall economy—about 2% (measured by income)—it has been growing rapidly and contributed significantly to economic growth as it raises the

productivity of a wide range of other industries. Hence, its total impact on the economy is much greater than its size suggests.

As noted, California's tax system has not kept pace with the telecommunications industry. Technological developments and deregulation have resulted in new entities that do not fit the traditional definition of telecommunications providers under state tax laws. This situation results in differing treatment of businesses competing to provide the same service. The current treatment of the industry violates basic principles of good taxation, in that it is inefficient, inequitable, and creates excessive administrative and compliance costs.

If developing the telecommunications infrastructure, and hence the economy as whole, is a goal of state economic policy, then tax policy should support this goal by encouraging (or at least not discouraging) investment in California's telecommunications industry.

Although our chief objective has been to present information rather than to advocate particular reforms, we conclude by suggesting a few improvements our analysis points to. These may lay the groundwork for potential reform of California's telecommunications tax system. Some of these recommendations can be implemented unilaterally by the state. Others require California to cooperate with local governments or with other states.

- **California should extend the Manufacturer s Investment Credit (MIC) and sales-tax exemption for new equipment purchases to telecommunication companies.** The primary purpose of the MIC and sales-tax exemption on equipment purchases is to avoid the pyramiding of taxes that can occur when both the inputs used to produce goods and services and the goods and services themselves are subject to the sales tax. While not subject to the sales tax, telecommunications services are subject to other taxes that total more than the sales tax. Since the MIC is intended to encourage investment, there is no reason for excluding telecommunications, given their importance in the new economy.

- **California should examine whether the income apportionment rules for its corporate franchise and income taxes are appropriate for telecommunications services.** All states must cooperate to ensure that multistate income is being apportioned to the proper states to avoid double taxation.

- **California should work with other states and the federal government to establish new nexus guidelines for the Information Age.** Federal Public Law 86-272 limits a state's power to tax an out-of-state company's income from sales of tangible property within the state, when the property is shipped from out of state. This law should be broadened to cover intangibles, such as telecommunications and Internet services, and extended to other types of taxes.

- **California should, in cooperation with its local governments, simplify and consolidate the various taxes and charges imposed on end-user revenues by local jurisdictions and the Public Utilities Commission.** California telecommunications customers currently pay seven different statewide taxes, fees, or surcharges in

addition to the federal excise tax and universal-service charges, and possibly a local utility user tax on their purchases of telecommunications services. Consolidation of statewide charges would significantly reduce the administrative burden of telecommunications companies in the state. Switching to a simple per-line charge to fund universal-service programs would result in fewer consumption distortions, less excess burden from taxation, and greater efficiency. If nonuniform rates are desired, long-distance service should be taxed less than local service to minimize the efficiency loss caused by taxation (which is the opposite of the current tax structure).

- **California should encourage local jurisdictions to unify the local utility user tax.** The compliance burden on telecommunications companies could be significantly reduced if local jurisdictions were to adopt a uniform rate and base for the utility user tax.

- **California should establish uniform assessment of business property.** Neither the assessed value of business property nor the allocation of the property-tax revenue from a particular property should be dependent upon who assesses it. Market-value assessment would be the most equitable and efficient method.

- **California should urge local governments to examine their local franchise fees.** Local franchise fees should be set to cover no more than the costs to local governments of managing public rights-of-way, and not to fund general municipal budgets. All providers of telecommunication services should be equally subject to these minimal franchise fees so as to avoid competitive advantages that influence the future development of new technologies.

- **California and other states should urge the federal government to clarify issues regarding Internet and cable telephony.** Currently telephone calls placed over the Internet are not subject to federal, state, or local taxes, and thus enjoy a competitive advantage. As the quality of such calls improves, more consumers will switch, which may lead to decreased economic efficiency and reduced government revenues. Certain forms of cable telephony raises unresolved issues regarding the applicability of the franchise fee and whether the property is subject to state or local assessment.

- **California and other states should monitor and work with the federal government in its efforts to restrict state and local tax systems.** Maintaining a competitively neutral tax system in California may require expanding the tax base to include previously untaxed services such as Internet access. Currently, federal and state moratoria prevent such reforms.

- **California should work with local governments to provide uniform relief for low-income individuals and households.** The taxes currently imposed on telecommunications services are regressive: Taxes represent a larger percentage of a low-income household's income than a high-income household's. A few cities offer UUT exemptions for low-income individuals and some relief from statewide surcharges exists, but the relief is not uniform.

James E. Prieger is assistant professor of economics at UC Davis. Terri A. Sexton is professor and chair of economics at California State University, Sacramento, and associate director of The Center for State and Local Taxation at UC Davis. Annette Nellen is professor of accounting and finance in the College of Business at San Jose State University.

This *Brief* is based on a study funded by CPRC's Policy Research Program. The authors' detailed research findings of the same title are available on the Web at www.ucop.edu/cprc/telecomtaxrpt.pdf. This *Brief* may be copied without permission.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA BANK AND CORPORATE FRANCHISE TAX

Background

? The bank and corporation tax began in 1911 as a 1% tax on the book value of their franchises. This tax system was changed by a 1928 initiative that changed the California Constitution to impose a tax on the net income of banks and corporations. There was a minimum franchise tax of $25. The determination of net income mainly followed federal income tax rules. Net income of multistate corporations allocable to California was determined based on property, sales and payroll factors. Banks were liable for an additional "add-on" rate paid in lieu of personal property taxes.[1]

Corporate tax rates have ranged from 2% in 1933 to 7.6% in 1972 to 9.0% in 1974 – 1979, 9.6% in 1980-1986. Today, the rate is 8.84%. The bank franchise rate and add-on rate has ranged from 6% in 1933, 11.6% in 1972, 12.978% in 1975. Today, the rate for bank and other financial corporations is 10.84%. The alternative minimum tax rate (AMT) for banks and corporations is 8.65% and 6.65%, respectively. The minimum franchise tax today for C and S corporations, banks and other financial corporations is $800.[2] S corporations are subject to a 1.5% tax rate (when greater than the $800 minimu m tax).

? The franchise tax is imposed on corporations "doing business" in California. It is measured using taxable income of the current tax year for the privilege of doing business in that year. "Doing business means actively engaging in any transaction for the purpose of financial gain or profit. … It is not necessary that the corporation conducts business or engages in transactions within the sate on a regular basis. Even an isolated transaction during the year may be enough to cause the corporation to be 'doing business.'" [2002 Form 100 booklet, page 5]

? Corporations subject to the minimum franchise tax are those that are (1) incorporated or organized in California, (2) qualified or registered to do business in California, or (3) doing business in California. The minimum franchise tax is owed even by inactive and loss corporations, as well as those not doing business in California. The minimum franchise tax does not apply in a corporation's first tax year.

? The California corporate income tax is "imposed on all corporations that derive income from sources within California but are not doing business in California." [2002 Form 100 booklet, page 5] This is a limited category of businesses. An example would be a non-California corporation that is a limited partner in a limited partnership doing business in California, but the corporation itself is not doing business in California.

? Federal income tax law allows corporations to carryover net operating losses. Such losses may be carried back for 2 years and forward for 20 years. Prior to 1998, the carryover periods were 3 back and 15 forward. California law is different. California does not allow NOLs to be carried back. For many years, only 50% of the NOL could be carried forward and only for 5 years. Recent changes have increased that percentage to 60% and the carryforward to 10 years. For tax years beginning in 2002 and 2003, California suspended use of an NOL carryforward, but extended the number of years in the carryforward period for the loss of the initial carryforward years. Beginning in 2004, new NOLs may be carried forward at 100% (rather than 60%). "New businesses" may carryforward 100% of their NOLs, but only for the first 3 years.

? To address taxation by the states of the income of multistate businesses, in 1959, Congress exercised its authority under the Commerce Clause by enacting Public Law 86-272 (15 U.S.C. §381). This law provides the minimum standards that must be met for a state to impose a net income tax on the operations of a remote vendor with respect to sales of tangible personal property. This law prohibits a state from taxing a foreign (out-of-state) corporation's net income derived from activities within the state if those activities consist merely of solicitation of orders for the sale of tangible personal property that are approved, filled, and shipped from outside the state. Issues have arisen over the years as to what activities fall within "solicitation of orders" and what constitutes an income tax.[3]

In 1967, soon after enactment of P.L. 86-272, the Multistate Tax Compact was created and adopted by most

[1] Doerr, David R., *California's Tax Machine*, California Taxpayers' Association, 2000 , pages 374 - 379.
[2] Franchise Tax Board, Annual Report 2001, pages 67 - 68;
available at
http://www.ftb.ca.gov/other/annrpt/2001/2001ar.pdf.
[3] For more information on California's interpretation of P.L. 86-272, see FTB Publication 1050
available at http://www.ftb.ca.gov/forms/misc/1050.pdf.

Comments? Contact Professor Annette Nellen, SJSU, anellen@sjsu.edu, (408) 924-3508.

states. The Compact serves to facilitate equitable apportionment of the income tax base among jurisdictions, to promote uniformity of rules among the states and to avoid double taxation. California is a member of the Compact. The Compact contains the Uniform Division of Income for Tax Purposes Act (UDITPA), which provides uniform rules for apportioning income for state income tax purposes.[4] California adopted UDITPA in

? Nexus Issues (when P.L. 86-272 does not apply):

Court decisions dealing with intangibles:

1) In the past several years, there have been issues (primarily outside of California) on whether intangibles create nexus such that the state may impose tax obligations upon the vendor. For example, in *Geoffrey, Inc. v South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993) *cert. denied* 510 U.S. 992 (1993), Geoffrey (G), a Delaware holding company executed a license agreement allowing Toys R Us (T) to use its trademarks, trade names, merchandising skills, and know-how to market, promote, market and sell products. G received a royalty equal to 1% of net sales. T did business in South Carolina (SC) and deducted the royalty it paid to G in computing its SC taxable income. SC held that G was required to pay the SC corporate license fee because of the presence of its license in SC, which G challenged. The court held that G had the minimum connection with SC to be subject to tax there without a due process problem. "We reject Geoffrey's claim that its intangible assets are located exclusively in Delaware. Accordingly, we find that Geoffrey's purposeful direction of activity toward South Carolina as well as its possessing intangible property here provide a definite link between South Carolina and the income derived by Geoffrey from the use of its trademarks and trade names in this State." The court also found that under SC law, G's royalty income would not be allocated or apportioned to Delaware.

2) In *Kmart Properties, Inc. v. Taxation and Revenue Dept*., No. 21, 140 (N.M. Ct. App, 11/30/01), use of a subsidiary's (KPI) trademark by the parent corporation (K Mart) was found to establish nexus and tax obligations in N.M. for KPI. In the Due Process analysis, the judge found that KPI purposefully directed its efforts towards N.M. residents and availed itself of N.M. markets by licensing its trademarks to Kmart in N.M. With respect to the Commerce Clause, the trial judge stated: "I have little difficulty determining that the contractual relationship between KPI and Kmart under the License Agreement creates the requisite physical presence required to subject KPI to New Mexico's taxing jurisdiction under the Commerce Clause. As noted in the Court's discussion in *Scripto* [362 U.S. 208 (1960)], the fact that KPI does not use its own employees to utilize its trademarks to generate sales to New Mexico residents, to enhance the associated value of its trademarks by utilizing them as a marketing tool, and to generate a stream of royalty income for itself should not be given constitutional significance. The License Agreement, with its attendant obligations upon Kmart to protect and enhance the value of KPI's trademarks, creates a contractual relationship between the parties in which Kmart uses the trademarks and their associated goodwill as a marketing tool to continuously solicit New Mexico residents to purchase merchandise associated with the trademarks, thereby creating the very income stream New Mexico seeks to tax. Kmart's relationship to KPI, particularly in light of the requirements of trademark law which render the trademarks inseparable from the goodwill of the business they are associated with, places Kmart in the same position as the salesmen in *Scripto* and the independent salesmen in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 107 S.Ct. 2810 (1987). Kmart is contractually obligated to do the very things which establish, maintain and enhance the market for KPI's trademarks in New Mexico in order to generate a re venue

stream for KPI derived from those marketing activities. These contractual obligations give KPI a presence in New Mexico which goes far beyond those of *Bellas Hess* and *Quill Corporation*, whose only contacts with the taxing states were by mail and common carrier." [footnote omitted]

The decision was upheld on appeal to the New Mexico Court of Appeals. That court also noted that the physical presence requirement laid out by the U.S. Supreme Court with respect to sales and use taxes in the *Quill* decision did not apply to income tax cases. The court also noted that its holding did not mean that Kmart or any of its employees were the agent of KPI. For purposes of establishing Commerce Clause nexus, the representatives creating nexus need not have legal authority to bind the taxpayer.

[4] The UDITPA tax allocation system was approved in 1957 by the National Conference of Commissioners on Uniform State Laws and by the American Bar Association. See 7A U. L. A. 91 (1978).

[5] The rules can be found at R&T §§ 25120 through 25139.

Proposals:

1) The Multistate Tax Commission (MTC) issued a draft proposal in 2002 to determine when a company has nexus for business activity taxes. The proposal – referred to as a "factor presence nexus standard" states that a company that is organized or commercially domiciled in a state has substantial nexus in that state. In addition, if during a tax period, a company has either (a) $50,000 of property, (b) $50,000 of payroll, (c) $500,000 of sales or (d) 25% of total property, payroll or sales in the state, it has substantial nexus in the state. The MTC approved the draft on October 17, 2002 with California abstaining.

2) S. 664 (107th Congress) - the "New Economy Tax Fairness Act" or NET FAIR Act proposes that no state may assert any business activity tax or impose sales and use tax collection obligations on a vendor that does not have a "substantial physical presence" in the State. The bill provides a list of activities which do not constitute a substantial physical presence. The list of "protected" activities includes solicitation of orders by the vendor or the vendor's representative for the sale of tangible or intangible personal property or services if the orders are approved or rejected outside of the state and approved orders are filled by delivery from a point outside of the State, presence or use of intangibles (such as trademarks or electronic signals or web pages) in the state, use of a web site, and use of an unaffiliated contractor in the state to perform warranty or repair work on property sold by a vendor located outside of the State. The "protections" do not apply to a vendor incorporated in the state or any individual domiciled or a resident of the State. An agency relationship may constitute a "substantial physical presence" in the State. An agency relationship only exists if it "(1) results from the consent by both persons that one person act on behalf and subject to the control of the other; and
(2) relates to the activities of the person within the State." The provision is effective upon enactment and so will not invalidate collection of any business activity tax imposed prior to that date (even though it violates one of the "protections'). If a vendor terminates its "substantial physical presence" in the State, the State can no longer after that point impose an obligation to pay a business activity tax or to collect and remit a sales or use tax upon the vendor.

? Corporations that are "unitary," meaning that there is a connection between the in- and out-of-state activities, must combine their income before determining the amount apportionable to California. Businesses are unitary if they are highly interdependent, such as having centralized decision-making, purchasing, marketing, or accounting. For more information see Form 100 and Schedule R.

? Corporations doing business within and outside of California will need to apportion their business income. Corporations apportion their business income to California using a double -weighted sales factor along with single weighted property and payroll factors. Corporations in banking, savings and loan, agriculture or extractive industries are not subject to the double-weighting requirement for the sales factor. Non-business income from intangible property is allocated to the state of commercial domicile. Non-business income from tangible property is allocated to the state where the property is located.

As provided in UDITPA, the property factor in California includes only the value of real and tangible personal property; intangible property is excluded. Property that produces non-business income is also excluded. Property is valued using its original cost for federal depreciation purposes, but without any adjustment for depreciation. The cost basis is increased for any capital improvements. Rented property is included in the property factor at eight times the annual rental rate.

The numerator of the payroll factor is total compensation paid in California to produce business income. The denominator is compensation paid everywhere to produce business income. Payments made to independent contractors are excluded.

The sales factor consists of gross receipts from business income including interest income and carrying charges. Sales from transfers of intangible property or services are apportioned to California if the income-producing activity is performed entirely in California. When the income-producing activity involving intangibles takes place both in and outside of California, the "all or nothing" approach is used. If the income producing activity is performed in California and elsewhere, but a larger portion of that activity is performed in California (based on the costs of performance) all receipts are allocated to California. If a larger portion of the income -producing activity is performed outside of California, none of the gross receipts are allocated to

California. In measuring costs of performance, only direct costs are considered. While gross receipts from licensing of intangibles is included in the sales factor, the intangible is not included in the property factor.

? Various tax credits are available to businesses. In 2000, corporations (including S corporations) used almost $1.2 billion of tax credits. This was a 33% increase over 1999.[6] Significant credit amounts claimed in 2000 were:

Research $564 million

Manufacturer's investment $410 million

Enterprise zone $103 million

Prior year AMT $ 51 million

In 2000, 9,101 of 497,844 corporate returns claimed some type of tax credit. The total credits claimed totaled $1,180,642,000 that reduced aggregate state tax liabilities of $6,968,515,000. [7]

? In 2000, corporations reporting loss, profit or none broke down as follows (state net income taxable in California):[8]

Net loss	35.1%
No income or loss	6.4%
$1 - $19,999	27.3%
$20,000 - $99,999	18.8%
$100,000 - $499,999	8.9%
$500,000 - $9,999,999	3.2%
$10 million or more	.2%

? Number of corporations reporting income, loss or neither:

Year	Reporting income	Reporting loss	Reporting neither
1946	53.4%	19.7%	26.9%
1955	53.6%	25.0%	21.4%
1965	58.4%	29.1%	12.5%

1975	59.8%	30.4%	9.8%
1985	53.4%	35.9%	10.7%
1990	51.6%	37.6%	10.8%
1995	57.3%	37.1%	5.6%
2000	58.5%	35.1%	6.4%

? Corporations reporting net income – percentage of tax paid to net income reported in aggregate:[9]

Year	%	Corporate tax rate	Minimum tax
1950	4.3%	4.0%	$25
1955	4.4%	4.0%	$25
1965	5.9%	5.5%	$100
1975	9.3%	9.0%	$200
1985	9.6%	9.6%	$200
1995	6.7%	9.3%	$800
2000	5.3%	8.84%	$800

[6] Franchise Tax Board, *supra*, page 29.
[7] Franchise Tax Board, *supra*, page 147.
[8] Franchise Tax Board, *supra*, page 142. Data likely includes all corporations, not just C corporations.
[9] *Id* plus pages 67 – 68.

? In the past several years, concerns have been raised, primarily by the IRS, regarding the use of abusive tax shelters by corporations. To the extent that such investments or activities are found not to have economic substance for federal income tax purposes, the same would apply to state income tax purposes. The extent of the problem on the reporting of California corporate income tax is unknown. Tax shelters of relevance at the state level, but not at the federal level can exist in actions taken to move operations or property to other states to reduce state income taxes. While this type of sheltering activity is not necessarily abusive, concerns exist by tax agencies that the actions are taken solely for tax purposes. The definition of an abusive tax shelter is subject to debate. Efforts have been made to define this term by the Treasury and IRS. The American Institute of CPAs (AICPA) has also weighed in on the issue and issued a suggested definition in April 2003.[10]

? In 2001, corporate income tax collections represented 7.3% of general fund revenues while the personal income tax (PIT) represented 57.4%.[11] In 1993, these percentages were 12.5% for the corporate tax and 43.9% for the PIT.[12] In 1997, these percentages were 11.2% for corporations and 48.3% for the PIT.[13]

? Corporate income tax rate range for 2002 – selected states:[14]

State	Tax rate	# brackets
Arizona	6.968%	1
California	8.84%	1
Colorado	4.63%	1
Massachusetts	9.5%	1
New York	7.5%	1

Oregon	6.6%	1
Virginia	6.0%	1

? 2001 corporate income tax collection as a percentage of total tax collections – selected states:[15]

Arizona	6.4%
California	7.6%
Colorado	4.5%
Massachusetts	7.0%
Michigan	9.4%
New York	7.1%
Oregon	5.5%
Virginia	2.8%
All States Average	5.7%

[10] See http://www.aicpa.org/members/div/tax/shelters.asp and http://www.aicpa.org/members/div/tax/shelters_qa.asp. [11] Franchise Tax Board, *supra*, page 8. [12] Franchise Tax Board, *1994 Annual Report*; available at http://www.ftb.ca.gov/other/annrpt/1994/intro1.html#intro03. [13] Franchise Tax Board, *1997 Annual Report*; available at http://www.ftb.ca.gov/other/annrpt/1997/intro.html#tblgfr. [14] Federation of Tax Administrators; table at http://www.taxadmin.org/fta/rate/ind_inc.html . [15] Federation of Tax Administrators; table at http://www.taxadmin.org/fta/rate/01taxdis.html.

? Comparisons to Other States[16] – Per LAO: "California's basic BCT rate of 8.84 percent is relatively high comp ared to other states (see accompanying figure). However, in making interstate tax-burden comparisons, one also must take account of more than just the tax rate--such as the various TEPs [tax expenditure programs , such as exemptions, deductions and credits] taxpayers benefit from. One way to adjust for this is by looking at corporate income taxes relative to personal income. In this regard, California's BCT burden is a bit above average for the U.S. as a whole (0.7 percent versus 0.5 percent)."

Comparison of Key BCT Provisions 1999 Tax Year

State	Tax Rate (%)	General Minimum Tax	S Corporation Taxability
Pennsylvania	9.99%		Exempt
Massachusetts	9.50	$456	Exempt
New Jersey	9.00	$250	Taxable
California	**8.84**	**$800**	**Taxable**
New York	8.50	$100 – $1,500	Taxable
Arizona	8.00	$50	Exempt
Wisconsin	7.90		Exempt
North Carolina	7.50		Exempt
Oregon	6.60	$10	Exempt
Ohio	5.10 – 8.50	$50	Exempt
Utah	5.00	$100	Exempt

Illinois	4.80		Taxable
Michigan	2.20		Taxable

"The BCT's Future - The BCT's relatively subdued growth performance in California throughout much of the 1990s also occurred nationally and raises questions regarding the BCT's future role as a major revenue source. While BCT growth occurred in the most recent two years, its flatness in prior years during which the economy performed well remains a concern. For example, between 1994-95 and 1998-99 BCT revenues were basically stagnant even though overall economic growth was strong. This pattern is not fully understood, but some tax experts have pointed to increased use of creative corporate accounting and tax shelters--activities that could continue to constrain growth in the future.

Future BCT growth also could be affected by the substantial overhang of previously generated, but as yet unclaimed NOLs . Although the magnitude of NOLs has declined recently, they still total almost $70 billion, and are worth a potential tax savings of approximately $6 billion to California corporations (and thus, revenue losses to the state), if and when used."

? City Income Tax Information – no city within California imposes an income tax. However, several states have cities that impose an income tax. Such states include Alabama, Delaware, Michigan, Missouri, New York, Ohio, and Pennsylvania. In Arizona, cities are prohibited from assessing an income tax. Instead, the state shares 15% of its income tax collections with cities based on population (*Urban Revenue Sharing*).[17]

[16] Legislative Analyst's Office, *California's Tax System – A Primer*, January 2001; available at http://www.lao.ca.gov/2001/tax_primer/0101_taxprimer_chapter4.html. [17] For further information see http://www.strongcities.org/04d_total_shared.htm and http://www.azleg.state.az.us/ars/43/00206.htm.

? Issue analysis from the Legislative Analyst's Office:[18]

"Key BCT issues involve:

- ❿ *Income Apportionment*. Does California's use of a double-weighted sales factor in its income apportionment formula best achieve the state's tax policy goals?
- ❿ *Dividend Taxation*. California (like the federal government) "double-taxes" dividend income, since it is taxed under both the PIT and BCT. Should this be changed?
- ❿ *Integration*. More generally, since both the PIT and BCT tax income, some have proposed integrating the two taxes in some fashion. Should this be considered?
- ❿ *Federal Conformity*. California conforms to federal BCT law in many areas. Is California's policy of generally conforming still appropriate, and should additional conformity occur where it does not currently exist (such as with depreciation)?
- ❿ *Tax Expenditure Programs*. Are certain BCT-related TEPs ineffective or inefficient and, therefore, deserving of elimination or modification?
- ❿ *Revenue Performance*. Given the BCT's relatively subdued growth performance in the recent past, what will its growth be and are there associated problems with how the tax is being admin istered and enforced?"

[18] *California's Tax System – A Primer, supra.*

Analysis

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	All corporations taxable in California are subject to a flat franchise tax rate and the same minimum tax. Thus, the system is not very progressive – that is, corporations with higher incomes do not pay tax at a higher rate. As noted in the comparisons with other states above though, many states have a flat corporate tax rate. The minimum tax makes the corporate income tax regressive in that corporations with income below $9,050 will pay a flat rate of $800. For example, a corporation with $7,000 of taxable income owes tax of $800 which is an average rate of 11.4%. A taxpayer with $1000 of taxable income has an average rate of 80%. Thus, corporations with lower taxable income pay a higher percentage of that income in tax than higher income corporations. The current inability of corporations to fully utilize an NOL penalizes corporations that have a loss in a particular year relative to other corporations who may have been able to spread deductions out over years when there was sufficient revenue to utilize the deductions. While NOLs can be carried forward at 100% beginning in 2004, the 10-year carryforward period, relative to the 20-year federal period (plus a 2-year carryback period) will result in some taxpayers not being able to fully utilize the deductions that created their NOL. From 1950 to 1985, the aggregate of tax paid to net income reported for corporations reporting net income was very close to the corporate tax rate (see earlier chart). In contrast, in 1995 and 2000 (years in between are not shown in the table above), the corporate tax rate was higher than the percentage of tax paid to net income reported. This occurred despite an increase in the minimum tax which should have led to an increased percentage of tax paid to net income unless very few corporations were subject to the minimum tax. However, FTB data shows that in 2000, at least 54.4% of corporations paid the minimum tax.[19] The likely conclusion is that the availability of tax credits has increased since 1985. Further analysis and additional data is needed to determine why the tax paid as a percentage of net income for corporations reporting net income decreased in the past decade. Such information would help in better understanding whether similar taxpayers are taxed similarly. Analysis should also be given to the issue of use of abusive tax shelters to determine the extent of the problem in California.	–

Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Corporations are well aware of state income taxes. Issues can arise as to whether a multistate business is subject to tax in a particular state. This is particularly true of corporations that do not sell tangible personal property and are therefore not covered by the protections/guidance of P.L. 86-272 (such corporations include those selling or licensing intangibles or leasing or licensing tangible property). While court cases and state regulations provide some guidance, it is often not consistent within a state and from state to state, making it difficult for a multistate corporation to always know if it owes tax in a particular state.	+/-

[19] Franchise Tax Board, *supra*, page 142. FTB data shows that 54.4% of corporations either had loss, no income or loss, or net income below $5,000. The cut-off point where taxable income leads to payment of the $800 minimum tax is $9,029 ($800/.0886). The FTB data shows that in 2000, 6.9% of corporation returns reported net income between $5,000 and $9,999 so some percentage of these returns paid the minimum tax.

Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Generally, California's income tax rules are complete. However, confusion can arise over the long list of areas where California law does not conform to federal law.	+/
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Corporations pay tax in quarterly estimated installments.	+
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	The Franchise Tax Board can rely to some extent on the results of IRS audits. Conformity to federal income tax rules helps reduce costs for both the state and taxpayers. Additional conformity would further reduce costs.	+/-
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	Like the federal income tax system upon which the California system is based, the system is complex. To the extent that California conforms to a federal rule, the California system is not any more complex than the federal system. Simplicity is partially achieved by conformity, but not fully achieved because of the complexity of the federal system. [20] In addition, the number of areas where there is no conformity requires California filers to learn additional rules and creates some level of comp lexity and often, additional recordkeeping.	+/

Minimum Tax Gap A tax should be structured to minimize non-compliance."	The California tax gap likely isn't too much different than that for the federal income tax system. The IRS estimates that the amount of taxes not voluntarily paid is about 17% of total federal income taxes each year (83% compliance rate). IRS enforcement efforts eventually raise the compliance rate to about 87% each tax year. [GAO, *Reducing The Tax Gap - Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157, June 1995, pages 2-3.] It is estimated that the federal income tax gap is The compliance rate for corporations is likely higher than for individuals.	-
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	The corporate income tax is fairly predictable, although not as predictable as the California property tax. In a booming or depressed economy, there is some unpredictability, but that is the nature of an income tax.	+

[20] There has been much written about the complexity of the federal income tax system. One good reference is a 2001 report by the Joint Committee on Taxation, *Study Of The Overall State Of The Federal Tax System And Recommendations For Simplification, Pursuant To Section 8022(3)(B) Of The Federal Tax System*, JCS-3-01, available at http://www.house.gov/jct/pubs01.html.

Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	Various provisions in the income tax system – both those coming from the federal system and those added by California (such as certain tax credits) were designed to affect a taxpayer's decision-making. For example, the California research tax credit is designed to encourage businesses to perform R&D work in California. The adverse impact to the neutrality principle from such provisions needs to be weighed against the other principles. In addition, such provisions should be evaluated periodically to determine if they are still needed and if they are helping the state to achieve the desired goal.	-
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	Compared to other states, California has a fairly high corporate tax rate and a high minimum tax. Also, California is dependent on the corporate income tax for a higher percentage of its revenues than other states (7.6% of California's revenue is from the corporate income tax versus 5.7% for all states on average). A recent study concluded that "the corporate net income tax has statistically significant negative impacts on the rate of growth in employment." In contrast, the researchers did not find that the negative impact from increases in personal income taxes and sales taxes to be statistically significant.[21] Consideration should be given as to whether the corporate tax rate and minimum tax are too high and whether it affects a business's decisions as to whether or not to locate or expand in California. This analysis should also consider the impact of California's double-weighted sales factor in	+/

	the apportionment formula along with a serious study of the impact of a single sales factor apportionment approach[22] as some businesses are calling for today. In addition, further analysis should be performed to determine how many corporations pay the minimum tax and the impact on their business operations. To help align the goals of cities/counties and the state, consideration should be given to sharing the income tax with local governments, as is done in Arizona. Such an approach could better incentivize both levels of government to attract high wage jobs to California and provide them with the infrastructure (such as housing) that they would need.	

[21] J. William Harden and William H. Hoyt, "Do States Choose Their Mix of Taxes to Minimize Employment Losses?" *National Tax Journal*, Volume LVI, No. 1, Part 1, March 2003, page 23.

[22] For an objective overview of the operation of a single sales factor, see a Joint Venture Tax Policy Group issues paper at http://www.jointventure.org/initiatives/tax/current_issues.html.

CALIFORNIA PERSONAL INCOME TAX

Background

- The California income tax was first enacted in 1935. The state income tax was set at about 25% of the federal income tax owed. The rates ranged from 1% on the first $5,000 of income to 15% on income over $250,000. The definition of taxable income was similar to that at the federal level and the returns were due on April 15.[1]
- The high level of conformity to federal law did not last. In 1982, AB 36 removed about 300 differences between the state and federal system.[2] Not all federal income tax changes are adopted by the California legislature, primarily due to revenue effects. Thus, individuals must make adjustments from their federal taxable income to compute California taxable income.
- Tax rates today range from 1% - 9.3%. The 1935 top rate of 15% was reduced to 6% in 1943. The top rate was raised to 10% in 1967 and then to 11% in 1971. The top rate was lowered to 9.3% in 1987. In 1991, temporary rates at the top of 10% and 11% were enacted.[3]
- Tax brackets began to be indexed for the effects of inflation (to prevent "bracket creep") in 1978.[4]
- The rate structure in 2002 for a married couple with two dependent children (see 2002 tax rate schedule for details of tax calculation):

Taxable income range	Marginal Rate	Tax after personal and dependency exemptions, if income is at top of this bracket	Average tax rate for prior column
$1 - $11,668	1.0%	$0	0%
$11,668 - $27,658	2.0%	$0	0%
$27,658 - $43,652	4.0%	$414	0.9%
$43,652 - $60,596	6.0%	$1,431	2.4%
$60,596 - $76,582	8.0%	$3,372	4.4%
Over $76,582	9.3%	$5,550 (assumes taxable income of $100,000)	5.5%

- In 2000, 13.4 million full-year resident individual income tax forms were filed. These consisted of 1.6 million Forms 540EZ, 3.4 million Forms 540A and 8.4 million Forms 540.[5]
- In 1998, individuals with annual income of $200,000 or more represented less than 3% of returns filed, but about 50% of PIT collected. Individuals with adjusted gross income under $50,000 represented over 70% of returns filed and less than 10% of PIT collected.[6] "Taxpayers with annual income of $500,000 or more constitute about 1 percent of returns but roughly 40 percent of revenue."[7] Also see FTB data for further breakdown (http://www.ftb.ca.gov/other/annrpt/2000/append.html).
- The PIT does not apply to individuals until their income exceeds about double the poverty line. In 2001, a married family of four did not owe income tax until income reached $38,800.[8]

[1] Doerr, David R., *California's Tax Machine*, California Taxpayers' Association, 2000, pages 37, 437 - 445.
[2] *Ibid*, page 191.
[3] *Ibid*, pages243, 437 – 445.
[4] *Ibid*, page 156.
[5] Franchise Tax Board, 2001 Annual Report, page 11; available at http://www.ftb.ca.gov/other/annrpt/2001/2001ar.pdf.
[6] LAO, *California's Tax System – A Primer*, January 21, page 20.
[7] LAO, *Governor's Tax Increase Proposal*, 1/29/03; available at http://www.lao.ca.gov/handouts \revtax\2003\ 030089_HO.pdf.
[8] Center for Budget

and Policy Priorities, *State Income Tax Burdens on Low-Income Families In 2001*, California fact sheet; available at http://www.cbpp.org/2-26-02sfp-ca.pdf.

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? PIT revenues declined 26% from 2000-01 to 2001-02.[9] A significant part of this is due to the decline in capital gains and stock option revenue. "[T]ax revenues [from stock options and capital gains] peaked at $17 billion in 2000-01, but fell abruptly following the stock market decline—to under $6 billion in 2001-02. This unprecedented 66 percent decline is the key factor behind the $10-plus billion annual mismatch between revenues and expenditures that began in 2001-02."[10]

? Comparison to other states:

- ❿ Only 7 states do not have a personal income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming).
- ❿ 2001 PIT collection as a percentage of total tax collections – selected states:[11]
- ❿ State income tax thresholds for a married family of four in 2001 – selected states:[12]

State	%
Arizona	27.2%
California	49.3%
Colorado	51.5%
Massachusetts	57.5%
Michigan	30.5%
New York	59.0%
Oregon	74.4%
Virginia	55.2%
All States Average	37.1%

State	Threshold
Arizona	$23,600
California	$38,800
Colorado	$28,700
Massachusetts	$22,700
Michigan	$12,800
New York	$24,900
Oregon	$15,100
Virginia	$17,700
Average 41 states + District of Columbia	$19,000

Based on an estimated poverty line of $18,104.

California had the highest thres hold among the 42 taxing jurisdictions.

[9] LAO, *The 2003-04 Budget Bill: Perspectives and Issues*; available at http://www.lao.ca.gov/analysis_2003/2003_pandi/pi_part_3_anl03.html. [10] LAO, *California's Fiscal Outlook LAO Projections, 2002-03 Through 2007-08*; available at

http://www.lao.ca.gov/2002/fiscal_outlook/fiscal_outlook_2002.html. [11] Federation of Tax Administrators; table at http://www.taxadmin.org/fta/rate/01taxdis.html. [12] Center for Budget and Policy Priorities, *State Income Tax Burdens on Low-Income Families In 2001*, available at http://www.cbpp.org/2-26-02sfp.htm.

❿ Per capita comparisons, total state revenues for 2000:[13]

State	Per capita	Rank
Arizona	$3,180	50
California	$5,092	15
Colorado	$3,966	35
Massachusetts	$5,042	16
Michigan	$4,982	18
New York	$5,870	6
Oregon	$6,142	4
Virginia	$4,154	30
All state summary	$4,489	

❿ Individual income tax rate range for 2002 – selected states:[14]

State	Tax rate range	# brackets
Arizona	2.87 – 5.04	5
California	1.0 – 9.3	6
Colorado	4.63	1
Massachusetts	5.3	1
Michigan	4.1	1
New York	4.0 – 6.85	5
Oregon	5.0 – 9.0	3
Virginia	2.0 – 5.75	4

States with a top individual tax rate equal to or greater than California's:

Montana 11.0%

District of Columbia 9.3%

? Contribution of PIT to California revenues:[16]

.❿ 15 states and the District of Columbia offer some version of an EITC based on the federal EITC.[15] Year	PIT as % of Total Tax Collections	PIT as % of Corporation Tax Collections	PIT as % of SUT Collections
1971	22.8%	237.6%	69.9%
1980	34.1%	259.2%	98.2%
1985	37.2%	295.0%	110.3%

1990	39.3%	340.5%	121.5%
1995	36.7%	327.3%	114.3%
2000	48.4%	596.1%	168.8%
2002	45.1%	620.0%	138.8%
2004*	42.5%	569.0%	119.5%

* estimates with Governor's proposed tax changes considered

[13] U.S. Census Bureau, information available at http://www.census.gov/govs/www/state00.html. [14] Federation of Tax Administrators; table at http://www.taxadmin.org/fta/rate/ind_inc.html . Also see information at http://www.taxpolicycenter.org/taxfacts/state/rates.cfm. [15] Center for Budget and Policy Priorities, *A HAND UP: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2001*, 12/27/01, page 6; available at http://www.cbpp.org/12-27-01sfp.pdf. [16] Governor's Budget Summary 2003-2004, Revenue Estimates, page 74; available at http://www.dof.ca.gov/HTML/Budgt03-04/BudgetSum03/08_Rev_Est.pdf.

? PIT is deductible on the individual federal income tax return for those who itemize their deductions, but is subject to alternative minimum tax (AMT).

? City Income Tax Information – no city within California imposes an income tax. However, several states have cities that impose an income tax. Such states include Alabama, Delaware, Michigan, Missouri, New York, Ohio, and Pennsylvania. In Arizona, cities are prohibited from assessing an income tax. Instead, the state shares 15% of its income tax collections with cities based on population (*Urban Revenue Sharing*).[17]

? Further analysis from Legislative Analyst's Office:[18]

"Some key PIT-related policy issues facing policymakers include:

- Marginal Rate Structure. Should California's PIT marginal tax rates be reduced, and the cost be financed through base broadening?
- Federal Conformity. Should California more fully conform to federal PIT law in areas where it currently differs, such as capital gains tax rates, depreciation, certain credits, and net operating losses?
- Broad-Based Simplification. Should California move towards a more simplified PIT system with fewer special provisions for particular groups/businesses?
- Targeted Simplification. Alternatively, should California leave its basic system intact, but focus on simplifications in those PIT areas where the greatest complexities for taxpayers lie, such as the AMT?
- Tax Expenditure Programs. Are there certain PIT-related TEPs that are ineffective and inefficient, and therefore in need of elimination or modification?
- Reliance on the PIT. Has California become overly dependent on the PIT, given that it is a somewhat volatile revenue source and now accounts for over half of the state's General Fund total?"

[17] For further information see http://www.strongcities.org/04d_total_shared.htm and http://www.azleg.state.az.us/ars/43/00206.htm. [18] Legislative Analyst's Office, *California's Tax System – A Primer*, January 2001; available at http://www.lao.ca.gov/2001/tax_primer/0101_taxprimer_chapter2.html.

Principle	Application and Analysis	Rating
	Fairness	
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	1. Horizontal Equity-Because the PIT is imposed by income class, it is generally thought of as performing well in this category; however, it is worth noting that two taxpayers with the same taxable income may have significantly different gross incomes or "abilities to pay". 2. Vertical Equity- California's PIT rates are highly progressive, although the brackets are extremely narrow. Coupled with the high filing threshold, taxpayers with a relatively small	_

	difference in "ability to pay" may find themselves not filing a return in the highest marginal bracket. **3.** Fairness- Normally, "fairness" is equated with "progressivity". In California, however, there has been recent focus on the growing concentration of PIT burden on a narrowing class of taxpayers. While California has the highest threshold for when PIT is owed, the mix of taxes must be considered to determine if the system as a whole is "fair." [more data needed]	
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Californians pay the PIT either through withholding or estimated tax payments. Thus, individuals are generally aware of that the PIT is being assessed or is due. While some phase-outs and the California AMT may make it difficult to easily compute the PIT on a transaction, it is possible to do so.	+
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Generally, the PIT is certain. There is well-established regulations and case law to help interpret the PIT statute. Yet, complexity of transactions can lead to uncertainty for some transactions. Generally, though this is the same uncertainty that individuals will encounter under the federal income tax system.	+

Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	As most PIT is paid through withholding or quarterly estimated payments, payment is fairly convenient.	+
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	The concentration of revenue in relatively few returns and the expansion of e-filing amongst lower-income taxpayers makes the California PIT fairly efficient for the government to collect. Information sharing agreements with the federal government is a great audit tool for the Franchise Tax Board. The expansion of e-filing, and the high filing threshold continues to address taxpayer compliance costs; moreover, the relatively high level of conformity to federal tax law makes the PIT a reasonable one with which to comply.	+

Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	The PIT is far from simple, although the complexity of the code most likely increases with the sophistication of the taxpayer. Much of the complexity stems from the federal income tax system upon which much of the PIT is based. Areas where California does not conform to the federal rules add to complexity in that taxpayers must spend more time with both compliance and recordkeeping. Given that 63% of individuals must file the long form (Form 540) rather than the somewhat easier Forms 540A and 540EZ, is another indication of some complexity. A PIT that was based solely on the federal income tax paid would certainly be simpler.	_
Minimum Tax Gap A tax should be structured to minimize non-compliance."	There is a great deal of debate about the size of the PIT "Tax Gap". Much of the focus has been on the problem of cash payments, particularly in some industries. The California tax gap likely isn't too much different than that fo r the federal income taxsystem. The IRS estimates that the amount of taxes not voluntarily paid is about 17% of total federal income taxes each year (83% compliance rate). IRS enforcement efforts eventually raise the compliance rate to about 87% each tax year. [GAO, *Reducing The Tax Gap - Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157, June 1995, pages 2-3.]	_
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Much has been said about the revenue "bubble" caused by stock options and capital gains in the past few years, and that this was caused by the growing reliance on high-wealth taxpayers to pay the bulk of the PIT. The short - term, "one-time" nature of the phenomenon was well-documented, and warnings went out from the FTB and the Legislative Analyst that the rate of growth of the PIT would not be sustained at that high level. In short, the PIT has been "unpredictable" and "volatile" in the sense of moving up and down drastically and unpredictably. Certainly, to the degree the PIT continues to concentrate on high-income taxpayers with fluctuating incomes, the potential for volatility will also continue. With the PIT being primarily generated by a small number of taxpayers, it is affected more significantly (both positively and negatively) when there are changes in the incomes of this small group of taxpayers. Unlike the sales and use tax, the personal income tax is deductible for individuals who itemize their deductions on th eir federal income tax	+/
	return. For some taxpayers, this deduction is reduced due to the federal alternative minimum tax.	
	Appropriate Purpose and Goals	

Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	The income tax system has many provisions that are intentionally designed to encourage or discourage certain activities. For example, the PIT allows individuals who itemize to deduct charitable contributions. Favorable depreciation rules are designed to encourage capital investment. High tax rates may lead individuals who do not need to work or live in California to move to a lower tax state.	**-**
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	As a greater percentage of the PIT is borne by fewer and fewer high-wealth taxpayers, a fear arises that the PIT could drive some of these taxpayers to move to low- or no-income tax states. These taxpayers are often the most productive and innovative in the economy. Moreover, to the degree that any such departures also results in a decline in California investment, future economic expansion is compromised. Relative to other states, California's tax rates are high. This, though, needs to be weighed in relation to other types of taxes, use of appropriate tax credits, and how the overall tax burden is distributed across income levels. While the PIT is very progressive, consideration should be given as to whether it offsets the regressivity of the sales tax. Or, should the sales tax be made more progressive (such as by taxing the types of consumption that higher income individuals tend to have such as services) and the income tax less progressive. To help align the goals of cities/counties and the state, consideration should be given to sharing the income tax with local governments, as is done in Arizona. Such an approach could better incentivize both levels of government to attract high wage jobs to California and provide them with the infrastructure (such as housing) that they would need.	+/

Policy Approach to Analyzing Tax Systems

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Analyses of tax systems almost always looks at tax principles as criteria for understanding and critiquing tax systems. The principles are typically the same although terminology, emphasis and sequencing may differ. Listed below are some examples of tax system analyses that have applied principles of good tax policy.

Joint Committee on Taxation – *Description and Analysis of Proposals To Replace the Federal Income Tax*, JCS-18-95, 6/5/95, pages 58 – 59.

Excerpt:

> Analysts generally judge tax systems in term so how well the tax system answers four different questions.
>
> ? First, does the tax system promote or hinder economic efficiency. That is, to what extent does the tax system distort taxpayer behavior? Does the tax system create a bias against the domestic production of goods and services? To what extent does it promote economic growth?
>
> ? Second, is the tax system fair? Does the tax system treat similarly situated individuals similarly? Does the tax system account for individuals' different capacities to bear the burden of taxation?
>
> ? Third, is the tax system simple? Is it costly for taxpayers to determine their tax liability and file their taxes?
>
> ? Fourth, can the tax system be easily administered by the government and can it induce compliance by all individuals? Is enforcement costly? Can some individuals successfully avoid their legal liabilities?
>
> The design of a tax system involves tradeoffs between these different goals. Measures designed to ensure compliance may increase the complexity of taxation for individual filers. Measures designed to promote simplicity may create distortions in individual choice of investments. Measures designed to promote growth may alter the distribution of the tax burden.

Legislative Analyst's Office – *The 2003-04 Budget Bill: Perspectives and Issues – The Governor's Tax Proposal: Evaluation and Alternatives*, February 2003, http://www.lao.ca.gov/analysis_2003/2003_pandi/pi_part_5a_taxes_anl03.html.

Excerpt (Figure 2)

Essential Criteria for Evaluating The Governor's Tax Proposals:

. ➓ *Growth Performance*—Will the new tax revenues grow along with the economy and/or the program responsibilities they are expected to fund?

. ➓ *Reliability and Volatility*—Are new revenues raised by the taxe s relatively stable over time or are they excessively volatile and difficult to predict?

. ➓ *Distributional Effects*—Is the additional burden or "incidence" from the increased taxes distributed among taxpayers in a manner that the Legislature believes is appropriate?

. ➓ *Tax Administration*—Are the new taxes simple to collect and administer or do they add additional complexity to the existing administrative structure?

. ➓ *Federal Interaction*—Would the increased taxes be deductible for federal purposes, allowing the state to “shift” some of the additional tax burden to the federal government?
. ➓ *Economic Climate*—What effects are the proposed tax increases likely to have on the business climate and overall economic activity?

Washington State Tax Structure Study Committee – *Tax Alternatives for Washington State: A Report to the Legislature*, November 2002, http://dor.wa.gov/Content/WAtaxstudy/Final_Report.htm.
The charge of the committee was to study Washington’s existing tax structure and recommend alternatives to improve the system. The extensive report issued in 2002 begins with an explanation of tax principles for a “well-designed tax system.” It also explains the existing structure and where it does and does not meet the tax principles. The study also explains various constraints to change that exist in the
U.S. and state constitutions and local government funding limitations. Such constraints are important in reform efforts as they are limitations that likely can’t be changed.
Various proposals are analyzed including major ones such as replacing a portion of the tax structure with some type of value-added tax or adding a state income tax (currently, Washington imposes no income tax). Incremental proposals such as continuing to impose an estate tax even after repeal of the federal tax, are also made. Additional proposals include extending the sales tax to consumer services, compensating vendors for collecting the sales tax, periodically reviewing exemptions and business incentives, and exempting construction labor from the sales tax. Each proposal made is analyzed in terms of it would allow the system to better meet the tax principles and what problems it might create in terms of not completely meeting particular tax principles.
The tax principles used to guide the committee’s work were as follows.[1]

? Adequacy/stability/elasticity
? Equity/fairness
? Economic vitality and harmony with other states
? Economic neutrality and efficiency
? Transparency and administrative simplicity
? Home ownership

[1] The principles were provided to the committee in ESSB 6153 (likely some type of legislative directive).

Hawaii 2001-2003 Tax Review Commission – *Report*, 2003, http://www.state.hi.us/tax/trc_rpt.html. The Commission used a set of principles for “sound tax policy” provided by the National Conference of State Legislatures (NCSL) that were compiled in 1988 with input from lawmakers and academics. The five principles are: 1) Provision of appropriate revenues – this principle focuses on sufficiency, stability and certainty of

revenues produced. 2) Neutrality 3) Equity 4) Easy and economical to administer 5) Accountability – the focus is at three key levels: (i) taxpayers being accountable for paying their
taxes, (ii) tax agencies accountable to administer and enforce the tax laws efficiently and fairly, and (iii) lawmakers accountable for the integrity of the tax laws.

Comparing Sets of Tax Principles

In 2003, Joint Venture: Silicon Valley Network issued *Tax Principles Workbook – A Tool for Critiquing Tax & Fiscal Proposals and Systems*.[2] The principles used in the workbook are based on a Tax Policy Statement issued by the American Institute of Certified Public Accountants (AICPA) in 2001.[3] As noted above, reports of other organizations and committees have used a set of tax principles to analyze tax structures and tax proposals. A logical question arises from looking at all of this – is there a common set of principles? The answer is yes. While terminology and layout may vary, the concepts are the same. Some reports either ignored a principle that others used or did not find it to be as important, perhaps, in its particular analysis. The following chart helps to illustrate the similarities among the principles outlined in the reports.

<table>
<tr><th>AICPA</th><th>Joint Venture[4]</th><th>Joint Committee on Taxation</th><th>Legislative Analyst’s Office</th><th>Washington</th><th>Hawaii</th></tr>
<tr><td>Equity and fairness</td><td>Fairness</td><td>(2) Is the tax system fair?</td><td>Distributional effects</td><td>Equity/fairness</td><td>Equity</td></tr>
<tr><td>Certainty</td><td>Operability</td><td rowspan="3">(4) Can the tax system be
easily administered?
Tax administration</td><td></td><td></td><td rowspan="4">Easy and economical to administer</td></tr>
<tr><td>Convenience of payment</td><td>Operability</td><td></td><td rowspan="3">Transparency and administrative simplicity</td></tr>
<tr><td>Economy of collection
Operability Tax administration
Operability</td><td></td><td rowspan="2"></td></tr>
<tr><td>Simplicity Operability (3) Is the tax system simple?
Operability</td><td>(3) Is the tax system simple?</td><td></td></tr>
<tr><td>Neutrality</td><td>Appropriate purpose and goals</td><td rowspan="2">(1) Does the tax system
promote or hinder economic efficiency?</td><td></td><td rowspan="2">Economic vitality and
harmony with other states
Economic neutrality and
efficiency
Home ownership [5]</td><td>Neutrality</td></tr>
<tr><td>Economic growth and
efficiency</td><td>Appropriate purpose and goals</td><td>Growth performance
Economic climate</td><td></td></tr>
<tr><td>Transparency and
visibility</td><td>Fairness</td><td></td><td></td><td>Transparency and
administrative simplicity</td><td>Accountability</td></tr>
</table>

Minimum tax gap	Operability	(4) Can the tax system be easily administered?			Easy and economical to administer
Appropriate government revenues	Operability		Reliability and volatility Federal interaction	Adequacy/stability/elasticity	Provision of appropriate revenues

[2] Available at http://www.jointventure.org/taxpolicyworkbook/.
[3] AICPA, Tax Policy Statement No. 1 – *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*,

http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf. [4] The Joint Venture workbook uses the AICPA's 10 principles, but groups them into three broader categories. [5] This principle is an unusual one in that it is so specific or narrow. It appears that the state has made this such an important goal that it is something to be followed in the design of their tax system to help ensure that individuals are able to "purchase and maintain a home consistent with their standard of living" (page 5)