

9/8/2009

To: COTCE

From: John Cogan
Chris Edley

Re: A Proposal for the Commission

As you know, the two of us have been uncharacteristically industrious, working with Gerry and the staff to examine the desirability and feasibility of including the BNRT in the package. Many Excedrin™ later, we believe that it makes great sense as a matter of economics and equity. We are optimistic that it will not be “dead on arrival”, notwithstanding its novelty. More than other options available, it speaks directly to the economy of this new century.

In our judgment, however, the benefits depend critically on the construction of the package as a whole. Therefore, we have worked with the staff to assemble the following components, which we hereby propose to you as the core package for Part I of our recommendations. In developing this package, we have attempted to incorporate the views and recommendations that various Commissioners have raised during our meetings. While we have been unable to satisfactorily accommodate all Commissioners’ concerns, we hope that you take this as our good faith effort to do so. We look forward to discussing all of this in detail on Thursday.

We are confident that the tax package is the right course for California. We also recognize that the BNRT represents an extraordinary change in California’s tax code. A tax change of this magnitude should only occur after the proposal has been fully vetted and all of its ramifications have been fully assessed by the Legislature and the Governor and the public. We believe that the BNRT is sufficiently promising to warrant the Commission’s recommendation that the Legislature and the Governor proceed with a public process to fully evaluate the BNRT proposed herein and, upon satisfactory completion of this process, to enact a BNRT into law as part of the proposed package.

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Package Components:

1. Personal Income Tax: tax cut for every AGI bracket
 - a. Exemption of \$45,000 for a family of two
 - b. Two tax rates:
 - i. 2.75% up to Taxable Income of \$56k for joint filers (\$28k for single filers)
 - ii. 6.5% thereafter.
 - c. Three deductions *only*:
 - i. Mortgage interest

- ii. Property Taxes
 - iii. Charitable donations
 - d. Retain the Constitutional provision imposing a one percentage point “millionaires tax”
- 2. Sales & Use Tax: Eliminate state portion of the SUT
- 3. Corporate Income Tax: Eliminate
 - a. Eliminate the Business & Franchise Tax for all businesses except financials if they are not included in the new tax (see below)
- 4. Business Net Receipts Tax: new tax, a “subtraction method” value-added tax
 - a. Tax rate of 4.2% (the rate is currently being analyzed)
 - i. Financial institutions included in new tax using a different calculation method or, alternatively, remain subject to current tax law
 - b. Filing threshold of \$500,000 and tax liability threshold of \$250,000
 - i. Phaseout for the \$500,000 BNRT filing threshold and the \$250,000 taxability threshold for higher revenue taxpayers
 - c. Applicable to all business entities, including pass-through (partnerships, LLCs, Subchapter S corps)
 - d. Retain Research and Development Tax Credit (for investments in CA)
 - e. Apportionment for nonresident firms; “waters edge” rule for multinationals
- 5. Phase-in
 - a. Five year phase-in, starting FY 2012
 - b. Year 1 will include BNRT of 2%, a down payment on the PIT reduction, and elimination of the Corporate Income Tax
 - c. Incremental increases in the BNRT, and corresponding reductions in the other currently applicable taxes
 - d. Annual revenues will be “trued up” to meet Finance Department revenue projections using Q3 and Q4 adjustments in the Sales Tax
 - e. The statute will incorporate an automatic trigger so that the Year 5 sales tax rate is set at the level best predicted, using data from returns in Years 1-3, to produce the same level of revenues that pre-reform tax law would have been expected to yield in Year 5

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In addition to these components, we are working together on a proposed Constitutional amendment to create a Rainy Day Fund.