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August 24, 2009

The Honorable Gerald Parsky
Chair, Commission on the 21st Century Economy
c/o State of California Department of Finance
915 L Street, 8th Floor
Sacramento, California 95814

Dear Chairman Parsky:

On behalf of the Silicon Valley Leadership Group, I am writing regarding recent discussions by the 21st Century Commission on the New Economy in preparation for the issuance of a final report on September 20.

The more than 300 member companies of the Leadership Group recognize the economic circumstances you and your colleagues are dealing with in your consideration of a revised state tax structure. We have previously communicated to the Governor and Legislature that without tax and budget reform, California will remain vulnerable to future economic difficulties.

The Leadership Group has yet to formulate specific positions on any of the proposed plans under consideration by the Commission, given that many of the details are not yet developed or known. Nonetheless, we respectfully ask that you consider the following general comments and suggestions in your ongoing deliberations.

First, although short-term revenue increases have regrettably been necessary to address the current budget crisis, such increased costs will hamper California's economic recovery and long-term health. To mitigate potential harm, and to regain our tax base as quickly as possible, we urge that any reform proposals be bench-marked in the context of their impact on jobs and California's competitiveness across both established industries and promising new sectors, including those related to green technology.

In the past, we have recommended the following to meet those goals, and believe that these issues also have relevance to the proposals now under consideration by the Commission:

- *Single Sales Apportionment Factor*: 22 states utilize single sales factor apportionment – including states adjacent to, and most competitive with, California. States, such as Texas, now have alternative corporate tax systems (not based on net income).

- *R&D Tax Credit:* It is critical that California remain competitive as a site for U.S. research and the innovations, jobs, and economic growth that such research fosters. Recent actions taken by state government to address our economic crisis have limited the ability of the current credit to produce its optimal favorable effect. It is vital that California return to encouraging research here to the greatest possible extent even if structural changes occur to the tax system.

- *Double Taxation of Productive Assets:* California, unlike virtually every other state, has double taxed productive assets used in both manufacturing and research. Academics, economists, and businesses all agree that taxing both business inputs and outputs constitutes inappropriate tax and economic policy. This practice should be avoided under any new tax structure.

Second, the Leadership Group has had a long-standing position opposing split roll property taxation, including split rate proposals and others proposing changes of ownership to trigger reassessments of commercial property. We believe such changes are undesirable, due to the inevitable increased tax burdens that would fall squarely on employers, as well as increased administrative burdens on taxpayers and government alike. If there are identified abuses of the current change of ownership rules, any revision should be limited to addressing such abuses, not altering the overall system to implement a split roll.

Third, the Commission's charter appears to propose revenue-neutral recommendations, rather than to raise additional revenue. However, there has been some discussion of new sources of revenue by members of the Commission. If and when added revenue may be considered, we suggest that revenue enhancements be both limited and strategic. In this regard, we believe:

- Any revenue enhancements should be shared broadly rather than falling disproportionately on any one sector.

- A reinstatement of the Vehicle License Fee should be among the first considered.

In addition, revenue increases and/or spending cuts will likely only temporarily address the state's fiscal problem, and meaningful budget reform will be needed as well. We urge the following:

- *A two-year budget* – This should include provisions for mid-course corrections and multi-year forecasts, to help elected officials analyze the downstream effects of policy decisions.

- *A more robust and secure reserve fund* – Even with a revision of the state's revenue structure, the state must institute provisions to smooth revenues and spending by setting money aside in flush times – neither spending it nor refunding – to provide a "cushion" when revenues fall.

Fourth, with respect to the proposed Business Net Receipts Tax (BNRT), the Leadership Group has no formal position at this time. We believe the general comments below raise important issues to be considered as a BNRT proposal is refined and is subject to further consideration. If the Commission were to ultimately recommend one, we offer the following comments (although as cited below, additional specific comments could emerge as more details of a BNRT become known):

- Changing to a net (or gross) receipts regimen will have a substantial impact on California businesses. Within the economic recession, importantly, our current corporate tax system allows for losses incurred during an accounting period to be carried over for use as soon as possible in a period of profitability. This reflects the fact that yearly accounting periods are not an accurate reflection of business economic circumstances. A fair and equitable measure needs to extend over a longer time period, or businesses with similar economic outcomes over time would be treated disparately in terms of their tax burdens. A BNRT, not being based upon profitability, has the potential to severely hurt California businesses when they can least afford it and when cash flow is critical – when they have no profits at all. Accordingly, a BNRT should retain some method to avoid any unfair outcome. The Commission should also take into account the potential federal impact of an alternative tax system, such as the BNRT.

- The enemy of a good business decision is uncertainty. Evidently, the proposed BNRT rate has already been subject to an increase over the one previously mentioned; the acceptability of the BNRT will depend in significant part upon a business calculating what would be eliminated (the corporate income tax and state sales tax) and what would replace it (the BNRT), so the BNRT rate is critical to that determination. Also, the BNRT rate should remain at a predictable level. And, future susceptibility to arbitrary rate manipulation or increases should be avoided. Moreover, taxes replaced should, to the greatest extent possible, not re-emerge later.

- Sourcing issues are critical within the context of a BNRT, and foreign income (dividends, royalties, etc.) should be excluded from the base. The tax should be imposed on the basis of a true water's-edge.

- As mentioned above, single sales factor apportionment should be employed to calculate taxable net receipts – to revert to doing otherwise would be to return California to a method that penalized California jobs and capital investments and ironically rewarded the same if in other states.

- Also as mentioned above, it is important that the BNRT preserve a measure targeted at the ongoing conduct and growth of research in California. Virtually every other state, including many of those with alternative tax systems, maintains a provision of some type to encourage new and added in-state research. Virtually all economists agree that, absent government aid, the private sector would under-invest in research.

  Thus, competition for research among other states, and other countries, is intense. A revised tax system should not place California in a lesser position. The BNRT should continue to include a provision designed to encourage research in California. Notably, in the recent past, legislative efforts have been made not only to retain our current 15% credit, but to also increase the rate to ensure that our lead is maintained, even as other states are moving to enhance their research credits and incentives.

- Also as cited above, a BNRT should avoid the double taxation of productive assets our current system has unfortunately included. It appears that the BNRT would do so through the elimination of the states sales tax and the BNRT exclusion of business purchases from its base. However, the initial proposal to expense capital asset investments has apparently now been altered to instead employ a depreciation system similar to the federal Modified Accelerated Cost Recovery System (MACRS), which could expose some productive assets to continuing double taxation. In addition, the local sales tax share presumably would continue to tax both business inputs and outputs, and produce double taxation in the future, unless the local sales tax was changed as well.

- In a transition to a BNRT system, it would be crucial that tax attributes from the prior tax system not be lost – for example, unutilized credits and losses carried over, and unclaimed depreciation of assets previously acquired, should be contemplated and be accommodated under a new tax system. If not, the economics and receptivity of the new system will be adversely affected.

We appreciate the opportunity to share our thoughts with you. Thank you in advance for your consideration and service in leading the Commission.

Sincerely,

Carl Guardino

Carl Guardino
President & CEO

cc: Governor Arnold Schwarzenegger
All Commissioners, Commission on the 21st Century Economy
Mark Ibele, Ph.D., Staff Director, Commission on the 21st Century Economy