

TAX PRINCIPLES
workbook

A TOOL FOR CRITIQUING TAX
& FISCAL PROPOSALS AND SYSTEMS
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Prepared by the Tax Policy Group of
Joint Venture: Silicon Valley Network



Joint Venture's Tax Policy Group consists of individuals from high tech industry, government, and academia who analyze various state and federal tax rules and proposals to consider the impact to local governments and high tech industries. The Group's current work encompasses international tax reform, worker classification, R&D incentives, major federal tax reform, incentives for donations of technology to K-14, and sales tax issues of electronic commerce. The Group works to promote better understanding of tax and fiscal issues of significance to the Silicon Valley economy through distribution of its reports, sponsorship of seminars and discussion forums, and submission of testimony to legislators and tax administrators.

For copies of the Tax Policy Group's publications visit: <http://www.jointventure.org/initiatives/tax/tax.html>

Joint Venture: Silicon Valley Network (www.jointventure.org) is a regional, non-partisan voice and a civic catalyst for solutions to problems, which impact all sectors of the community. Joint Venture brings together established and emerging leaders from business, labor, government, education, and community organizations. It also involves citizens in the region and is a neutral forum for new ideas and creative solutions. Real benefits for people, business, and community organizations are its goals.

Why this Workbook?

This workbook contains a tool to help policymakers and others analyze existing tax and fiscal structures and proposals to determine how well they satisfy the basic principles of good tax policy. The analysis requires the user to consider the purpose of the tax or proposal, how it works, its degree of fairness, and whether it will operate efficiently. The analysis will point out where there are plusses and minuses (areas for improvement) in the item being analyzed.

The analysis should also help to stimulate debate and discussion on the finer points of tax proposals and alternatives. This should lead to a deeper understanding of tax and fiscal systems and issues.

The worksheet needed to do the analysis is included in this workbook (along with a brief explanation of the tax principles and four case studies of analyzed items). A blank worksheet can also be obtained at the Joint Venture Tax Policy Group website.

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Principles of Good Tax Policy

Joint Venture's Tax Policy Group has used the American Institute of Certified Public Accountants' (AICPA) tax policy statement to create a tool to help policy-makers and others interested in improving California's tax and fiscal structure. The tool is described and demonstrated in this workbook. The AICPA's statement—*Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, provides ten principles for determining if an existing tax or a proposal to modify a tax rule follows good tax policy. The framework recognizes that it is not always possible to incorporate all ten principles into tax systems – that some balancing is needed.

The workbook was created by Joint Venture to help policymakers and others evaluate pluses and minuses in either existing taxes or proposals to change existing tax rules. The tool regroups the AICPA's principles within three broad categories:

- ① Fairness
- ② Operability
- ③ Appropriate Purpose and Goals

The ten principles, as grouped by Joint Venture's Tax Policy Group, are explained next. Following this section are four case studies of how the principles can be used to evaluate tax and fiscal structures and proposals.

Joint Venture extends its gratitude to the AICPA for granting Joint Venture permission to use Tax Policy Statement No.1 in this workbook. AICPA Tax Policy Statement No.1 - *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals, 2001*; available at <http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf>.

FAIRNESS

1. Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

Equity refers to both horizontal and vertical equity. Horizontal equity describes the concept that taxpayers with equal abilities to pay should pay the same amount of tax. Vertical equity means that taxpayers with a greater ability to pay should pay more tax. The question of how much more tax people with higher income should pay is not an issue for the framework to resolve. Instead, the framework serves to note the importance of the principle, rather than to state how equity is achieved. How equity is to be defined and achieved for a tax system is a matter of political, social and economic debate.

The presence of both horizontal and vertical equity in a tax system is thought to make the system fair. However, the term fair has different meanings to people owing to differing opinions on what “similarly situated” means and how progressive a tax should be. For example, some would view an income tax system as “fair,” if there were deductions for basic items such as medical expenditures and child care. Others would view the system as “fair” if there were almost no deductions. In addition, some view an income tax as “fair” if it represents a higher percentage of a high-income taxpayer’s income relative to a lower income taxpayer (that is, the system is progressive). On the other hand, some view an income tax system as “fair” if everyone pays at the same rate (the tax is the same

percentage of every taxpayer’s income yet high-income taxpayers pay more because they have more income).

Because taxpayers usually pay a range of different types of taxes, equity is best measured by considering the range of taxes people pay, rather than looking at only a single tax.

2. Transparency and Visibility

Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

Transparency and visibility in a tax system enable taxpayers to know the true cost of transactions. These features enable taxpayers to know when a tax is being assessed or paid and to whom. This principle relates to fairness because taxpayers should be able to know what type of taxes they are paying and how much. For example, the California sales tax is visible because it is separately charged by retailers rather than being included in the price marked on the goods. On the other hand, consumers indirectly pay various excise taxes when they buy gasoline, but they typically do not know how much of the total amount paid represents excise taxes. If the federal or California gasoline excise tax were increased, consumers would most likely perceive that the price of gas had increased rather than realizing that the manufacturer’s excise tax had increased.

Progressive vs. Regressive

Progressive means that the tax represents a higher percentage of a high income taxpayer’s income relative to a lower income taxpayer. In contrast, *regressive* means that the tax represents a higher percentage of a low income taxpayer’s income relative to a higher income taxpayer.

OPERABILITY

3. 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.

If taxpayers have difficulty measuring the tax base or determining the applicable tax rate or the tax consequences of a transaction, then certainty doesn’t exist. Certainty might also be viewed as the level of confidence a person has that the tax is being calculated correctly. For example, if a taxpayer cannot determine whether an expenditure should be capitalized or expensed or whether a particular transaction is subject to sales tax, then certainty does not exist for that tax.

4. 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.

Convenience in paying a tax helps ensure compliance. The appropriate payment mechanism depends on the amount of the liability and the how easy or difficult it is to collect. Discussion of this principle in designing a particular rule or tax system would focus on whether it is best to collect the tax from the manufacturer, wholesaler, retailer or customer, as well as the frequency of collection.

5. Economy in Collection

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

This principle considers the number of revenue officers needed to administer a tax. Compliance costs for taxpayers should also be considered. This principle is closely related to the following principle of simplicity.

6. 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.

Simplicity in a tax system reduces the number of errors. Simplicity increases respect for the system and therefore improves compliance. A simple tax system better enables taxpayers to understand the tax consequences of their actual and planned transactions.

7. Minimum Tax Gap

A tax should be structured to minimize non-compliance.

The tax gap is the amount of tax owed less the amount collected. To minimize the tax gap, procedural rules

are needed to attain compliance. Generally, there is a need to strike a balance between (a) the desired level of compliance, and (b) the costs of enforcement and the level of intrusiveness of the tax system.¹

8. Appropriate Government Revenues

The tax system should enable the government to determine how much tax revenue will likely be collected and when.

A tax system should have some level of predictability and reliability to enable governments to know how much revenue will be collected and when. Generally, a government realizes better stability with a mix of taxes. For example, in an economic downturn, unemployment and a declining stock market would lead to reduced income tax collections. If the jurisdiction also had other taxes, such as a property tax or sales tax that was less affected by employment or stock values (or not affected as quickly), government revenues in total would be less adversely affected than if the government relied solely on an income tax.

APPROPRIATE PURPOSE AND GOALS

9. 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 principle of neutrality stands for the proposition that taxpayers should not be unduly encouraged or discouraged from engaging in certain activities due to the tax law. The primary purpose of the tax system is to raise revenue, not to change behavior. Of course, a completely neutral tax system isn't really possible. For example, an income tax could be said to discourage earning income. However, within the system, the neutrality principle would come into play in determining how to measure income or ability to pay.

10. Economic Growth and Efficiency

The tax system should not impede or reduce the productive capacity of the economy.

A tax system should be aligned with the economic goals of the jurisdiction imposing the tax. For example, the system should consider the jurisdiction's

goals for economic growth, capital formation and international competitiveness. Generally, the system should not favor one industry or type of investment at the expense of others. For example, a jurisdiction would probably not want to design an income tax that imposes a 90% rate on the top 25 percent of income earners because such a system would harm the jurisdiction's economic growth.

The principle of economic growth and efficiency might seem to be in conflict with the principle of neutrality. This is not necessarily the case though. This principle just recognizes that rules to calculate the tax base and tax rate have economic effects. For example, if the income tax system calls for a 30-year depreciable life for semiconductor manufacturing equipment, the jurisdiction must recognize that such a rule will have an effect (here, an adverse one) on the cost of semiconductors and site location decisions of semiconductor manufacturing companies.

Economic Effect of Depreciation
Today, the federal income tax system allows semiconductor manufacturing equipment to be depreciated over 5 years which many firms view as too long relative to the economic life of the equipment and what is allowed by other countries.

¹ General Accounting Office (GAO), *Reducing the Tax Gap – Results of a GAO-Sponsored Symposium*, June 1995, GAO/GGD-95-157, page 13.

How to Use This Workbook

The ten tax principles can be applied to identify and evaluate the plusses and minuses of any existing tax or any proposal to change a tax rule or tax system. The evaluation will point out the strengths and weaknesses of the tax or proposal and help identify ways to reduce or eliminate the weaknesses. Before beginning any analysis, it is helpful to know the background of the tax or proposal to be evaluated. An understanding of the proposal's purpose, how it works, who it applies to, recent reforms, and even what other jurisdictions do, will make it easier to perform the analysis and make the analysis more complete.

A rating system is used in the four case studies included in the workbook. However, you might find that a different rating system or even no rating system is preferable. The rating system chosen for the workbook is designed to be objective (relative to a 1–10 scale, for example). The key to the rating system is:

RATING	FOR THE ITEM BEING EVALUATED
+	this principle is satisfied
-	this principle is not satisfied
n/a	this principle is not affected
+/-	some aspects meet the principle and other aspects do not
?	unknown (for some proposals, it might be unknown whether an intended result, such as job growth, will really occur)

None of the examples includes a conclusion. The rationale for this is that each evaluator needs to apply his or her moral and political viewpoints to identify which principles are most important for the item being evaluated. In addition, each evaluator needs to deter-

mine if minuses need to be or can be improved or whether the plusses outweigh such efforts.

The case studies included in this workbook to help explain the meaning and application of the ten principles include a current tax, a tax question and tax proposals. These different types of items were chosen to help demonstrate the versatility of the evaluation tool. The case studies are:

- I. Existing Tax:** California's sales & use tax.
- II. Tax Question:** Should Internet commerce be subject to sales and use tax?
- III. Tax Proposal:** California AB 680 (2002) proposal to reallocate local sales & use tax in the Sacramento region.
- IV. Tax Proposal:** Measure F on the City of San Jose's November 2002 ballot - to increase the transient occupancy tax for a special purpose.

A blank score sheet is provided after the case studies to allow the now-experienced reader/analyzer to provide his or her own tax example and score it.

Case Study I: California Sales & Use Tax (SUT)

The California sales tax was created by the legislature when it enacted the Retail Sales Act of 1933. It was imposed on retailers for the privilege of selling tangible personal property. The impetus behind the new tax was the need to raise revenue to cover a budget deficit. The rate was 2.5% and the base was most tangible personal property. The use tax was enacted in 1935 to complement the sales tax. It was imposed on the storage, use or other consumption in California of tangible personal property purchased from any retailer on or after July 1, 1935. The rate was 3%, dropping to 2.5% after June 30, 1943. The sales tax rate followed the use tax rate changes.

Additional historical information can be found in David R. Doerr's book, *California's Tax Machine*, 2000; information available at <http://www.caltax.org>.

A 1963 California Appellate Court decision provided the following explanation of the use tax: "One of the chief purposes of the use tax is to help retailers in this state, who are subject to sales tax, to compete on an equal footing with their out of state competitors who are exempt from the sales tax. Thus it is intended to reach property purchased for use and storage in this state from retailers who, being outside of the territorial boundaries of California, are not subject to its laws at all. It also seeks to reach such property where the taxable event of a sales tax, i.e., the sale, occurs outside of this state or where such property is immune from the sales tax because of the commerce clause.... The use tax is complementary to the sales tax, and as such is intended to supplement the latter by imposing upon those subject to it a tax burden equivalent to the sales tax in order that tangible per-

sonal property sold or utilized in this state would be taxable once for the support of the state government.... It is not intended to apply to property subject to the sales tax.... This does not mean, however, that all property which is subject to the sales tax is exempt from the use tax, 'but, rather, that all property not actually covered by the sales tax is subject to the use tax.' ... 'The use tax applies to property purchased for use in this state wherever purchased, unless the gross receipts from the sale have been included in the measure of the California sales tax (Rev. & Tax. Code, sec. 6401), or unless the transaction is otherwise exempted by the statute or by the state or federal Constitution....' The use tax is imposed upon the purchaser rather than seller and the former is primarily liable therefor....

“It should be pointed out, moreover, that while the California sales tax and use tax are complementary to each other, they are not interdependent. Each is a separate tax. The sales tax is imposed upon the retailer for the privilege of selling tangible personal property (§6051), while the use tax ... is upon the purchaser who stores, uses or consumes property in this state.... The definitions contained in the ‘Sales and Use Tax Law’ (§§6002 to 6019 incl.), however, apply to both taxes, except where the contract specifically limits the particular definition to one and not the other. (§6002.)” [*Bank of America National Trust and Savings Association v. State Board of Equalization*, 209 Cal App 2d 780, 26 Cal Rptr 348 (First App Dist 1963).]

As noted above, there are constitutional limitations on a state imposing the sales tax on vendors outside of the territorial boundaries of the state. This position was reaffirmed by the U.S. Supreme Court in 1992 in the *Quill* decision.² In that decision, the Court ruled that to be within the Commerce Clause, a vendor must have a physical presence in the state before the state can impose sales tax collection obligations upon the vendor. Litigation continues in the states as to how much physical presence is required for a vendor to have nexus (taxable presence) in the state. For example, would ten hours of employee time be sufficient or a leased computer or use of a trademark? These questions are not always resolved similarly among state courts.

In the 1940’s, some cities began to also assess a sales tax. By 1954, about half of California cities were imposing a sales tax which was producing significant revenue for them. Each city administered its sales tax on its own. In response to complexity concerns raised by businesses, the legislature enacted the Bradley-Burns Uniform Local Sales Tax Act in 1955. The Act allowed counties and cities to impose a sales tax with a base similar to that of the state and administered at the state level. Regulation 1802 provides that for retailers with one place of business, the sale is deemed to occur at that place of business. Thus, cities are incentivized to get businesses to locate a sales office or large retail outlets within the city borders.

Not all tangible personal property is subject to the sales and use tax. There are many exemptions, such as for food and bottled water. Other states also tend to have a variety of exemptions. About half of the states exempt food from sales tax. Some states exempt equipment purchased by manufacturers.

The state and local level sales tax rate in California is 7.25% (at January 2003). Some areas also impose a sales tax with the result that the rate varies among counties from 7.25% to 8.50%. The 7.25% California sales tax rate is composed of the following elements:

RATE	JURISDICTION
5.00%	State (General Fund)
.50%	State (Local Revenue Fund)
.50%	State (Local Public Safety Fund)
1.25%	Local (County/City) (City & County Operations + County Transportation)
7.25%	Total Statewide Base Sales/Use Tax

The combined state and local sales tax rates in the other 45 states that impose such a tax range from 4 to 9%.

In 2000/2001, \$35.4 billion of sales and use taxes were collected in California. The sales tax represents about 10% of a city’s total revenues.

Commerce Clause

“The Congress shall have power... to regulate commerce with foreign nations, and among the several States, and with the Indian tribes.” [Article I, Section 8, clause 3] Courts often refer to the “dormant Commerce Clause” because the Commerce Clause does not specifically limit state activities—it just grants power to Congress to regulate commerce. In applying the dormant Commerce Clause, the courts consider the purpose served by the Commerce Clause and “whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve.” *Wardair Canada v. Florida Dept. of Revenue*, 477 U.S. 1 (1986).

Nexus

Nexus may be thought of as a connection between the vendor and state such that subjecting the vendor to the state’s sales tax rules is neither unfair to the vendor nor harmful to interstate commerce. These two requirements of fairness to the vendor and no impediment to interstate commerce stem from the U.S. Constitution—respectively, from the Due Process Clause and the Commerce Clause. Both of these requirements must be satisfied before a state may impose sales and use tax collection responsibilities on a vendor.

² *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

Analysis

① FAIRNESS: Equity and Fairness

Rating

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Similarly situated taxpayers should be taxed similarly.

All California taxpayers pay SUT at the same rate (with slight variations by county), making it appear “fair.” However, the tax is regressive because consumption of tangible personal property (and thus the amount of SUT paid) represents a higher percentage of a low-income person’s income relative to a higher income person.

The California SUT was originally intended to do what it still does today – tax purchases of tangible personal property. It was not created decades ago to tax all consumption. However, over the past several years, consumption of services has increased while consumption of goods has declined. For taxpayers who consume a lot of services, they will not proportionately pay as much SUT on their consumption as would someone who has a high consumption of goods.

The California SUT does not apply to intangible goods, such as software delivered via the Internet, but does apply to the tangible equivalent, such as off-the-shelf software purchased at an electronics store. Thus, where one person downloads the software and manuals, while another person purchases the same software on a diskette or CD, the first person pays no sales tax and the second one does even though each ends up with the same software.

A use tax complements a state’s sales tax and is imposed at the same rate. A use tax generally applies when a taxpayer buys a taxable item outside of the state for use inside the state. For example, when a resident buys a book from a remote (non-present) vendor, the resident is responsible for submitting the use tax to the state taxing agency. California makes no meaningful effort to collect the use tax from individuals (note, most businesses are use tax compliant). The tax is mentioned in

the instructions to Form 540, but not where people would likely see it and many people today don’t get the instructions because they use a software package to prepare their return. The State Board of Equalization released Publication 79B a few years ago that explains the use tax and includes a form for calculating and remitting it. However, this publication is not sent to individuals. Several states try to collect the use tax by including a line item on the state income tax form (such as Maine, Michigan and North Carolina). Failure or inability to collect use tax from consumers on mail or Internet ordered tangible goods raises two equity issues:

- ① A consumer purchasing a tangible item, such as a computer, via the vendor’s web site where the vendor has no physical presence in California, will not be charged sales tax, but owes use tax. If the tax is not paid, the consumer has not been treated similarly to a consumer who purchases a computer from a vendor located in California.
- ② Main street vendors are concerned that because they must charge sales tax to customers who purchase goods within their stores, while remote vendors selling the same items online or by mail order do not have to charge the tax, the vendors are not being treated similarly.

The California SUT is also flawed in that businesses also pay the tax. SUT paid by businesses is then built into the cost of the goods they sell and consumers, in essence, pay a tax on a tax. This is referred to as a cascading effect. Cascading affects industries differently depending on the amount of taxable purchases a business makes, thereby violating the equity principle.

The Quill Decision

The 1992 U.S. Supreme Court decision in *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), held that a state may not impose sales and use tax collection obligations on sellers who do not have a physical presence in the state. The Court modified its earlier ruling in *National Bellas Hess, Inc. v. Dept. of Rev.*, 386 U.S. 756 (1967), by ruling that a physical presence was no longer needed under the Due Process Clause. North Dakota had challenged the 1967 ruling as being out of date with today’s ways of conducting business. Today, a company doesn’t need a salesperson in a state to obtain a sale. Instead, a catalog and a mail-order sales system can be just as successful for a company. The Court agreed that conducting business in the state was sufficient to satisfy the Due Process Clause to allow a state to subject the vendor to taxation. However, the Court ruled that physical presence is still necessary under the Commerce Clause in order for a state to impose sales tax collection obligations on a remote (non-present) vendor.

2 FAIRNESS: Transparency and Visibility

Rating

+/-

Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

Sales and use taxes are visible because they are shown on the customer's invoice. Even invoices prepared at Internet sites will show any sales tax charged. However, many consumers may not know that a use tax exists on particular transactions. For example, many consumers who are not charged sales tax on online sales likely believe it is due to

the Internet Tax Freedom Act moratorium when it is most likely due to the Quill decision. Also, customers likely don't know all that the sales and use tax applies to – for example, will it apply to “free” items obtained from online vendors? Does it apply to shipping charges?

Internet Tax Freedom Act

Enacted in 1998, the Internet Tax Freedom Act prohibits certain state and local taxes on Internet access, unless the tax was generally imposed and actually enforced before October 1, 1998. The moratorium also prohibits state and local governments from imposing *multiple or discriminatory* taxes on e-commerce. The moratorium was originally created by the Internet Tax Freedom Act which imposed a 3-year moratorium (from 10/1/98 through 10/21/2001) [Public Law 105-277, 10/21/98] This moratorium was extended to November 1, 2003 by Public Law No. 107-75 (enacted 11/28/01).

3 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.

For the most part, the rules and tax forms are fairly clear. Issues can arise as to whether a vendor has nexus (physical presence) in California and thus obligated to collect SUT.

4 OPERABILITY: 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.

Vendors selling taxable items should collect the SUT at time of payment which is convenient for the buyer. Where a use tax is owed, to be paid by the buyer, payment is due at a later date, and as mentioned above, is usually not paid by individual

consumers (and some businesses). Payment of use tax by individual consumers requires that they maintain a list of purchases for which SUT was not collected and which items and charges are subject to SUT.

5 OPERABILITY: Economy in Collection

+/-

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

Because the SUT is for the most part, collected by vendors (use tax is paid by buyers), there is economy of collection relative to collecting SUT from

customers because there are far fewer vendors than customers. However, costs of collecting use tax, particularly from consumers, can be high.

Rating

6 OPERABILITY: 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.

Generally, within a single state, the SUT is fairly simple in that efforts have been made through legislation, regulations and rulings to identify the tax base. In many states, including California, the tax rate can vary from county to county and it may not always be clear in which county a taxpayer is located. From a multistate perspective, vendors face a myriad of tax bases and rates. In a few states, such as Colorado, the state and local SUT

bases may vary. In the 1992 Quill decision (discussed earlier), the Court noted that there are over 6000 jurisdictions in the U.S. imposing an SUT with varying bases, rates and filing procedures which poses complications for vendors. Thus, vendors dealing only with California rules have a fairly simple system. In contrast, multistate vendors face additional complexities.

7 OPERABILITY: Minimum Tax Gap

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A tax should be structured to minimize non-compliance.

The use tax causes a tax gap because so few consumers (and even some businesses) know what a use tax is or that it exists to complement the sales tax. While some states have made efforts to inform residents about the use tax, such as by adding a line on the state personal income tax form for it, as evidenced by the GAO data, compliance is very low. Improvement could be made by states educating consumers about the use tax and simplifying compliance, simplifying sales tax systems such that Congress might exercise its authority under the Commerce Clause and allow states to collect use tax from remote vendors, or replacing the sales tax with another type of consumption tax. The Internet not only makes it easier to purchase

items from a vendor in another state, but also in another country. While Congress could require a remote vendor to collect a state's sales and use taxes, it will be far more difficult, to get a vendor in a foreign country to collect a state's sales tax. Thus, if the tax is to be collected, states will need to get consumers to voluntarily comply or to exempt foreign sales, which violates the neutrality principle. An alternative consumption tax to the sales tax would be for consumers to measure their consumption as Income less Savings. Of course, this would also involve extra recordkeeping and it would broaden the tax base over what it is today (it would tax all consumption rather than just tangible personal property).

A June 2000 General Accounting Office (GAO) study estimated that the state and local sales and use tax losses for all Internet sales for 2000 was between \$0.3 and \$3.8 billion (about 2% of projected sales tax revenue). This included both business-to-business and business-to-consumer Internet sales. The projected loss for 2003 was between \$1.0 and \$12.4 billion (5% of projected sales tax revenue). The differences between the high and low figures is due to varying assumptions as to business-to-business compliance rates and the estimated amount of e-commerce sales. GAO, *Sales Taxes – Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000.

8 OPERABILITY: Appropriate Government Revenues

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The tax system should enable the government to determine how much tax revenue will likely be collected and when.

Tax agencies should be able to derive reasonable estimates of sales and use tax collections based on prior years' data and consumption data. However, declines due to increased on-line purchases from

remote vendors (for which use tax may not get collected), and a shrinking base of consumption subject to California sales tax may lead to less reliability of the sales tax for California jurisdictions.

9 APPROPRIATE PURPOSE AND GOALS: Neutrality

Rating

-

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 current situation where remote (non-present) vendors are not required to collect sales tax can cause sales tax to play a part in a customer's decision as to how and where to purchase goods and services. For example, a customer may decide to purchase a computer online to avoid sales tax rather than purchase the computer from a Main Street vendor. Also, in a few states, such as California, software (and other digitized goods) transferred

online are not subject to sales tax, while their tangible counterpart (that is, a boxed music CD or software) is subject to sales tax. Thus, the sales tax law is not neutral in that it will play a role in a customer's decision as to how and where to purchase certain products.

See later case study on e-commerce for further discussion.

10 APPROPRIATE PURPOSE AND GOALS: Economic Growth and Efficiency

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The tax system should not impede or reduce the productive capacity of the economy.

Cities in California have become more and more dependent on the sales tax for revenues over the past several years. This is due to restrictions upon local governments to raise revenues (such as Proposition 218). This has led to a phenomenon referred to as fiscalization of land use. This means that the focus of decisions on how to best use land is driven more by the tax revenues to be generated than by how the land can best serve the needs of the community. While a city needs a majority vote of its citizens to raise the sales tax (or other tax) rate, it could instead have a large retailer or industrial sales office locate within its borders to generate sales tax revenues.

Regulation 1802 encourages cities to entice manufacturers to locate a sales office within its borders particularly where customers are located outside of the borders.

Because the sales tax base does not include digitized items (intangibles), when software vendors switch from selling software on CDs or diskettes to transferring the software electronically, the cities that house the sales offices for such vendors are seeing a drop in sales tax revenues.

Finally, due to the increase in consumption of services, rather than tangible goods, cities continue to see a drop in sales tax and a base that becomes more regressive, which adversely impacts lower income residents.

Case Study II: Should Internet Commerce be Subject to Sales & Use Tax?

See page 11 for an explanation of the Internet Tax Freedom Act moratorium.

As noted in the earlier case study, a state may only require a vendor to collect sales tax from customers if the vendor has a physical presence in the state. The e-commerce business model makes it relatively easy for vendors to have customers in all states, but only have physical presence in a few states. Thus, the vendor is only required to collect tax from a subset of customers. Customers in states where the vendor is not required to collect the sales tax are required to self-assess the use tax, but compliance is very low because most consumers do not know about the tax or do not maintain sufficient records to calculate the tax. In fact, many consumers who are not charged sales tax on a purchase from an Internet company, such as Amazon.com, likely assume either that the goods are not taxable or are exempt by the Internet Tax Freedom Act moratorium.

Some people have suggested that e-commerce should not be subject to sales and use tax in order to help this form of commerce grow. Others may believe that sales tax from e-commerce sales should be subject to a different set of rules, such as having the vendor collect the tax based on its location (origin) rather than the customer's location (destination).

State and local governments are very interested in the issues of how sales and use tax is imposed and collected on e-commerce transactions because as this form of commerce grows, so will the amount of uncollected sales and use tax.

Analysis

Note: The following ratings were derived by asking the question – Is the principle met if e-commerce transactions that are equivalent to traditional commerce transactions are not subject to sales and use tax?

1 FAIRNESS: Equity and Fairness

Rating

-

Similarly situated taxpayers should be taxed similarly.

Vendors selling goods and services online should be treated similarly to “Main Street” vendors selling the same goods and services and vice versa. While the cost of the sales and use tax is actually imposed on the buyer, rather than the seller, the compliance burden and price competition presented by the sales tax makes this a significant tax to vendors. Certainly, the compliance costs of the sales tax is greater for vendors with customers and taxable presence (nexus) in many states because of the varying sales tax rules among states and even some cities. But, is a multistate vendor similarly situated to a “Main Street” vendor with a single location? For example, assume vendors are required to collect sales tax from all customers, even in states where the vendor has no physical presence. A Main Street retailer with a store in San Jose

would have much lower compliance costs than an online vendor also located only in San Jose, but who sells to customers in all states. The online vendor would need to determine where all of its customers live and charge the applicable sales tax (in contrast, under today’s sales tax law, the Main Street vendor is allowed to just charge the San Jose rate to all customers that come into the store).

Thus, arguments of “leveling the playing field” must consider the added compliance burden placed upon vendors required to collect tax based on the location of their buyers. While the prices charged by the multistate vendor and Main Street retailer would be the same if both are required to collect sales tax, the playing field is not level if the online vendor has greater compliance costs.

Addressing Fairness

Equity and fairness between Main Street and online vendors requires some consideration of the compliance costs each faces. This principle could be achieved by 1) requiring the Main Street retailer to charge sales tax based on where its customers live, 2) allowing the online vendor to charge San Jose/California sales tax to all customers regardless of where they live (origin approach), 3) providing compensation to the online vendor for the extra compliance costs, or 4) providing a mechanism, such as a third party collector funded by the government, to handle the online vendor’s compliance activities.

2 FAIRNESS: Transparency and Visibility

+/-

Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

Sales and use taxes are visible because they are shown on the customer’s invoice. Even invoices prepared at Internet sites will show any sales tax charged. However, many consumers may not know that a sales tax exists on particular transactions. For example, many consumers who are not charged

sales tax on online sales likely believe it is due to the Internet Tax Freedom Act when it is most likely due to the Quill decision. Also, customers likely don’t know all that the sales tax applies to – for example, will it apply to “free” items obtained from online vendors? Does it apply to shipping charges?

3 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.

Lack of certainty in the tax system reduces the confidence taxpayers have that they have computed their tax liability correctly. Today, with over 6,000 jurisdictions able to assess sales tax and a lack of uniformity in the rules of these jurisdictions, as well as frequent changes to the rules, uncertainty exists for multistate vendors. In addition, vendors

with customers in many states face uncertainty as to where they have tax filing obligations because the rules are not clear as to how much physical presence is needed to cause a vendor to have nexus (taxable presence) in a state. If e-commerce transactions were not subject to sales and use tax, certainty would exist.

Rating

- ④ **OPERABILITY: Convenience of Payment** n/a

A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

Convenience of payment could exist in taxing e-commerce because a customer's credit card could be charged by the state taxing agency for the sales tax at the same time the vendor is paid.

- ⑤ **OPERABILITY: Economy in Collection** +

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

The costs to taxpayers of complying with the sales tax rules of many states are quite significant for multistate vendors due to the large number of taxing jurisdictions and lack of uniformity in the rules.

- ⑥ **OPERABILITY: Simplicity** n/a

The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.

For multistate vendors, sales and use taxes fail to satisfy the simplicity principle. The multiple definitions, rules, registration procedures, exemptions, rates, filing and audit procedures result in a great

deal of complexity. While not subjecting e-commerce transactions to sales and use tax would provide simplicity to e-commerce vendors, the system is still complex for other types of transactions.

- ⑦ **OPERABILITY: Minimum Tax Gap** +

A tax should be structured to minimize non-compliance.

If e-commerce transactions were exempt from sales and use tax, no tax would be owed and current non-compliance would no longer exist.

Simplifying Sales Tax

Improvements to simplify the sales tax system include uniformity of rules and procedures, better use of technology to compute and collect the tax, use of a third party to compute and remit the tax, or perhaps a federal level tax to replace the state sales tax. An example of efforts to simplify sales and use tax compliance is the Streamlined Sales Tax Project (<http://www.streamlinedsalestax.com>).

OPERABILITY: Appropriate Government Revenues

Rating

-

8 *The tax system should enable the government to determine how much tax revenue will likely be collected and when.*

Today, less than 1% of retail sales are online sales. Thus, lost use tax is still small. It is really the potential growth of e-commerce that poses the greatest use tax loss for state and local governments. This growth will adversely affect the predictability and reliability of governments to determine their expected tax revenues. Also, for the few states, such as California, that do not tax products transferred electronically, as more and more items are trans-

ferred in digitized form, there will be a drop in the tax base. To improve the predictability and reliability (as well as stability) of sales tax revenues, improvements are needed to the system now while the revenue losses are relatively small.

If e-commerce transactions were exempt from sales and use tax, state and local governments would lose an important source of revenue.

APPROPRIATE PURPOSE AND GOALS: Neutrality

-

9 *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.*

As evidenced by the earlier statements, the sales tax law is not neutral with respect to e-commerce for either vendors or customers. Sales tax has played a part in location and form of operation decisions for some vendors. For example, the founder of Amazon.com has stated that he purposely did not locate the company in California because he expected to have many customers there and did not want to have to charge sales tax.³ Also, as noted in the testimony of Peter Lowy for the e-Fairness Coalition, some brick-and-mortar vendors established separate subsidiaries for their online sales in order to reduce the number of states where the online entity would have a physical presence, and thus, a sales tax collection obligation.⁴ Thus, sales tax has played a significant role in taxpayer location and form of operation decisions and is not neutral.

Also, the current situation where remote (non-present) vendors are not required to collect sales tax can cause sales tax to play a part in a customer's decision as to how and where to purchase goods and services. For example, a customer may decide to purchase a computer online to avoid sales tax rather than purchase the computer from a Main Street vendor. Also, in a few states, such as California, software (and other digitized goods) transferred online are not subject to sales tax, while their tangible counterpart (that is, a boxed music CD or software) is subject to sales tax. Thus, the sales tax law is not neutral in that it will play a role in a customer's decision as to how and where to purchase certain products.

Addressing Neutrality

Example of further analysis to identify how a minus might be addressed: The sales tax could be made more neutral by requiring sales tax to be charged by remote vendors, enforcing use tax rules (customers making taxable purchases from remote vendors would be required to remit use tax on their own), exempting all digitized items from sales tax along with their tangible counterpart, or taxing all products regardless of how they are transferred.

3 David Streitfeld, "Booking the Future; Does Amazon.com Show That Publishing Clicks on the Internet?" *The Washington Post*, July 10, 1998, page A1.

4 Hearing on Internet taxation (107th Congress) at <http://www.senate.gov/~commerce/hearings/0314low.pdf>.

10 **APPROPRIATE PURPOSE AND GOALS: Economic Growth and Efficiency**
The tax system should not impede or reduce the productive capacity of the economy.

Rating

+/-

This is the argument to support not taxing online sales – that doing so will impede growth of the Internet. However, the Internet seems to be growing without any indication that it is due to the current tax rules. For example, the Department of Commerce reported that e-commerce sales increased 33.5% in first quarter 2001 over first quarter 2000.⁵ In early 1998, prior to the enactment of the Internet Tax Freedom Act, it was reported that the number of Internet hosts was growing at a rate of 40% to 50% annually.⁶ While some studies have found that taxation of online shopping will reduce online shopping, the issue isn't really so simple as to argue that taxes should be avoided. Today, online purchases are subject to sales and use tax in all states that impose a sales tax. However, the ability of states to collect use tax on remote online sales is quite low. Also, will imposition of taxes eliminate the sale, or just move it from the Internet to Main Street? Or, will Internet vendors find some way to reduce costs to help “compensate” for the added costs of both shipping and sales tax?

⁵ Department of Commerce, press release of May 16, 2001, <http://www.census.gov/mrts/www/current.html>.

⁶ James Glave, “Dramatic Internet Growth Continues,” *Wired News*, February 16, 1998, <http://www.wired.com/news/topstories/0,1287,10323,00.html>

Case Study III: AB 680 (2002) Proposal to Reallocate Local Sales & Use Tax in the Sacramento Region

“This bill would, pursuant to specified definitions and procedures, require the board to distribute sales and use tax revenue, derived from the application of a 1% tax rate by a qualified or electing county or city in the greater Sacramento region, among those same counties and cities on the basis of (1) the amount of sales and use tax revenue that those counties and cities received in the 2003 calendar year, as annually adjusted for inflation, as provided, and (2) the relative populations of those counties and cities, as determined by the board and the population research unit of the Department of Finance. The bill would provide that up to 1/3 of the sales and use tax revenue growth be shifted away from those counties and cities in the region that fail to become housing eligible, as defined, and require those revenues to instead be allocated to the Sacramento Area Council of Governments (SACOG) for the funding of regional projects, as defined, unless certain revenue targets are not met, in which case this bill would provide that all of these revenues be allocated in the manner prescribed by existing law. By imposing allocation duties upon SACOG, this bill would create a state-mandated local program.” [AB 680, as amended by the Senate on 8/21/02]

Analysis

- | | | |
|----------|--|--|
| 1 | <p>FAIRNESS: Equity and Fairness</p> <p><i>Similarly situated taxpayers should be taxed similarly.</i></p> <p>Payors of sales tax would still pay the same amount of sales and use tax on their purchases. AB 680 proposes only to change the allocation of where all of the sales tax goes once collected.</p> | <p style="font-size: small;">Rating</p> <p style="border: 1px solid black; padding: 2px; display: inline-block;">n/a</p> |
| 2 | <p>FAIRNESS: Transparency and Visibility</p> <p><i>Taxpayers should know that a tax exists and how and when it is imposed upon them and others.</i></p> <p>Taxpayers would still know when they have paid sales and use taxes. They would not easily know where the 1.25% went – all to their city or shared with other cities.</p> | <p style="border: 1px solid black; padding: 2px; display: inline-block;">n/a</p> |
| 3 | <p>OPERABILITY: Certainty</p> <p><i>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.</i></p> <p>The payor would know the amount to pay, but would not necessarily know where the tax would eventually be allocated. However, payors would not be concerned with this from a payment per-</p> | <p style="border: 1px solid black; padding: 2px; display: inline-block;">n/a</p> |
| 4 | <p>OPERABILITY: Convenience of Payment</p> <p><i>A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.</i></p> <p>No change from existing SUT rules.</p> | <p style="border: 1px solid black; padding: 2px; display: inline-block;">n/a</p> |
| 5 | <p>OPERABILITY: Economy in Collection</p> <p><i>The costs to collect a tax should be kept to a minimum for both the government and taxpayers.</i></p> <p>No change from existing SUT rules.</p> | <p style="border: 1px solid black; padding: 2px; display: inline-block;">n/a</p> |

	Rating
<p>6 OPERABILITY: Simplicity</p> <p><i>The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.</i></p> <p>For consumers, there would be no change. They would still pay the same amount of sales and use tax and in the same manner. The collected tax (the 1.25% Bradley Burns amount) would just be allocated to local governments differently.</p>	n/a
<p>7 OPERABILITY: Minimum Tax Gap</p> <p><i>A tax should be structured to minimize non-compliance.</i></p> <p>No effect.</p>	n/a
<p>8 OPERABILITY: Appropriate Government Revenues</p> <p><i>The tax system should enable the government to determine how much tax revenue will likely be collected and when.</i></p> <p>Local governments would likely be less able to determine how much of new sales taxes would be allocated to them since they do not know the details of what other locals in the Sacramento region are doing or how the mix of all sales tax growth activities and housing projects would affect the allocation of certain sales and use tax amounts.</p> <p>It would likely become more difficult for locals to make decisions regarding economic and housing development because they would not readily know what the sales and use tax revenue generating results would be and locals are very dependent on such revenues.</p>	-
<p>9 APPROPRIATE PURPOSE AND GOALS: Neutrality</p> <p><i>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.</i></p> <p>While AB 680 would not likely change the decisions of buyers as to where to buy a taxable item, AB 680 could change the decision-making of local governments as to how to use land (industrial or housing or something else), which is the intent of AB 680.</p>	n/a
<p>10 APPROPRIATE PURPOSE AND GOALS: Economic Growth and Efficiency</p> <p><i>The tax system should not impede or reduce the productive capacity of the economy.</i></p> <p>Local governments have been making land use and investment decisions for many years based on the current sales and use tax sharing structure. A city that has invested in industrial and retail growth may find it difficult to change that to increase population and housing in order to retain or gain revenue growth.</p>	-

Case Study IV: Measure F on the City of San Jose's November 2002 Ballot

Measure F proposed to increase the City of San Jose's transient occupancy tax (TOT) from 10% to 14%. A two-thirds majority vote was required because the revenues would be earmarked for improvement and expansion of the San Jose McEnery Convention Center. The measure lost narrowly with just 65% of voters supporting the Measure.

Analysis

Note: The ratings indicated below are based on the proposed tax increase rather than on the TOT itself.

1	FAIRNESS: Equity and Fairness	Rating n/a
<p><i>Similarly situated taxpayers should be taxed similarly.</i></p> <p>The increased TOT would apply similarly to all hotel guests staying in San Jose. While the tax may not be the same as in a neighboring city, that is also the case without the tax increase and generally, people have a choice of staying at another hotel (and some hotels are near public transportation to get them to the San Jose Convention Center).</p> <p>While the TOT (or hotel tax) is often described as a tax on out-of-towners, “in-town” residents also pay it. A local resident deciding to stay at a</p>	<p>local hotel for a weekend or a business having employees from out-of-town stay in a San Jose hotel would pay the tax.</p> <p>Basically, this principle is met because all hotel guests are treated the same – they all pay the same percentage of TOT on their hotel bills. Arguably, there is also some vertical equity because lower-income individuals would likely stay in a lower cost hotel than a high-income individual and so would pay less TOT.</p>	<p>Rating n/a</p>
<p>2</p> <p><i>Taxpayers should know that a tax exists and how and when it is imposed upon them and others.</i></p> <p>The TOT is shown on a customer’s hotel bill and so at that point, is very visible. The TOT is used by many cities in the U.S. so short-term visitors to a city should know that it may have a TOT and could inquire ahead of time as to the TOT rate.</p>	<p>FAIRNESS: Transparency and Visibility</p>	<p>n/a</p>
<p>3</p> <p><i>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.</i></p> <p>Both the hotel guest and hotel can easily determine when the tax is owed and the amount owed. The rules are not complex.</p>	<p>OPERABILITY: Certainty</p>	<p>n/a</p>
<p>4</p> <p><i>A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.</i></p> <p>The hotel guest pays the TOT along with the balance of his or her hotel bill (typically at check-out). The hotel remits the tax periodically.</p>	<p>OPERABILITY: Convenience of Payment</p>	<p>n/a</p>

5 OPERABILITY: Economy in Collection Rating
n/a

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

Because hotels (and other places for short-term stays) remit the tax, rather than each guest filing a form on their own, economy of collection is achieved for the government. Also, given the simple nature of the tax, economy of collection is

achieved for the majority of hotels. Also, since the proposal calls for increasing the rate only, little additional guidance from the city would be needed in order for taxpayers to comply.

6 OPERABILITY: Simplicity n/a

The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.

This is a single rate tax applicable to short term stays. The tax meets the simplicity principle even with a higher rate.

7 OPERABILITY: Minimum Tax Gap n/a

A tax should be structured to minimize non-compliance.

Hotels are likely to have a high compliance rate. Landlords renting out rooms in homes or less visible locations might not be as compliant, but hotels are likely to be the key source of this tax and compliance is likely very high.

8 OPERABILITY: Appropriate Government Revenues n/a

The tax system should enable the government to determine how much tax revenue will likely be collected and when.

The City should be able to reasonably project how much revenue will be generated based on statistical data and bookings at the Convention Center and elsewhere in the City.

9 APPROPRIATE PURPOSE AND GOALS: Neutrality

Rating

n/a

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.

A TOT is a technique to have visitors – who do use city services, pay for some of those services. It is difficult to precisely measure how much visitors “cost” a city in terms of use of the roads, police and fire protection and use of city-owned facilities. This is fine given that the TOT is a general revenue tax rather than a special purpose one. Also, it is unlikely that many travelers would forego stay-

ing at a hotel due to a TOT since many major cities have them and visitors can understand that they are using city services while visiting.

The rate of the tax, if significantly different from a neighboring city, may lead visitors to stay in a city with a lower TOT. However, the rate differential among cities is not significant and other factors affect a traveler's choice of hotel.

10 APPROPRIATE PURPOSE AND GOALS: Economic Growth and Efficiency

?

The tax system should not impede or reduce the productive capacity of the economy.

It is difficult to know whether the tax increase would reduce tourism in the city or would increase it once the expanded Convention Center was built. This is an “educated guess” that the city must make. It is assumed that the sponsors of Measure F had data based on current convention sizes, the experience of other cities, etc. in advo-

cating for the 4 percentage point tax increase.

The proposed additional TOT represents a special tax because it would be used for a specific purpose. Consideration should be given to alternative funding sources and whether an increased TOT would better serve as a general revenue source for the city.

2 FAIRNESS: Transparency and Visibility

Rating

Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

3 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.

4 OPERABILITY: 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.

5 OPERABILITY: Economy in Collection

Rating

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

6 OPERABILITY: 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.

7 OPERABILITY: Minimum Tax Gap

A tax should be structured to minimize non-compliance.

8 OPERABILITY: Appropriate Government Revenues

Rating

The tax system should enable the government to determine how much tax revenue will likely be collected and when.

9 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.

10 APPROPRIATE PURPOSE AND GOALS: Economic Growth and Efficiency

The tax system should not impede or reduce the productive capacity of the economy.

Tax versus Fee: What Difference Does It Make?

The terms “tax” and “fee” are not the same. Each term has a legal significance in California as well as in many states and localities outside of California.

WHAT IS A TAX?

A *tax* is paid by individuals, businesses and organizations to fund government operations. There is no correlation between the amount of tax individuals and entities pay and the amount of government services they receive. Instead, tax revenues are used to benefit the public, as broadly defined. The Internal Revenue Service (IRS) has defined a tax as “an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes, and not as a payment for some special privilege granted or service rendered.”⁷

WHAT IS A FEE?

A *fee* is something charged to individuals, businesses and organizations for the cost of services they directly receive. Examples of fees include building permit fees and park entrance fees.

Article XIID, Section 2(e) of the California Constitution provides: “‘Fee’ or ‘charge’ means any levy other than an ad valorem tax, a special tax, or an assessment, imposed by an agency upon a parcel or upon a person as an incident of property ownership, including a user fee or charge for a property related service.”

TAX VERSUS FEE

Significance: The significance of a government “charge” being a tax or a fee is the type of majority required to enact the tax or fee. Article XIII A, Section 3 of the California constitution provides: “any changes in state taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature, except that no

new ad valorem taxes on real property, or sales or transaction taxes on the sales of real property may be imposed.” The legislature does not need to have a 2/3 majority vote to impose or increase a fee; a simple majority will suffice.

Also, Article XIII A, Section 4 provides that cities, counties and special districts may only impose special taxes (except for taxes on real property) if there is a 2/3 majority vote of qualified electors in the jurisdiction.

Local jurisdictions may be required to hold public hearings and notify the public prior to instituting or increasing certain fees.

Definitions: The approaches used by federal courts to distinguish a tax from a fee include the following.

- A tax is arbitrarily imposed for some public purpose, while a fee is a payment for a voluntary act with the fee used to defray regulatory expenses.
- “A payment is a tax when it confers no special benefit on the payee, or when the assessment is intended to raise general revenue; in contrast, a fee gives the payee value for payment, in the form of defraying the regulatory expenses necessary to keep certain services active.”
- “An assessment may be a tax if it is not fairly tied to both the value received by the payee and to the cost of the service to the agency.”⁸

Several decades ago, the U.S. Supreme Court provided guidance on the fee versus tax issue with regard to the possible regulatory effect of both. The Court stated: “Every tax is in some measure regulatory. To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed. But a tax is not any the less a tax because it has a regulatory effect, ... and it has long been established that an Act of Congress which on its face purports to be an exercise of the taxing power is not any the less so because the tax is burdensome or tends to restrict or suppress the thing taxed.”⁹ Also, just because a fee raises revenue does not make it a tax. “[A]ll regulatory fees are necessarily aimed at raising ‘revenue’ to defray the cost of the regulatory program in question,

⁷ Revenue Ruling 79-201, 1979-1 C.B. 97.

⁸ *Thomas v. Network Solutions, Inc. and National Science Foundation*, 2 F. Supp. 2d 22 (DC DC 1998). At the federal level, the primary relevance as to whether an item is a tax or fee is that only Congress has power to lay taxes.

but that fact does not automatically render those fees ‘taxes.’ As stated in *United Business*, if regulation is the primary purpose of the fee measure, the mere fact that the measure also generates revenue does not make the imposition a tax. (*United Business, supra*, [91 Cal. App. 3d 156, 154 Cal. Rptr. 263 (1979)] 91 Cal. App. 3d at p. 165; see also *Mills v. County of Trinity, supra*, 108 Cal. App. 3d at p. 660 [rejecting broad definition of ‘tax’ as including all fees and charges that exact money for public purposes].)¹⁰

California court decisions have held that a “charge” is a fee rather than a tax if:¹¹

- The fee does not exceed the reasonable costs of providing the services for which the fee is charged. It is permissible for the fee to be a fixed amount without it being a tax where the cumulative fees collected do not exceed the costs of administering the associated regulatory program and there is a reasonable basis for distributing the costs among the payors of the fee.
- The fee relates to the purpose for which it is charged (it is not being used for some other purpose).
- There is a connection or relationship between the payor and the purpose of the fee assessed.

More on fees: There are three key types of fees: (1) special assessments, (2) development fees, and (3) regulatory fees. As explained in *Sinclair Paint Co. v. State Board of Equalization*, 15 Cal. 4th 866 (1997), special assessments are “based on the value of benefits conferred on property.” Development fees are “exactied in return for permits or other government privileges. Regulatory fees are “imposed under the police powers.” Various cases have held that these types of fees are not taxes – more specifically, are not “special taxes” (see later explanation).

GENERAL TAX VERSUS SPECIAL TAX

Article XIII C, Section 1(a) of the California Constitution defines a general tax as “any tax imposed for general governmental purposes.” Section 1(d) defines a special tax as “any tax imposed for specific purposes, including a tax imposed for specific purposes, which is placed into a general fund.” The significance of these terms is that a local government may not impose, extend, or increase a general tax unless approved by a majority of the electorate. A special tax may not be imposed, extended, or increased unless approved by a 2/3 majority of the electorate (Article XIII C, Section 2; Proposition 218).

SUMMARY

	GENERAL TAX	SPECIAL TAX	FEE
STATE IMPOSED not an ad valorem tax on real property or a sales or transaction tax on the sale of real property	Need 2/3 vote of both the California Assembly and Senate.	Same	Simple majority
LOCAL IMPOSED not an ad valorem tax on real property or a sales or transaction tax on the sale of real property	Need majority vote of electorate.	Need 2/3 majority vote of electorate.	No vote of electorate required, but may need public hearing and other documentation.
AD VALOREM tax on real property or a sales or transaction tax on the sale of real property	Need constitutional amendment.	Need constitutional amendment.	If based on value, likely a tax, rather than a fee.

9 *Sonzinsky v. U.S.*, 300 U.S. 506, 37-1 USTC ¶9195; 18 AFTR 1171; 1937-1 C.B. 351.

10 *Sinclair Paint Co. v. State Board of Equalization*, 15 Cal. 4th 866 (1997).

11 *Sinclair Paint, supra*, and *Calif. Assoc. of Professional Scientists v. Dept. of Fish & Game*, 79 Cal. App. 4th 935, 94 Cal. Rptr. 2d 535 (3rd App. Dist. 2000).

Background on the Tax Principles Workbook

Joint Venture has been sponsoring educational forums on tax issues for many years. On September 26, 2002, Joint Venture, with the generous support of the California Policy Forum, held a forum entitled *Taxes & Our Communities – Is Our System Sustainable?* Over 120 individuals from state and local governments, industry, education, and non-profit organizations attended. The forum was held in Mountain View. Further information about the Forum, including copies of presentation materials, can be found at: <http://www.jointventure.org/news/press/taxforum02.html>

The forum was designed to bring together a diverse group of leaders from the greater Silicon Valley area to broaden the understanding of California's tax and fiscal structure within the state and its 5,000+ taxing jurisdictions.

The goals for the forum were to:

- Provide concise information on the basics of California's myriad of taxes, fees, limitations and jurisdictions in order to provide a better understanding of how our system impacts quality of life matters, such as housing, land use, education, transportation and the pursuit of economic development that represents the new economy.
- Help participants become informed advocates for improvements to California's tax and fiscal structure, which is necessary if we want to ensure a strong economy and healthy and educated society.
- Explore new ideas for improvements to our tax and fiscal structure using the broad and diverse expertise of our speakers and participants.

- Bring many sectors of the greater Silicon Valley area together to discuss issues that are of importance to everyone and to share information and ideas.
- Stress the importance of working together to solve issues, and identify and act upon opportunities collaboratively as a region.
- Begin a process to create the necessary tools to more effectively analyze and understand legislative proposals and our current tax and fiscal structures; tools that will encourage and enable each level of government to work together, rather than at cross purposes, and ensure that principles of good tax policy are followed when designing or redesigning tax systems.

This workbook is part of the final goal listed above. Joint Venture plans to help people continue to better understand the state's fiscal structure and engage in dialog on issues and opportunities presented by that structure. Please visit the Joint Venture web site for additional output from the September 2002 Forum: <http://www.jointventure.org/>.

SOURCES OF INFORMATION ON CALIFORNIA'S TAX & FISCAL STRUCTURE AND POLICIES

History of California Taxes

Doerr, David R., *California's Tax Machine*, California Taxpayers' Association, 2000.

Government Information on California Taxes

California Department of Finance, <http://www.dof.ca.gov/>.

California State Controller, <http://www.sco.ca.gov/>.

Franchise Tax Board, <http://www.ftb.ca.gov/>.

Legislative Analyst's Office, <http://www.lao.ca.gov/>.

• Primer on California taxes:

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Principles Framework

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