

The Business Net Receipts Tax: A Dog That Will Not Hunt

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Introduction

The business net receipts tax (“BNRT”) is the centerpiece proposal of the Commission on the 21st Century Economy (“Commission”), which California governor Arnold Schwarzenegger charged with making recommendations for changes in the state’s tax laws that would, *inter alia*, “establish [a] 21st century tax structure that fits with [the] state’s 21st century economy.”¹ The BNRT, which is intended to replace revenues from the corporate income tax, most of the state portion of the general sales tax, and part of the individual income tax, is advertised as a form of value-added tax (“VAT”).² But, unlike the standard credit-method VAT, the BNRT employs the subtraction method to calculate value added. In an attempt to achieve destination-based taxation for multi-state businesses, the BNRT employs a sales-based apportionment formula, rather than

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1. REPORT OF THE COMMISSION ON THE 21ST CENTURY ECONOMY, at iii (2009), available at http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf [hereinafter COMMISSION REPORT]. It is worth noting that only nine of the 14 members of the Commission approved the Commission’s report. In his annual State of the State address, delivered on January 6, 2010, Governor Schwarzenegger encouraged the legislature to take up the Commission’s recommendations.

2. COMMISSION REPORT, *supra* note 1, at 44–46. Appendix A of the Commission Report describes the BNRT.

border tax adjustments (“BTAs”), which, absent a federal VAT, would be difficult to implement at the subnational level.

The BNRT was immediately attacked by business,³ labor,⁴ public interest advocates,⁵ leading academic tax experts,⁶ and other observers,⁷ as well as by several minority members of the Commission⁸ and various public officials—including one member of the State Board of Equalization⁹. Eric J. Miethke notes that “the Commission’s record is devoid of support for the BNRT,” and Steven M. Sheffrin notes that almost two-thirds of the respondents to a poll conducted in October 2009 opposed the substitution of the BNRT for other taxes.¹⁰ While some attacks focused primarily on the shift in tax

3. CalChamber, *CalChamber-Led Coalition Urges Legislature to Address Questions on Net Receipts Tax*, (Oct. 29, 2009), available at <http://www.calchamber.com/headlines/pages/calchamberledcoalitionurgeslegislaturetoaddressquestionsonnetreceiptstax.aspx>; Posting of John Kabateck to Fox & Hounds Daily Blog, available at <http://www.foxandhoundsdaily.com/view/fhdblog> (Nov. 20, 2009).

4. Among the many statements made by labor advocates opposing the BNRT is “Statement by California Labor Federation Executive Secretary-Treasurer Art Pulaski on Release of Commission on the 21st Century Economy Tax Recommendations,” released September 29, 2009, [hereinafter Pulaski Statement] available at http://www.calaborfed.org/newsroom/2009_press_releases/tax_commission_statement_092909.pdf.

5. See, e.g., JEAN ROSS, CALIFORNIA BUDGET PROJECT FATALLY FLAWED: WHAT WOULD THE COMMISSION FOR THE 21ST CENTURY ECONOMY’S RECOMMENDATIONS MEAN FOR CALIFORNIA? (Oct. 2009), available at http://www.cbp.org/pdfs/2009/091007_Fatally_Flawed.pdf.

6. See Letter from Joseph Bankman et al. to Gerald Parsky (Sept. 5, 2009), available at <http://www.cotce.ca.gov/documents/correspondence/public/> (follow “September 5, 2009: Correspondence from Kirk Stark, *Professor of Law*, UCLA School of Law” hyperlink).

7. See Eric J. Miethke, *Is California Ready for a Business Net Receipts Tax?*, 54 STATE TAX NOTES [12], 867–77 (Dec. 21, 2009); Correspondence—Public Comments, <http://www.cotce.ca.gov/documents/correspondence/public/> (last visited Feb. 16, 2010).

8. Letter from Richard D. Pomp, Commissioner, Commission on the 21st Century Economy, to the Commission on the 21st Century Economy (Sept. 25, 2009), available at http://www.cotce.ca.gov/documents/correspondence/staff_and_commissioners/ (follow “September 25, 2009: Correspondence from Richard Pomp, Commissioner, to COTCE Commission RE: My Vote – Dissenting Report” hyperlink) [hereinafter *Pomp Statement*]; Letter from Fred Keeley, Commissioner, Commission on the 21st Century Economy, to Darrell Steinberg, Speaker Pro Tempore, California State Senate (2009), available at <http://www.assembly.ca.gov/acs/committee/c21/Publications/2009/Commissioner%20Keeley%20letter.pdf>; and Bill Hauck, Op-Ed., *Viewpoints: Revenue Spikes, Not Tax Structure, Are to Blame*, SACRAMENTO BEE, Oct. 12, 2009, at 2E. Hauck is President of the California Business Roundtable.

9. Michelle Park Steel, Op-Ed., *No Time for New, Untested Tax*, ORANGE COUNTY REGISTER, Oct. 16, 2009, available at <http://www.ocregister.com/opinion/tax-215111-state-brnt.html>.

10. Miethke, *supra* note 7, at 870; Steven M. Sheffrin, *Tax Reform Commissions in the Sweep of California Fiscal History*, 37 HASTINGS CONST. L.Q. (forthcoming 2010) (citing

burdens from upper- to lower-income households that would occur if the BNRT were substituted for other state taxes, many dealt specifically with the likely economic effects of the BNRT considered in isolation.

This paper describes and appraises the BNRT for non-financial businesses. Section I describes the BNRT. Section II examines perception problems and opposition to the BNRT by business and labor groups resulting therefrom. Section III notes the philosophical inconsistency between the stated objectives of the BNRT and the tax proposed. Sections IV through VI explain the defects of the subtraction method VAT, the effects of sales-based formula apportionment, and opportunities for tax planning. Sections VII and VIII explore legal challenges that may arise under the United States Constitution, federal statutory law, and international trade rules. Sections IX to XI ask whether any of the defects examined earlier can be fixed, note the political instability of Michigan's VAT, and suggest that a better alternative would exist if and when the federal government adopts a VAT. The conclusion offers the summary appraisal that the BNRT is a dog—a dog that will not hunt; it should not be seriously considered, much less adopted.

It is useful to note a few issues this Article does not address, as it is concerned only with the structure of the BNRT, not the substitution of that tax for the other taxes named above. First, there are the relative transparency, familiarity, breadth, volatility, complexity, compliance and administrative burdens, economic neutrality, revenue yield, and progressivity of the BNRT and the taxes it would replace.¹¹ The Article also does not discuss the

State Constitutional Reform and Related Issues, CALIFORNIA POLL INDEX (The Field Poll, San Francisco, California), Oct. 2009, available at <http://www.field.com/fieldpollonline/subscribers/COI-09-October-CA-Constitution-Reform.pdf>).

11. Many of these issues are addressed in Miethke, *supra* note 7, and *Alternatives to the Tax Recommendations of the Commission on the 21st Century Economy: Hearing Before the California State Assembly Committee on Revenue and Taxation* (Jan. 13, 2010) (testimony of Annette Nellen) [hereinafter *Nellen Testimony*]. See also Bankman et al., *supra* note 6; *Academic Perspectives on the Tax Recommendations of the Commission on the 21st Century Economy: Hearing Before the California State Assembly Committee on Revenue and Taxation* (Oct. 14, 2009) (testimony of Steven M. Sheffrin) [hereinafter *Sheffrin Testimony*]; *Academic Perspectives on the Tax Recommendations of the Commission on the 21st Century Economy: Hearing Before the California State Assembly Committee on Revenue and Taxation* (Oct. 14, 2009) (testimony of Kirk J. Stark) [hereinafter *Stark Testimony*]; *Pomp Statement*, *supra* note 8; and Letter from Richard D. Pomp, Commissioner, Commission on the 21st Century Economy, to the Commission on the 21st Century Economy (Sept. 14, 2009), http://www.cotce.ca.gov/documents/correspondence/staff_and_commissioners/ (follow "September 14, 2009: Correspondence

desirability of recommended changes in the personal income tax (e.g., eliminating the deduction for medical expenses and the child-care credit), or the apparent inequity and non-neutrality of eliminating the corporate income tax but not the individual income tax on business income.¹² Worth special mention is the ill-conceived idea of leaving intact the local retail sales tax (“RST”), which suffers from at least two faults. First, the state would continue to determine the base of the RST and administer that tax on behalf of local governments, although it would have no direct financial stake in the outcome of its legislative and administrative efforts. Second, keeping the local RST, while adding the BNRT, would increase compliance and administrative burdens.¹³

I. The BNRT

The Basic Calculations. For a business operating only in California, the tax base and tax liability would be calculated as follows:

Gross Receipts – Purchases from Other Firms = Net Receipts

Net Receipts x BNRT Rate = BNRT Liability

Gross receipts would be comprised essentially of sales of goods and services. Deductible purchases would exclude employee compensation and (in the case of the non-financial businesses examined here) interest payments.¹⁴ Negative net receipts could be carried forward for up to five years.¹⁵ The Commission recommended that the tax rate be no more than four percent, which it stated would be sufficient to replace revenues from the corporate income tax, most

from Richard Pomp, Commissioner, to COTCE Commission RE: Why I Think We Are Heading In The Wrong Direction” hyperlink) [hereinafter Pomp, Wrong Direction]. On the question of volatility, see Legislative Analyst’s Office Analysis of COTCE Revenue Proposals (Jan. 13, 2010), available at http://www.lao.ca.gov/handouts/Econ/2010/COTCE_01_13_10.pdf (report accompanying testimony of Paul Warren).

12. *But see* Miethke, *supra* note 7.

13. *See* Miethke, *supra* note 7; *Nellen Testimony*, *supra* note 11; Sheffrin, *supra* note 10.

14. COMMISSION REPORT, *supra* note 1, at A-4 to A-5. Much of the description that follows is taken from the Commission Report, some of it word-for-word. In a few cases, what seem to be inadvertent errors in describing the BNRT have been corrected. Quotation marks are omitted.

15. COMMISSION REPORT, *supra* note 1, at A-9.

of the state portion of the general sales tax, and part of the individual income tax.¹⁶

Coverage. The BNRT would apply to all forms of business entities considered to be “doing business” in California, including corporations, pass-through entities, and sole proprietorships. There would be a small business filing threshold of \$500,000 in gross receipts, and a tax credit would effectively exempt net receipts of \$250,000 or less from the BNRT. In combination, the filing threshold and the tax credit would create what below is called a “small business exemption.”¹⁷ The tax would be paid quarterly, based on estimated liabilities.¹⁸

Nexus. A business entity would be deemed to be doing business in California if any of the following conditions hold: (1) The business is organized or commercially domiciled in California; (2) Sales of the business in California exceed the lesser of \$500,000 or twenty-five percent of a taxpayer’s total sales; (3) The real property and tangible personal property of the business in California exceed the lesser of \$50,000 or twenty-five percent of a taxpayer’s total real property or tangible personal property; or (4) The amount paid in California by the entity to employees for compensation exceeds the lesser of \$50,000 or twenty-five percent of the total compensation paid by the taxpayer.¹⁹

16. COMMISSION REPORT, *supra* note 1, at 44. The Legislative Analyst’s Office has since estimated, based on 2007 income tax data, that a four percent BNRT would yield about twenty percent less revenue than required to achieve revenue-neutrality. See Legislative Analyst’s Office, *supra* note 11, at 1. This implies that a tax rate of about five percent would be required for revenue-neutrality. An even higher rate would be required to replace revenues from the other taxes during the earlier part of the decade. See *Sheffrin Testimony*, *supra* note 11; *Sheffrin*, *supra* note 10; *Stark Testimony*, *supra* note 11 (These commentators argue that the Commission’s view that a sizeable fraction of the burden of the BNRT would be shifted to the federal government, is flawed. The Commission’s reasoning is that revenues from the BNRT, which business taxpayers can deduct as an expense, would replace revenues from the RST, which many individual taxpayers do not deduct in calculating their income tax liability. Sheffrin and Stark note that the deduction for the BNRT merely offsets inclusion of the BNRT in gross receipts.)

17. The small business exemption would be phased-out, based on a graduated schedule. See COMMISSION REPORT, *supra* note 1, at A-6. The Commission Report does not specify the mechanics of either the credit or its phase-out. Section 27801 of the draft legislation appended to the Commission Report specifies the calculation of the credit. Commissioner Richard Pomp has indicated that the Commission did not approve—or even discuss—the legislative draft. See *Pomp Statement*, *supra* note 8, at 5.

18. COMMISSION REPORT, *supra* note 1, at A-5.

19. COMMISSION REPORT, *supra* note 1, at A-5.

This definition of “doing business” is consistent with that effective January 1, 2011, for the California corporate income tax.²⁰

Unitary Method. The unitary method would apply to both single entities and to groups of affiliated entities that operate a unitary business inside and outside of California.²¹ Business entities and affiliated entities could operate one or more unitary businesses, each of which would pay tax separately. All types of business entities would be included in the unitary group, including pass-through entities and sole proprietorships.²²

Combination. The business net receipts of a unitary group would be the sum of the net receipts of the entities included in the unitary group. Transactions between members of the unitary group would be eliminated, as under the present corporate income tax.²³

Water’s Edge. A unitary group would file on a water’s-edge basis. The definition of a water’s-edge group would be similar to that in current law for corporate income tax purposes. Thus, affiliated entities organized in the U.S. would be considered inside the water’s edge, while entities organized outside of the U.S., including sub-part F corporations, generally would not be, except to the extent of their U.S. activities. Entities with activities in tax haven jurisdictions would include these activities in the water’s edge return.²⁴

Apportionment. The combined aggregate business net receipts of a unitary group (or a single entity) with multi-state operations would be apportioned using a single-factor sales formula.²⁵ For purposes of calculating the sales factor, the numerator would consist of sales in California and the denominator would be sales

20. *Id.* See CAL. REV. & TAX. CODE § 23101 (2004).

21. COMMISSION REPORT, *supra* note 1, at A-6. Whereas the Commission Report refers to “single businesses” and groups of “affiliated business,” it seems preferable to refer to “single entities” and groups of “affiliated entities,” as in the text. The Commission Report includes the qualifying words “operating inside and outside of California” only with regard to single entities. It is assumed here that they are also meant to apply to unitary groups. Presumably, affiliated entities that operate a unitary business entirely within California would also be allowed—and required—to file on a combined basis, as they currently are under the corporate income tax, so that losses from one entity could be offset against gains of another, even though no “apportionment” issue is raised by such combined reporting, because the entire tax base is in California.

22. COMMISSION REPORT, *supra* note 1, at A-6.

23. *Id.*

24. *Id.*

25. See equation (3) in Section II.B *infra* for an algebraic statement of the apportionment formula. The same formula is available on an elective basis under the corporate income tax.

everywhere. If any member of the unitary group has nexus in California, all in-state sales by any member of the unitary group would be included in the numerator of the formula (the so-called *Finnigan Rule*).²⁶

The Definition of Sales. Sales would only include receipts from the provision of goods and services; they would not include receipts from financial transactions. Occasional sales would also be eliminated from the numerator and the denominator of the apportionment factor. Both sales of tangible property and sales of services and intangible property would be attributed to the state of destination.²⁷

Non-business Receipts. Only business receipts—those arising from the conduct of a trade or business—would be subject to apportionment. Non-business receipts, such as receipts from passive investments unrelated to the business, would be allocated to specific states. California non-business net receipts would be added to the portion of business net receipts apportioned to California to determine total net receipts subject to the tax.²⁸

II. Perception Problems

The BNRT is intended to have the effects of a value-added tax, but it looks, functions, and “feels” like an income tax. As a result, there is a high probability that business, and perhaps the courts, will see the BNRT as a peculiar form of income tax—one that allows no deduction for either labor costs or interest.

A. Will the Real BNRT Please Stand Up?

The BNRT would not be implemented like either the familiar RST or a standard credit-method VAT.²⁹ The RST and the standard VAT are both calculated and applied on a transaction-by-transaction basis. A California retailer must show the RST as a separate line item on an invoice, unless the sale is made at a “tax-included price.” VAT

26. COMMISSION REPORT, *supra* note 1, at A-7. See Appeal of Finnigan Corporation (*Finnigan I*), Cal. St. Bd. of Equal. No. 85A-623-LB (1988); Opinion on Petition for Rehearing (*Finnigan II*), Cal. St. Bd. of Equal. No. 85A-623-DB (1990).

27. COMMISSION REPORT, *supra* note 1, at A-7.

28. *Id.* at A-6.

29. See Sijbren Cnossen, *A VAT Primer for Lawyers, Economists, and Accountants*, 55 TAX NOTES INT'L 4, 319-32 (Jul. 27, 2009), for an excellent explanation of the basic structure of the RST and of credit-method, subtraction-method, and addition-method VATs.

on sales to registered traders must also be shown separately, as credit can be claimed only for tax shown on invoices.

By comparison, like all subtraction-method VATs, the BNRT would be calculated by subtracting purchases from gross receipts in a manner that resembles the calculation of income tax liability. Since it is not calculated on a transaction-by-transaction basis, it could not be shown separately.

The BNRT would provide a credit for research and development, loss carry-forwards, the carry-over of credits and net operating losses accumulated under the corporate income tax, allowance for BNRT purposes of depreciation, amortization and depletion for property acquired before implementation of the BNRT, and recognition of items deferred under the corporate income tax.³⁰ Loss carry-forwards can reasonably be seen as a surrogate for the refund of negative liability under a credit-method VAT. The allowance for BNRT purposes of depreciation, amortization, and depletion for property acquired before implementation of the BNRT, and perhaps the carry-over of credits and net operating losses and recognition of items deferred under the corporate income tax, can be justified as resembling the type of transition measures employed in switching from an income tax to a sales taxes. But the research and development credit is the type of provision found only in income taxes; it has no place in a sales tax.³¹ Moreover, like the income tax, the BNRT provides for the apportionment of the tax base, based upon the ratio of California sales to total sales.

But the BNRT is not an income tax—or at best, it is a strange one. It would not apply to dividends and interest income and would not allow deductions for wages and salaries or for interest expense, expenses that are virtually always deductible in calculating taxable income. Moreover, it would allow immediate expensing of the cost of additions to inventories and expenditures on amortizable, depletable, and depreciable assets, treatment that is unusual in an income tax. By comparison, credit-method VATs normally do allow credits for tax associated with such expenditures, but do not apply to interest and dividends.

30. COMMISSION REPORT, *supra* note 1, at A-10.

31. In addition, Miethke, *supra* note 7, argues that it may not be possible for political reasons to eliminate many of the other credits found in the income tax.

B. Taxpayer and Labor Perceptions

How taxpayers and labor perceive the BNRT will condition whether they accept or oppose this new tax.

The BNRT as a Tax on Labor. Since the BNRT looks like an income tax that allows no deduction for labor costs, it has been branded a tax on labor and excoriated by labor leaders and others.³² Their primary complaint is that, because labor expense is non-deductible but purchases of machinery and equipment are expensed in the year acquired, the BNRT would induce substitution of capital for labor, thereby reducing jobs in California. That it would induce outsourcing and misclassification of employees as independent contractors is a product of the small-business exemption that is not inherent in the tax.³³

This opposition illustrates the importance of perceptions.³⁴ Leaving aside the troublesome treatment of interstate and international trade and problems associated with the exemption for small business discussed below, the BNRT is simply a subtraction-method VAT. As such, it should have roughly the same economic effects as a conventional credit-method VAT or an ideally designed RST. Of course, like all consumption-based VATs, the BNRT is a tax on labor (and profits),³⁵ as well as a tax on consumption.³⁶ But this

32. See, e.g., Kabatech, *supra* note 3; Pulaski Statement, *supra* note 4; Ross, *supra* note 5.

33. See *infra* Section VI.

34. Michael J. McIntyre & Richard D. Pomp, *A Policy Analysis of Michigan's Mislabeled Gross Receipts Tax*, 53 WAYNE L. REV. 1275, 1281 (2007) (speculating regarding the political acceptability of Michigan's new modified gross receipts tax (MGRT), which bears a close family resemblance to the BNRT, compared to the single business tax (SBT) that it replaced). "Although the MGRT implicitly includes wages in its base, that fact is far less obvious than it was under the SBT, which required taxpayers to explicitly add wages to their income, as computed for Federal tax purposes. As a result of this change in form, the MGRT is less likely to be chastised for discouraging job creation in Michigan." *Id.* Observers in California were quick to realize, however, that the lack of a deduction for wages in the BNRT, a subtraction-method VAT, is economically equivalent to taxing wages under an addition-method VAT.

35. The tax would also be a tax on economic profits and, to the extent that it is not eliminated by transition rules, on the return to old capital.

36. The California Franchise Tax Board ("FTB") has noted that "[f]or taxpayers with little or no payroll, the BNRT could be viewed as equivalent to a tax on income, whereas for taxpayers with no income and significant payroll, the BNRT could be viewed as equivalent to a tax on payroll. Or one could simply view the BNRT as being equivalent to a tax on the sum of the taxpayer's net income and payroll." The latter is, of course, value added. THE CALIFORNIA FRANCHISE TAX BOARD, ANALYSIS OF TAX NEXUS ISSUES CONCERNING THE COMMISSION ON THE 21ST CENTURY ECONOMY'S BUSINESS NET RECEIPTS TAX PROPOSAL [hereinafter FTB NEXUS REPORT] (Aug.21, 2009), available at

does not mean that it would induce substitution of capital for labor anymore than a credit-method VAT or an ideally designed RST would.³⁷ A basic theorem of the economics of taxation is that a tax on consumption—and thus a tax on labor—does not affect factor proportions.³⁸

The BNRT Formula and Taxpayer Perceptions. The formula used to calculate liability under the BNRT is usually stated as follows:

$$T = t (G - P)(S_c/S)$$

where T is tax liability, t is the tax rate, G is gross receipts, P is purchases, S_c is California sales, and S is total sales.³⁹ Written this way, the formula says that the tax base is a fraction of the taxpayer's total value added, where the fraction is the ratio of the taxpayer's California sales to its total sales.

But the formula can also be rewritten in the following equally correct manner:

$$T = S_c t (G - P)/S$$

Written this way, the tax appears to be levied on the taxpayer's California sales, at an effective rate that depends on the ratio of the taxpayer's value added to its total sales, as well as the statutory tax rate. (By comparison, under a credit-method, unless multiple rates

http://www.cotce.ca.gov/documents/correspondence/staff_and_commissioners/documents/FTB%20Analysis%20for%20COTCE%20-%2008.21.09.pdf.

37. The RST is seldom, if ever, said to cause such substitution. In fact, because extant RSTs commonly apply to many capital purchases, they may actually induce substitution of labor for capital.

38. See Cnossen, *supra* note 29, at 324. Cnossen provides the following heuristic explanation of the neutrality of a credit-method VAT toward the choice between labor and capital. Since registered traders are allowed a credit for VAT paid on purchases, the only tax that ultimately matters is that levied on sales to households. *Id.* Thus, a credit-method VAT does not distort the choice of factor proportions. *Id.* Since credit-method and subtraction-method VATs are economically equivalent, the latter form of VAT also does not distort this choice. *Id.* at 320–22. It is worth noting that, despite some concern that the credit-method VATs levied in the European Union could cause the substitution of labor for capital, these taxes are generally seen as taxes on consumption and thus are generally well-received, despite their regressivity. It should be recognized, however, that the regressivity of the European VATs is moderated by progressive elements in the rest of the tax system and by the social services the VATs help finance. The political context in which the BNRT was proposed (e.g., reducing the regressivity of the income tax) is, of course, quite different.

39. COMMISSION REPORT, *supra* note 1, at A-7.

are specified, the effective rate is the same rate on all sales; it is the statutory rate.) This formulation can be expected to cause those whose value added represents a high percentage of their sales, such as those in the professions, but also software companies, to complain that the tax is unfair. The California Chamber of Commerce, in testimony before the Assembly Revenue and Taxation Committee on behalf of a coalition of business and labor groups has stated, “[B]usinesses with low profit margins and high employee expenses presumably would be especially hard-hit as would companies in a loss position.”⁴⁰

The BNRT and Economic Losses. Taxpayers are accustomed to being required to collect and remit RST, even when they do not show a profit. Thus, they would likely accept the responsibility to collect and remit a conventional credit-method VAT under those circumstances. By comparison, they quite rightly expect to be required to pay income tax only when they have income. But liability for BNRT does not depend on profitability. Indeed, because labor costs and interest are not deductible expenses, it could be quite common for businesses that do not show a profit to be obliged to remit BNRT. Experience in Michigan suggests that taxpayers may not understand why they must pay what appears to be an income tax, even if they have no income, and will resent doing so.⁴¹ This is borne out by opposition to the BNRT expressed by a representative of the California Chamber of Commerce: “The business net receipts tax may be imposed on companies even when they are losing money and cannot be passed on as a transactions tax.”⁴²

Lessons from Michigan. Experience under Michigan’s widely discredited and recently repealed single business tax (“SBT”), an addition-method VAT that shares many of the perceived problems and other defects of the BNRT described here, is instructive. McIntyre and Pomp have written:

The SBT was rarely seen as a value-added tax by the businesses collecting it or by the legislators asked to revise it. Instead of

40. CalChamber, *supra* note 3.

41. See James R. Hines Jr., “State Income, Sales and Consumption Taxes” (Feb. 12, 2009), available at <http://www.cotce.ca.gov/meetings/2009/2-12/testimony/>; ROBERT CLINE, ANALYSIS OF BUSINESS NET RECEIPTS TAX, PRESENTATION TO THE CALIFORNIA COMMISSION ON THE 21ST CENTURY ECONOMY (June 16, 2009), available at: http://www.cotce.ca.gov/meetings/testimony/documents/Robert_Cline-CA_Tax_Commission_6-16-09.pdf.

42. CalChamber, *supra* note 3.

being viewed as a tax collected by business and passed on to consumers, it was viewed as a peculiar and unfair tax on business. Although wages are properly included in the base of a VAT, their inclusion in the base of the SBT was widely criticized. Critics claimed that this feature of the tax discouraged employment. In addition, unlike an income tax, but like a sales tax, the SBT was collected, sometimes in substantial amounts, by businesses operating at a loss. Many businesses felt this result was unfair.⁴³

This epitaph for the SBT, co-authored by a member of the Commission, could have served as prophesy for the Commission regarding public reception of the BNRT.⁴⁴

III. Philosophical Inconsistency

Destination-based VATs are commonly seen as a way of charging consumers, if only approximately, for the public services they receive. Underlying this way of thinking is the idea that household consumption of taxable goods and services is roughly correlated with the benefits of services provided by government. By comparison, origin-based VATs can be seen as charging businesses for the benefits of services they receive.

The Commission seems to confuse the means and ends of benefit taxation. Its report states, "The BNRT is designed to tax the value a business adds to its production of products and services in California and thus attempts to approximate the benefits of services and programs utilized by the business."⁴⁵

This statement could be interpreted as describing an attempt to use the BNRT to levy a benefit-related tax on businesses. Such a tax would be an origin-based VAT, and, in fact, the first part of the statement describes an origin-based VAT. But an origin-based tax, if apportioned, would presumably be apportioned on the basis of payroll, and perhaps property, rather than sales. Of course, the Commission did not propose an origin-based tax; it proposed what it

43. McIntyre & Pomp, *supra* note 34, at 1279.

44. One can only wonder whether a credit-method VAT (if one were feasible) would have engendered different perceptions and whether opposition would have been as strong as to the BNRT.

45. COMMISSION REPORT, *supra* note 1, at A-3.

sees as a destination-based tax. Thus the design of the tax is logically inconsistent with the philosophy said to underlie it.⁴⁶

IV. Defects of the Subtraction-Method VAT

The conventional credit-method VAT operates in a manner quite different from the subtraction method underlying the BNRT.⁴⁷ These operational differences have important economic and political implications.

Under the credit-method VAT, registered traders collect tax on non-exempt domestic sales and claim credit for tax paid on purchases giving rise to non-exempt sales.⁴⁸ There is thus no multiple taxation of products passing between registered traders as there is under an RST that does not exempt all sales to registered traders—the only kind found in the United States.⁴⁹

Because of the way the credit-method VAT operates, exemption of sales to registered traders causes aggregate tax liability to be higher, not lower, since no credit is allowed for the tax paid on purchases by the exempt seller. This has an important political implication: there is an incentive to seek exemptions only for sales to consumers (and to unregistered traders).⁵⁰

Incentives—both economic and political—are quite different under the subtraction-method VAT, which can be said to tax “slices” of value added—the difference between sales and purchases. Any value added that is exempt escapes tax.⁵¹ Besides undermining

46. In a closed economy—one with no trade between jurisdictions—the distinction between origin- (or production) and destination- (or consumption) based taxation is meaningless. Of course, as the Commission clearly recognized, it does matter in an open economy.

47. For a discussion of the mechanics of the VAT, including an elementary discussion of the disadvantages of the subtraction-method VAT, see CHARLES E. MCLURE, JR., *THE VALUE ADDED TAX: KEY TO DEFICIT REDUCTION* ch. 6 (1987). For a more complete discussion of the relative merits of credit- and subtraction-method VATs, see Itai Grinberg, *Where Credit is Due: Advantages of the Credit Invoice Method for a Partial Replacement VAT*, available at <http://www.americantaxpolicyinstitute.org/research.html>, 63 *TAX L. REV.* (forthcoming 2010), and presented at a conference sponsored by the American Tax Policy Institute on “Structuring a Federal VAT: Design & Coordination Issues,” Washington, February 18–19, 2009).

48. Sellers making both taxable and exempt sales can claim credit for VAT on purchased inputs only to the extent they are used to produce taxable (non-exempt) sales.

49. Raymond J. Ring, Jr., *Consumers’ Share and Producers’ Share of the General Sales Tax*, 52 *NAT’L TAX J.* 79, 81–90 (1999).

50. MCLURE, *supra* note 47, at 72–74.

51. *See id.* at 75–76.

revenues and economic neutrality, this system provides a powerful incentive to seek exemptions.⁵²

The use of sales-based formula apportionment in the BNRT leaves this basic defect intact. The small-business exemption would create holes in the tax base that would have the effects posited above. Moreover, one would not be surprised to see the proliferation of other deductions and credits of the type that are common (if not appropriate) to income taxes but rare in sales taxes including credit-invoice VATs.

Michigan's experience is also relevant here. Under the Single Business Tax ("SBT") in effect from 1976 through 2007, Michigan allowed deductions for a long list of things other than for small businesses, including contributions to higher education, libraries, nonprofit organizations, historic restoration, community foundations, and homeless shelters; child care; summer youth employment; supplemental workers; apprenticeships and location in Michigan; activities in enterprise, "brownfield," and renaissance zones; investment of minority venture capital; and transportation, utility, agriculture, certain retail, and pharmaceutical companies.⁵³ The following appraisal of the SBT, made in 1982, just six years after the tax was introduced, was even more apt by the time the tax was repealed. "An ideal consumption-type VAT would require all organizations engaged in production to be taxed on their value added (minus capital expenditures). An account of the SBT's structural

52. McLure calls a system that allows deductions for all purchases, regardless of whether or not the vendor has paid tax, a "naive" subtraction-method VAT. A "sophisticated" VAT would address this problem by allowing deductions only for purchases that are not exempt. It should be relatively easy to allow deductions only for purchases from vendors that are subject to the BNRT. *Id.* at 75-79. See, however, the discussion of the constitutional problem of doing this in a state tax. *Infra* note 86 and accompanying text. Since the subtraction-method is not levied on individual transactions, as the credit-method tax is, it would be extraordinarily difficult to implement this modification on a product-by-product basis. Although the Commission's BNRT proposal does not include product-based exemptions, it would not be surprising to see them appear over time, either before or after initial introduction of the tax, as occurred in Michigan. See also Grinberg, *supra* note 47; David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599 (2000).

53. See HOUSE FISCAL AGENCY, STATE OF MICHIGAN HOUSE OF REPRESENTATIVES, MICHIGAN'S SINGLE BUSINESS TAX (Nov. 2003), available at <http://house.michigan.gov/hfa/archives.asp>. Only two retailers qualified for the credit for retailers and only one, which declined the credit, qualified for the credit for pharmaceuticals. *Id.* at 28.

details is mainly an account of departures from this simple principle.”⁵⁴

The incentives to seek exemptions under the new modified gross receipts tax (“MGRT”), the subtraction-method VAT introduced in 2008 to replace the SBT (described above) still exist. Regarding the MGRT, McIntyre and Pomp observe: “Unfortunately, the new package has a host of complex special features that can only be explained by politics running amok.”⁵⁵ This experience offers a clear warning for California, if ever it should consider adopting the BNRT—especially since the four percent BNRT rate proposed by the Commission is five times as high as the MGRT rate.⁵⁶

V. The Effects of Formula Apportionment

The BNRT has been sold as a destination-based VAT. As explained in the next paragraph, the credit-method VAT used by roughly 150 countries employs “border tax adjustments” (“BTAs”) to subject imports to VAT and relieve exports of VAT.⁵⁷ By comparison, the BNRT employs sales-based formula apportionment in an attempt to achieve destination-based taxation. But the BNRT does not necessarily eliminate tax on exports from California, and even where it does, the effect may not be lower prices for exports. Under some circumstances the BNRT on imports into the state could be avoided, as explained in the next section. Even where it is not, it may not be reflected in the price of imports.⁵⁸

Under the credit-method VAT, imports are taxed, either at the border or upon their first domestic sale. Exports are zero-rated (not exempt), and tax paid before the export stage is credited against tax liability on domestic sales and is refunded, if net liability after credits is negative. This system—in which BTAs are used to assure that tax

54. Robin Barlow & Jack S. Connell, Jr., *The Single Business Tax, in MICHIGAN'S FISCAL AND ECONOMIC STRUCTURE* 679 (Harvey E. Brazer ed., 1982).

55. McIntyre & Pomp, *supra* note 34, at 1282.

56. Indeed, a BNRT rate of five percent, which Legislative Analyst's Office suggests may be needed to achieve revenue neutrality, is more than six times the Michigan rate. *See supra* note 11.

57. Cnossen, *supra* note 29, at 324. The prevalence of the destination principle is so well-established that authorities such as Cnossen do not even bother to mention it. He does, however, indicate the difficulty of implementing BTAs under a subtraction-method VAT. *Id.* at 322–23.

58. In what follows the terms “exports” and “imports” generally refer to interstate as well as foreign trade. The discussion of the legality of the BNRT under international trade rules, refers only to foreign trade. *See infra* Section VIII.

is levied where products are consumed, rather than where they are produced—is commonly called destination-based taxation. BTAs are generally accurate, in that imports pay the same tax as domestic products and exports are relieved of tax paid at prior stages of the production-distribution process, neither more nor less.⁵⁹

A. Exports

Sales-based apportionment of net receipts means, in effect, that no tax is levied directly on out-of-state sales of California taxpayers. This does not mean, however, that exports are free of the burden of the BNRT or that formula apportionment would produce the same result as BTAs, namely lower prices for exports than for in-state sales of the same product. Two cases deserve examination.

Vertically Integrated Taxpayers. The first case is that in which exporting taxpayers make no in-state purchases from other firms subject to the BNRT, which for expositional convenience can be called vertically integrated taxpayers. In theory, for exports by this special class of taxpayers, formula apportionment would produce the same result as BTAs. But theory may not reflect reality.

Where Theory Goes Wrong. If California exporters are not to be placed at a competitive disadvantage by the BNRT, it is necessary that they reflect the effects of formula apportionment in the prices of products—that the price of exports be less than the price of the same products sold in California by the amount of the BNRT. This almost certainly will not occur in many cases.

The theoretical result is most likely to prevail where “customized pricing” is the norm, that is, where the price of a product is tailored to reflect the attributes of the buyer, including its location; for example, Boeing’s sale of aircraft to foreign buyers. In this case, the purchase price could be adjusted to reflect the effect of sales-based formula apportionment in eliminating the BNRT liability related to export sales. If that occurs, out-of-state buyers would pay less than in-state

59. Because of the effects of the exemptions described earlier, it is difficult to achieve accurate BTAs under a subtraction-method VAT that includes exemptions. If there are exempt producers or exempt products, the tax applied to imports and rebated on purchases used to produce exports should be less than the statutory tax rate. See MCLURE, *supra* note 46, at 79–81. Failure to recognize this can trigger complaints under the General Agreement on Tariffs and Trade (“GATT”), the multilateral agreement that governs international trade discussed in Section VIII. This difference is not relevant for present purposes, given the use of formula apportionment as a surrogate for BTAs in the BNRT.

buyers, and sales-based formula apportionment would produce the same effects as BTAs.

The theoretical result is unlikely to hold in the case of “standardized pricing,” in which the same price is charged to all buyers regardless of location, as occurs, for example, in the case of catalog sales and other sales (including those made to businesses) based on nationally uniform price lists. Here, even if formula apportionment were to eliminate the BNRT liability related to export sales, that elimination would not be reflected fully in the price of exports; thus, sales-based formula apportionment would not produce the same results as BTAs. (The exception to this generalization is the extreme case in which all sales by vertically integrated entities are for export; in this case, the elimination of the BNRT on exports would presumably be reflected in export prices. In the more typical case of mixed in-state and export sales, it would not.)⁶⁰

It is easy to see why the combination of the subtraction-method of calculating value-added and sales-only formula apportionment does not generally produce the same effect as BTAs for exports. Under the credit-method VAT, tax on individual transactions is calculated and added to the net-of-tax price of in-state sales, but not to the price of exports (and tax paid at prior stages is rebated). Under the subtraction-method calculation that underlies the BNRT, tax is not calculated on individual transactions and thus cannot be reflected in the price for in-state sales, but not the price of exports. As Miethke observes, “There is no mechanism for ‘backing out’ the tax, or selling in a two-tier pricing system (one price for in-state sales, one for out-of-state sales).”⁶¹ While sales-only apportionment has the effect of reducing tax liability to the extent that an entity exports (and perhaps enabling lower prices for both exports and in-state sales), it does not guarantee that the lower liability will be reflected in differences in the prices of in-state sales and of exports.

Unintegrated Taxpayers. Under the apportionment-based BNRT, the situation is worse than just described for taxpayers in a supply chain that is not vertically integrated through the export stage. In this case, while tax related directly to export sales would be eliminated by formula apportionment, there would be no rebate of

60. Elimination of BNRT liability related to export sales would allow the standard price to be lower than otherwise. But that lower price would be applied to in-state sales, as well as export. The price reduction would be directly related to the fraction of sales that are exported.

61. Miethke, *supra* note 7, at 872.

tax paid before the export stage, as occurs under a credit-method VAT.⁶² (That exports would effectively be exempt from the BNRT paid directly by the exporter does not mean that the effective exemption would be reflected in differences in in-state and export prices. That would depend on the kind of analysis presented above for integrated exporters.) In short, the BNRT would burden California exports, penalize small businesses that are not exempt, and encourage vertical integration. As Bankman et al., states:

[F]irms exporting goods and services produced in California will, to the extent that they purchase inputs from firms subject to the tax, have a BNRT cost embedded in their production process. As with the current RST, a firm's ability to pass this cost on to its non-California consumers will be limited. This illustrates a fundamental design flaw with the BNRT concept—apportionment (even single-factor sales apportionment) is not an adequate substitute for the type of border tax adjustments used in typical cross-border VAT designs.⁶³

Some may note that the same phenomenon occurs under the corporate income tax, to the extent that a sales factor is employed to apportion the income of multi-state enterprises. But this is not relevant, as a conceptual matter. It is not unreasonable to believe that sales should be included in the formula used to apportion corporate income, as one of the determinants of where income originates. That proposition is equally true, whether the income of a single vertically integrated firm or that of two or more unintegrated firms is being apportioned. That this methodology results in less income being apportioned to California in the former case than in the latter would not have the same significance as in the case of the BNRT, where the intent is to approximate the effects of a destination-based VAT, not to attribute income to the state where it originates.

B. Imports

The analysis of effects on imports is analogous to that of exports in the above case of vertical integration. Because of sales-only apportionment, sales in California by out-of-state vendors meeting

62. Thus, Cline is simply wrong when he states, "Subtraction of all input purchases . . . eliminates . . . pyramiding (double taxation)." See Cline, *supra* note 41.

63. Bankman et al., *supra* note 6, at 1–2. The Appendix uses simple algebra to demonstrate these points.

the BNRT nexus requirements would create a liability for the BNRT that other sales would not produce. Again, this suggests that, in theory, formula apportionment would produce the same result as BTAs. But, as with exports, theory may not always reflect reality.

Customized pricing could be made to reflect the BNRT liability associated with sales to California. But, because the BNRT is not calculated and applied to individual transactions, standardized pricing would not do so.⁶⁴

VI. Opportunities for Tax Planning

At least two types of tax planning would be possible under the BNRT. There are presumably more.

Substitution of Independent Contractors for Employees. Whereas payments to independent contractors are deductible expenses, wages and salaries are not. Contrary to what some think, this difference would not per se create an incentive for outsourcing to independent contractors, if independent contractors were subject to the BNRT.⁶⁵ But the small business exemption can provide a significant incentive to replace employees with independent contractors or to misclassify employees as independent contractors, in order to reduce aggregate tax payments. Outsourcing and misclassifying employees undermines economic neutrality, revenues, and equity.

Imports. If an out-of-state seller either lacks economic nexus in California or qualifies for the small business exemption, the BNRT would not be collected on sales it makes into the state. Given the relatively low nexus threshold based on economic presence in California and the application of unitary principles in determining tax liability, this may seem not to be an important problem—at least not if the nexus standard passes legal scrutiny, an issue discussed in Section VII below. But it may be possible to structure transactions in which sales into California are channeled through unrelated out-of-state intermediaries that have little net receipts.⁶⁶ This would not be

64. For a discussion of the interaction of the small-business exemption and formula apportionment, *see also* Section VI *infra*.

65. It may be worthwhile to explain this point: If there was no small-business exemption, so that all independent contractors were subject to the BNRT, the tax on independent contractors would make up for the fact that payments to them are deductible. The small-business exemption in the Commission's proposal eliminates this compensating effect, creating an incentive for outsourcing and misclassification of employees as independent contractors.

66. Indeed, California firms might be able to avail themselves of this ruse, by routing sales through out-of-state intermediaries. Anti-abuse rules would be easier to apply than

prevented by either the unitary business rules or arm's length pricing rules. Perhaps it could be prevented by anti-abuse rules, but not without devoting substantial amounts of scarce administrative resources to it. In any event, outsourcing to small out-of-state independent contractors would be encouraged and perfectly legal. Moreover, depending on how the water's edge limitation is interpreted, "offshoring" to foreign vendors that lack nexus could be encouraged.⁶⁷

VII. Legal Challenges

It is unclear how the BNRT would be treated as a matter of constitutional and federal statutory law. If it is seen as a sales tax, the economic nexus standard will likely be held to violate the rule, announced in *National Bellas Hess v. Department of Revenue of Illinois*⁶⁸ and affirmed in *Quill v. North Dakota*,⁶⁹ that out-of-state vendors can be required to collect use tax only if they have a physical presence in the state.⁷⁰ If, on the other hand, it is seen as a business activity tax, it would fall into judicial limbo, since the United States Supreme Court has not clarified whether taxes other than sales taxes are subject to the physical presence test of nexus.⁷¹

in the case of sales originating from out-of-state vendors, but not without difficulty. The same problem seems to plague use of the sales factor in the corporate income tax.

67. Fred Keeley, Commissioner, An Undated Letter to Daniel Steinberg, President pro Tempore of the California State Senate, *available at* <http://www.assembly.ca.gov/acs/newcomframeset.asp?committee=21>. Commissioner Fred Keeley warns, "The use of a water's edge approach, combined with the questionable ability of the state to impose the BNRT on firms without a physical presence in California, would likely encourage businesses to outsource to firms outside of the United States that are not subject to taxation in California." *Id.* See also Miethke, *supra* note 7.

68. *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U. S. 753 (1967).

69. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

70. Indeed, if the BNRT is seen to be a *sales* tax, it may not be possible to require even out-of-state vendors with a physical presence in the state to collect the tax, if sales are deemed to occur outside the state. After all, the *Quill* nexus rule applies to obligation to collect the *use* tax, a separate levy that accompanies the sales tax.

71. For a carefully reasoned analysis of these issues, see FTB, NEXUS REPORT, *supra* note 36, at 6–11. See also McIntyre & Pomp, *supra* note 34, at 1303–06 (discussing the constitutionality of the economic presence test of nexus in the MGRT under *Quill*, but not its consistency with Public Law 86-272). They conclude that the MGRT is not likely to be classified as a sales tax to which the physical presence test applies; Walter Hellerstein and John A. Swain reach essentially the same conclusion. Walter Hellerstein & John A. Swain, "Classifying State and Local Taxes: Current Controversies," 54 STATE TAX NOTES 35, 42 (Oct. 5, 2009), reprinted in part in Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, 3rd ed. (Boston: Warren, Gorham, and Lamont, 1998, rev. 2009). Nellen

If courts see the BNRT as a tax on net income, it may run afoul of Public Law 86-272, which protects taxpayers from the requirement to pay income tax if their only activity in the state is solicitation for sale of tangible property delivered from out-of-state. As the California Franchise Tax Board (“FTB”) has noted, “Because Public Law 86-272 applies only to a ‘net income tax,’ the critical question is whether the BNRT would be viewed a net income tax within the meaning of the statute.”⁷²

While warning of the uncertainty of how courts would decide these issues, the FTB concluded that: (1) the BNRT is a business activity tax (“BAT”), rather than a sales tax; (2) “a factor presence nexus standard . . . should pass constitutional muster”; and (3) the strictures of Public Law 86-272 would likely not apply, because the BNRT, which allows no deduction for payroll, is not a net income tax.⁷³ On the other hand, Commissioner Richard Pomp, himself a respected authority on state and local tax law, has written:

If the Nevada consultant whose only contact with California was that its customer was based in California were viewed as having economic nexus with the State, so would I sitting in Connecticut talking on the phone with a California client (and of course billing by the word). So would any out-of-state vendor that loaded its goods onto a California firm’s trucks for use back in California. So would exporters around the world have economic nexus. This view of economic nexus would simply rewrite everything we think we know about the concept.⁷⁴

As the FTB acknowledges, “The BNRT, if enacted, presents some novel tax issues that undoubtedly will lead to court

concludes, “Because the BNRT is neither a sales tax or income tax, it is not subject to the physical presence or PL 86-272 standards.” *Nellen Testimony, supra* note 11.

72. FTB NEXUS REPORT, *supra* note 36, at 12.

73. *Id.* at 12–14. The FTB added with regard to the third conclusion, “However, because the scope of Public Law 86-272 is a question of federal law, and there are no federal authorities on the subject, it is hard to place a high degree of confidence in this conclusion.” *Id.* at 14.

74. Pomp, Wrong Direction, *supra* note 11, at 12. Pomp goes on to say regarding the FTB analysis, which he describes as “very thoughtful” that “The FTB was not asked, however, to apply that standard to the type of situations raised above. It is one thing to opine that a court would apply an economic nexus standard; it is quite another to opine on how that standard would apply to particular fact problems.” *Id.*

challenges.”⁷⁵ The BNRT may be able to pass unscathed between the Charybdis and Scylla represented by the legal standards described above. But litigation that would settle the matter could take a long time—upwards to a decade or more. In the meantime, there would be an unacceptable amount of uncertainty for both the state fisc and taxpayers.⁷⁶ By adopting the BNRT, the state would expose itself to the risk of having to refund enormous amounts of money to out-of-state vendors.⁷⁷

Moreover, legislation pending in the United States Congress could impose on taxes such as the BNRT a nexus standard based on the taxpayer’s having a physical presence in the state. Enactment of this legislation would undermine both the revenue potential and economic neutrality of the BNRT.⁷⁸ Although the ultimate fate of this legislation cannot be predicted, it seems ill-advised for California to undertake now, in the shadow of pending legislation, the wrenching adjustments implied by the BNRT.⁷⁹

75. FTB NEXUS REPORT, *supra* note 36, at 14. *See also* McIntyre & Pomp, *supra* note 34, at 1305 (stating in regard to the Michigan analog to the BNRT, “Whatever the merits of its position, Michigan can expect litigation over its use of an economic-presence test.”).

76. McIntyre & Pomp, *supra* note 34, at 1306. McIntyre and Pomp appear to take a more sanguine view in stating: “Certainly, the threat of litigation should not deter a state from adopting a rule that it considers to be both constitutional and significant. Otherwise, all contentious legal issues would be decided by default in favor of the taxpayer.” While this view may be appropriate when limited to specific issues such as the use of the economic presence test of nexus, the proviso stated in the last four words of the first sentence should be amended in the case of fundamental reforms such as the BNRT to require that the proposal also be sensible—a test the BNRT fails.

77. While acknowledging that the Supreme Court may “ultimately repudiate *Quill*, or at least distinguish it for taxes other than the retail sales tax,” Stark warns:

[A]t this point there is little evidence to support that position. Just to be clear, I have no problem with the state challenging the scope of *Quill*. However, if the question is whether we should fundamentally restructure the state tax system based on a prediction of how the Supreme Court will decide some future nexus case, I would err on the side of caution.

Stark Testimony, supra note 11.

78. H.R. 1083, 111th Cong. (2010). If enacted, H.R. 1083 would also restrict the assertion of nexus for the corporate income tax. But it would not affect either the individual income tax or the RST, revenues from which the BNRT would replace. Business Activity Tax Simplification Act, H.R. 1083, 111th Cong. (2009).

79. Thus, Nellen warns, “Given the likelihood that P.L. 86-272 will be updated in the near future, the BNT is a riskier proposition if it cannot be imposed on businesses with very limited physical presence in the state.” *Nellen Testimony, supra* note 11. The FTB NEXUS REPORT also observes that the US Congress could require a physical presence for taxable nexus under a BAT. FTB NEXUS REPORT, *supra* note 36, at 10, fn. 50. Since any

VIII. The Illegality of the BNRT Under International Trade Rules

The rules governing international trade, primarily the General Agreement on Tariffs and Trade (“GATT”) and the Agreement on Subsidies and Countervailing Measures (“ASCM”), provide that border tax adjustments are allowed for indirect but not direct taxes. The ASCM states this explicitly in regards to exports by describing BTAs for direct taxes as a prohibited export subsidy. Annex I to the ASCM, entitled “Illustrative List of Export Subsidies,” includes the following (with footnote 58 numbered here as in the original): “e) The full or partial exemption remission, or deferral specifically related to exports, of direct taxes⁵⁸ or social welfare charges paid or payable by industrial or commercial enterprises.” Footnote 58 of ASCM Annex I, states: “The term ‘direct taxes’ shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property.”

As noted earlier, the BNRT is a tax on wages and profits and thus could be seen as a direct tax under this definition. Since, as noted in Section V above, sales-only apportionment is tantamount to providing a tax exemption related to exports, despite its deficiencies in that regard, described earlier, the BNRT treatment of exports arguably violates the ASCM.

The GATT does not similarly state unequivocally that BTAs on imports for direct taxes are forbidden. Rather, this must be inferred from statements regarding the types of taxes for which BTAs *are* allowed. GATT Article II.2(a) says that BTAs for imports are allowed for: “a charge equivalent to an internal tax imposed . . . in respect of the *like domestic product* or in respect of an article from which the imported product has been manufactured or produced in whole or in part.” Since direct taxes are not levied on products, the references to taxation of products—and the lack of any reference to direct taxes—implies that, as with exports, BTAs on imports are not allowed for direct taxes.

This view is confirmed by the conclusions of the 1970 Working Group on Border Tax Adjustments:

14. . . . The Working Party concluded that there was convergence of views to the effect that *taxes directly levied on*

such legislation is unlikely to have retroactive effect, it would not imply refunds of taxes collected previously. But the state could be left scrambling for future revenue.

products were eligible for tax adjustment. Examples of such taxes comprised specific excise duties, sales taxes and cascade taxes and the tax on value added. . . . Furthermore, the Working Party concluded that there was convergence of views to the effect that certain taxes that were *not directly levied on products* were not eligible for tax adjustment.⁸⁰ (emphasis added)

Since the BNRT is not levied on products, providing BTAs on imports, which sales-only apportionment in effect does, arguably also violates the GATT.

The legality of state taxes under international trade rules is probably not something most legislators and governors worry about. They may not even know that there is an issue. However, an eminent American authority on the GATT has observed, “Article XXIV:12 obligates the United States to compel state adherence to [GATT]”⁸¹ That article provides: “Each contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territories.”

The trading partners of the United States may not notice that the BNRT, if enacted, would violate the rules, complain about it if they do notice, or be able to convince the federal government to enforce their complaints.⁸² That does not change the fact that the BNRT would arguably contravene those rules.

IX. Could the BNRT Be Fixed?

Given the defects of the BNRT, it is reasonably to ask whether—and how—it could be fixed to avoid the problems identified here.

80. BORDER TAX ADJUSTMENTS, report of the Working Party adopted on 2 December 1970, available at <http://www.worldtradelaw.net/reports/gattpanels/bordertax.pdf>. It should be noted that, while the concept of a subtraction-method VAT was known in 1970, the credit-method VAT (imposed by the Brazilian states and the members of the European Common Market), was the only one that actually existed in practice and was presumably what was meant by the reference to “the tax on value added.”

81. Robert E. Hudec, *The Legal Status of GATT in the Domestic Law of the United States*, in *THE EUROPEAN COMMUNITY AND GATT* 187, 221 (Meinhard Hilf, Francis G. Jacobs, and Ernst-Ulrich Petersmann eds., Boston: Kluwer 1986).

82. Foreign governments seem not to have taken notice of the fact that sales-only apportionment of state corporate income taxes, also a form of direct taxation, violates the rules, despite the publication of Charles E. McLure, Jr. & Walter Hellerstein, *Does Sales-only Apportionment of Corporate Income Violate International Trade Rules?*, 25 *STATE TAX NOTES* NO. 11, 1315, 1318–19 (Sept. 9, 2002).

The Small-Business Exemption. The small business exemption is a seemingly reasonable—if not well-reasoned—response to the desire to free small business of the obligation to comply with the BNRT. Unfortunately, it would create a gaping loophole through which outsourcing to small independent contractors (including out-of-state ones) and misclassification of employees as independent contractors could easily pass. The result would be revenue loss and economic inefficiency.⁸³

Reducing the upper limit on availability of the small business exemption would alleviate these problems, but impose an unreasonable compliance burden on thousands of small businesses and stretch the resources of tax administration. In principle, a more appropriate solution, which would dampen the incentive to seek exemptions that is inherent in the naive subtraction-method VAT, would be to allow deductions only for purchases made from entities subject to the BNRT.⁸⁴ To the extent that a small-business credit leads to outsourcing and misclassification of employees, this restriction would not solve the problem. This solution, which would resemble in spirit the availability of tax credits only for VAT shown on purchase invoices under the credit method, would also entail compliance and administrative burdens. But only entities that are registered for the BNRT would experience the compliance burdens. The real problem with this solution, however, as noted by Professor Kirk Stark in his October 2009 testimony before the California Committee on Revenue and Taxation,⁸⁵ is that, no matter what its justification as a matter of economic principle, it would raise serious, if not insuperable constitutional objections by granting a tax deduction only for entities engaged in in-state activity (and therefore subject to the BNRT) but not for entities not engaged in in-state activity (and not subject to the BNRT).⁸⁶

83. See *supra* Section VI.

84. See MCLURE, *supra* note 47; Grinberg, *supra* note 47; and Weisbach, *supra* note 52, for discussions of a “sophisticated” subtraction-method VAT.

85. Stark Testimony, *supra*, note 11.

86. See *Farmer Bros. v. Franchise Tax Bd.*, 108 Cal. App. 4th 976, 986–87 (2003), cert. denied, 540 U.S. 1178 (2004); *Ceridian Corp. v. Franchise Tax Bd.*, 85 Cal. App. 4th 875, 883 (2000). In both of these cases, the California Court of Appeal invalidated a dividends-received deduction that was limited to dividends received from payors that were subject to tax in California. As the court declared in *Farmer Brothers*:

[S]ection 24402 is discriminatory on its face because it affords to taxpayers a deductions for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California. As a result, the dividends received deduction scheme

Multiple Taxation of Exports. As indicated in Section V.A above, sales-based formula apportionment is not a satisfactory substitute for export BTAs. There seems to be no satisfactory solution to this problem,⁸⁷ short of implementing BTAs, which should not be contemplated absent a federal VAT—in which case the BNRT would make even less sense.

Legal Issues. Given that the United States Supreme Court has never stated clearly whether the *Quill* physical presence test of nexus applies to taxes other than sales taxes—and has declined invitations to do so—uncertainty regarding the application of this test to the economic presence test of nexus for the BNRT is inevitable, as is uncertainty regarding the applicability of Public Law 86-272.⁸⁸ Of course, eliminating this test would avoid that, but that solution would truly be to throw the baby out with the bath water.

GATT Legality. It appears that sales-based apportionment of the BNRT may violate international trade rules and that this defect is inherent in the system proposed.⁸⁹ But it is uncertain whether foreign governments would complain and whether the federal government would respond positively to such a complaint. This risk of a successful GATT challenge seems low.

Perceptions. In addition to the technical issues just examined, there are the much more important problems of perception and the associated political opposition to the BNRT. There is no easy way to eliminate them.

Summary. There seem to be no easy fixes for the three most important defects of the BNRT: the problems caused by the small

favors dividend-paying corporations doing business in California and paying California taxes over dividend-paying corporations which do not do business in California and pay no taxes in California. The deduction thus discriminates between transactions on the basis of an interstate element, which is facially discriminatory under the commerce clause.

Id. at 986–87.

It appears that a credit-method VAT would not suffer from the same infirmity. Business purchasers registered for the VAT would be allowed credit for tax they had paid. In this regard, in-state and out-of-state taxpayers would be treated equally.

87. The theoretically sound solution mentioned by McIntyre & Pomp, *supra* note 34, at 1298, allowing pre-export vendors to treat part of their sales to exporters as exports, is obviously unworkable. Even if an exporter's supplier could obtain the information needed to implement this adjustment, its suppliers (and suppliers of its suppliers further back in the production-distribution chain) could not easily obtain the required information. As these authors admit, "The obvious problem with the fix is that it presents serious administrative problems." *Id.*

88. See *supra* Section VII.

89. See *supra* Section VIII.

business exemption, the multiple taxation of exports, and perception problems. In addition, the uncertainty of the legality of the BNRT under both the United States Constitution and federal statutory law should give anyone considering the tax pause.

X. The Political Instability of Michigan's 'Value-Added Taxes'

Michigan recently began to levy the MGRT, a tax that resembles the BNRT in many respects.⁹⁰ Experience with that tax is too new to draw conclusions. It is worth noting, however, that this is the third value-added tax Michigan has enacted since 1953, when it introduced the Business Activity Tax ("BAT"), an apportioned subtraction-method VAT tax that was repealed in 1967 and replaced with a corporate income tax. Less than 10 years later, in 1976, Michigan backtracked and introduced the SBT, an apportioned addition-method VAT that was repealed in 2007 and replaced in part by the MGRT, another subtraction-method VAT.⁹¹ During the two periods that the BAT and the SBT were in place, totaling almost 50 years, Michigan tinkered incessantly with the two taxes, apparently in an effort to "get it right"—or simply to satisfy the political demands of various constituents.⁹²

California might not repeat the instability of Michigan's tax system: subtraction-method VAT, replaced by a corporate income tax, followed by an addition-method VAT, and then a subtraction-method VAT. But it would be wise to consider why Michigan's system has exhibited so much instability, and whether a state VAT implemented using either the addition- or subtraction-method VAT, which share many faults, is a good idea.⁹³

Even if the BNRT were to be enacted and left in place, uncertainty would exist. Sheffrin has stated the problem well:

I believe the novelty of the BNRT and the expected, but unknown, difficulties that will arise in its implementation, would initiate a long period of instability in California's system

90. See generally, McIntyre & Pomp, *supra* note 34.

91. See HOUSE FISCAL AGENCY, STATE OF MICHIGAN HOUSE OF REPRESENTATIVES, MICHIGAN'S SINGLE BUSINESS TAX, *supra* note 53, at 4-6; see also McIntyre and Pomp, *supra* note 33, at 1275-82.

92. McIntyre & Pomp, *supra* note 34, at 1283-90.

93. *Observation on Income, Sales and Consumption Taxes before the Commission on the 21st Century Economy* (Feb. 12, 2009) (testimony of James R. Hines Jr.), available at <http://www.cotce.ca.gov/meetings/2009/2-12/testimony/>.

of taxation. There is much to be said in favor of the maxim, that an “old tax is a good tax.” Moving away from familiar taxes whose parameters have been established through litigation, such as the corporation tax and the state sales tax, to a new and untested tax will create additional uncertainty for firms and increased lobbying and rent-seeking on the part of special interests. The Commission’s recommendation for including a Research and Development credit—despite virtually no evidence on its efficacy—and possibly even allowing deductions for employee health insurance—previews the types of interventions we would expect. I would also expect strong pressure from groups representing labor to push for deductibility of some forms of employee compensation, particularly if outsourcing becomes an important consideration. As a result of the inevitable changes that will be enacted to the tax, firms considering investing in California will not be able to count on a stable framework. This additional uncertainty can easily act as a punitive “tax” on doing business in California.⁹⁴

XI. Is There a Better Alternative?

Until recently it was thought that subnational governments could not implement VATs, because of the difficulty of implementing BTAs.⁹⁵ Quebec, however, has demonstrated that a provincial credit-method VAT is possible.⁹⁶ But it does so in the context of a federal VAT. In the absence of a federal VAT, the conventional wisdom remains intact. However, if the federal government were to enact a VAT, California could take the opportunity either to adopt a state

94. *Sheffrin Testimony*, *supra* note 11, at 3.

95. See Charles E. McLure, Jr., *Implementing State and Local Sales Taxes in the Context of a Federal VAT*, PROCEEDINGS OF THE 102ND ANNUAL CONFERENCE OF THE NATIONAL TAX ASSOCIATION, (forthcoming); Charles E. McLure, Jr., *How to Coordinate State and Local Sales Taxes with a Federal Value Added Tax*, 63 TAX L. REV. (forthcoming 2010), (presented at a conference sponsored by the American Tax Policy Institute on “Structuring a Federal VAT: Design & Coordination Issues,” Washington, Feb. 18–19, 2009, available at <http://www.americantaxpolicyinstitute.org/research.html>).

96. Richard M. Bird & Pierre-Pascal Gendron, *Dual VATs and Cross-Border Trade: Two Problems One Solution?*, 5 INT’L TAX AND PUBLIC FINANCE 429 (Jul. 1998); Richard M. Bird & Pierre-Pascal Gendron, *Sales Taxes in Canada: The GST-HST-QST-RST ‘System,’* 63 TAX L. REV. (forthcoming 2010), (presented at a conference sponsored by the American Tax Policy Institute on “Structuring a Federal VAT: Design & Coordination Issues,” Washington, Feb. 18–19, 2009, available at <http://www.americantaxpolicyinstitute.org/research.html>).

VAT or to vastly improve its sales tax, by coordinating it with the federal tax.⁹⁷

It is understandable that the Commission could not recommend coordinating the state sales tax or a newly enacted credit-method VAT with a non-existent federal VAT. But, as noted by Bankman et al., given the defects of the BNRT, many of which have been described here, it would have been better for the Commission to propose improvements to the existing RST, rather than proposing the BNRT. That would not have been “bold,” but it would have been prudent.

Conclusion

Not only does the BNRT exhibit the well-known defects of a subtraction method VAT; sales-only apportionment would not actually achieve the desired effects of destination-based taxation in many important cases. If enacted, the BNRT is likely to be subject to both tax planning (including the substitution of independent contractors for employees and reclassification of employees as independent contractors) and legal challenges, and to be unpopular with California business and labor. It is, in short, a dog—a dog that will not hunt; it should not be seriously considered, much less adopted. As Professor Stark noted last October in his testimony before the Assembly Committee on Revenue and Taxation, adoption of the Commission’s proposals would be “a major step backwards for the state of California.”⁹⁸

97. See McLure, Jr., *How to Coordinate State and Local Sales Taxes with a Federal Value Added Tax*, *supra* note 95; McLure, Jr., *Implementing State and Local Sales Taxes in the Context of a Federal VAT*, *supra* note 95.

98. *Stark Testimony*, *supra* note 11.

Appendix

Demonstration That Apportionment Does Not Always Relieve Exports of BNRT

Under the standard credit-method VAT, exports occur tax-free. This is not the case under the BNRT.

Consider two scenarios: A) an “unintegrated” two-stage production/distribution process in which California firm 1 sells all its output to California firm 2, and B) an integrated process in which a single firm I combines the activities carried out by firms 1 and 2. Assume for the sake of simplicity that sales that enter the sales factor in the apportionment formula and gross receipts that enter the calculation of net receipts are the same.

The BNRT tax bases of firms 1 and 2 in the first (“unintegrated”) scenario would be:

$$N_1 = (S_1 - P_1) S_{C1}/S_1 \text{ and (1)}$$

$$N_2 = (S_2 - P_2) S_{C2}/S_2; \text{ (2)}$$

where N , S , P , and S_C , with the appropriate subscripts, describe the two firms’ apportioned net receipts, sales, purchases, and sales in California.

Since firm 1 sells all its output to firm 2, $S_{C1} = S_1$ and $P_2 = S_1$. The two equations can thus be rewritten as:

$$N_1 = (S_1 - P_1) \text{ and (1a)}$$

$$N_2 = (S_2 - S_1) S_{C2}/S_2. \text{ (2a)}$$

The total BNRT tax base of the two firms can be written as:

$$N_1 + N_2 = (S_1 - P_1) + (S_2 - S_1) S_{C2}/S_2. \text{ (3)}$$

Because of the way the example is constructed, the sales and apportionment factor of the integrated firm are the same as those of firm 2 and its purchases are the same as those of firm 1. Thus its BNRT tax base would be:

$$N_1 = (S_2 - P_1) S_{C2}/S_2. \text{ (4)}$$

That the aggregate tax base of the two unintegrated firms will generally exceed that of the integrated firm can be seen by subtracting equation (4) from equation (3):

$$\Delta_N = N_1 + N_2 - N_1 = (S_1 - P_1) + [(S_2 - S_1) S_{C2}/S_2] - (S_2 - P_1) S_{C2}/S_2. \text{ (5)}$$

After some algebraic manipulation, this can be rewritten as;

$$\Delta_N = (S_1 - P_1) (1 - S_{C2}/S_2). \text{ (5a)}$$

Assuming that $S_1 - P_1$ is positive (i.e., that firm 1 has positive net receipts), this difference is zero if and only if $S_{C2} = S_2$, that is, if and only if firm 2 makes all its sales in California. If, on the other hand,

firm 2 exports all its output, so that $S_{c2}/S_2 = 0$, this difference equals the net receipts of firm 1. That is, the portion of firm 2's exports equal to the value added of firm 1 is subject to double taxation. More generally, to the extent that firm 2 exports its product, apportionment does not fully compensate for NBRT paid before the export stage. If products pass through more stages in California before being exported, the BNRT paid on value added at those earlier stages is also not relieved from tax.
