1201 "K" Street, Ste. 1000
Sacramento, CA 95814
(916) 441-5351
www.calcpa.org

May 10, 2018

Senator Robert Hertzberg
California State Senate
State Capitol, Room 4038
Sacramento, CA 95814

RE: SB 993 (Hertzberg) – Sales Tax on Services: As Amended May 10, 2018 OPPOSE

Dear Senator Hertzberg:

On behalf of the 44,000 members of the California Society of CPAs representing the CPA profession working in large, medium and small public accounting firms, as well as businesses and industries throughout California, we are writing to inform you that we remain in opposition to SB 993, as amended on May 10, 2018. This bill would impose a massive new tax on business services that will needlessly complicate an already complex state tax code and add a substantial new burden to California business and taxpayers.

When CalCPA members met with legislators in January, they discussed their concerns with a tax on services and the importance of fair, effective and efficient tax policy that is practical and administrable for all California taxpayers. CalCPA's March 12, 2018 opposition letter to the introduced version of SB 993 further elaborated on the negative impact of such a drastic change in California tax policy. The recent amendments to SB 993 do not change CalCPA's position, nor do they address our broader concerns with a business services tax.

Specifically, CalCPA opposes SB 993 for the following reasons:

California Consumers Will Bear the Tax Burden Without a Corresponding Benefit. As a threshold matter, we raise the question of whether this proposed tax is sound policy. Taxing virtually all services provided to all businesses is not a way to address the inequities and volatility of our tax system. *Rather, it is simply a tax on economic productivity, which is already subject to taxation through personal and corporate taxation*. The cost of the goods or services to the final customer factors in all the costs associated with the development of a good or service. A business services tax will increase business costs that will ultimately translate into higher prices for the products and services a consumer uses. Consumers might not be taxed on the food they buy, but the cost of produce at the grocery store will likely increase since the grocery store overhead has gone up to include more costly accounting and tax services.

Many times the added cost will be unavoidable for services that certain business are required by law to purchase. For example, a small business that elects to have a retirement plan for its employees is required by law to meet certain audit requirements, which requires the use of an external CPA. Or they may need an audit or review as part of their application for a bank loan. Either the business absorbs the added tax on the service they are required to get, passes the cost to their consumers or elects to no longer offer a retirement plan to employees or opt to not pursue a planned expansion. This is just one example of an indirect, but negative, impact to middle-income Californians – many of whom would not pay the tax directly, but bear its consequences.

No Assurance of Revenue Neutrality. SB 993 attempts to combine a business services tax with a reduction of the current sales and use tax to be revenue neutral to the state of California. However, there is no certainty that the tax reduction will offset the new tax revenue, nor does this take into account the initial and ongoing costs to businesses and the state to comply with the new tax. The problematic aspects of a new tax directly on business activities will still negatively impact California businesses and consumers regardless of any perceived neutrality. SB 993 would be making an immense shift in tax burden with no assurance of a broadened base or revenue neutrality.

Does Not Broaden the Tax Base or Stabilize Revenues. One of the stated goals of SB 993 is to broaden the tax base to decrease reliance of state revenue streams on the ups and downs of the economy. However, it does not "broaden the tax base" relative to reliance on personal income tax versus other forms of taxation. It just increases taxes on most businesses in California. SB 993 specifically targets business-to-business activity, which is still tied to the overall health of the economy. In an economic slowdown, businesses are less likely to pursue expansion activities that involve the use of accounting, legal, and other consulting services associated with the growth. They may even forgo or reduce the level of outside services they currently purchase until the economy improves or look outside the state for services.

While the bill purports to address the apportionment of state/out of state services relative to the tax liability, it does not acknowledge how such determinations will create an administrative nightmare for the business and its tax advisors. It would be nearly impossible for a multistate business, either providing or receiving a service, to decipher when the service has a nexus to California, what portion is subject to the tax or how to calculate the appropriate tax obligation. Multistate apportionment and nexus issues are already complicated under current tax laws and this would further convolute the challenges. For example, how would a business with a large plant in California and an out-of-state headquarters calculate their services tax obligation if they use a CPA firm for management consulting at their headquarters? If all the benefit of the services is for the business's management purposes, is there still an obligation to pay a services tax in California? If so, how will it be calculated? These types of issues are common and will lead to over or under collecting of taxes and the subsequent refund, appeals and legal challenges.

Businesses are Still Sorting Through the Impact of Federal Tax Law Changes. The full scope and impact of the federal tax reform on California taxpayers is yet to be determined. Based on the size, complexity and multitude of external factors, it may take years to fully understand the impact of the federal changes on taxpayer liabilities and decisions. The new laws on business are extremely complex and the impact could be drastically different depending on each taxpayer's unique situation and the decisions they make. For example, professional service firms are treated much differently than other pass-through entities and may not be able to use the lower rates under the new federal laws. Further, many service providers are sole practitioners, who may not be able to take advantage of lower federal tax rates in the same way as other businesses. The added business services tax, accompanying complexities and administrative costs come at a time when reliance on professional tax services is most needed.

Administrative Burden Will be Costly. The California Department of Tax and Fee Administration (CDTFA) will be tasked with administering and collecting the new tax for a new set of businesses. The CDTFA will need to develop regulations, guidance and new publications. They will also face logistical challenges to reprogram computer and software systems, modify or create new tax forms, develop new internal procedures, manage a flood of taxpayer inquiries, perform more audit and collection activities, and establish new refund and appeals programs, among others. Further, the CDTFA will need to adequately train and hire qualified staff to facilitate these changes. These undertakings will be in addition to already navigating a massive reorganization, overseeing a new cannabis tax and processing requests for tax relief from recent natural disasters.

Service providers not already set up to collect a sales tax would face administrative complexities and costs as they create and maintain point-of-sale systems to account for and properly remit sales tax. In addition to the up-front costs of implementing the system, there are ongoing costs to maintaining a system to accurately track and manage transactions. Businesses that provide services and tangible goods would need to revamp their systems to be able to separate what is a tangible good versus what is service, and appropriately calculate and collect the different rates. Any inaccuracy or misinterpretation of how the tax applies could lead to delayed compliance, inadvertent non-compliance or an incorrect assessment. All of these could be detrimental for many small, unsophisticated service providers.

California Businesses Will be at a Significant Competitive Disadvantage. SB 993 states that the business services tax would only apply to services "purchased by a business for benefit for use in California." Being subject to a costly and complex new tax will be detrimental to the health of businesses in California and put them at a serious competitive disadvantage to out-of-state competitors. The added burden in an already challenging business climate can force businesses to make decisions between expanding, hiring and even surviving.

Small and Medium Sized Businesses Will Be Most Impacted Despite Exemptions. The small-business exemption in SB 993 only applies to very small businesses. There are many small and self-employed businesses that exceed the $100,000 threshold, but still operate under very tight margins. These are the businesses that will be most negatively impacted by a business services tax. Large employers can avoid paying a services tax by shifting to in-house professional services instead of using the services of outside providers. Businesses that cannot afford to bring services in-house, must still engage the services of outside professionals and pay the new tax. Further, the added cost could drive many small businesses to a "do-it-yourself" approach or look at under-the-table arrangements–both of which can lead to costly mistakes and noncompliance.

Further, the exemptions remain unclear. What happens if a service provider mistakenly collects or does not collect a tax? If a recipient of a service is exempt, how would they prove that they do not need to pay the tax? How will the provider know if a user of their service is exempt? What happens if a "small business" crosses the exemption threshold and it had not been collecting or paying the tax? The provisions of SB 993 raise many significant questions about who would really be subject to this tax and who will be tasked with making the determinations.

For these reasons, we strongly oppose SB 993. A new business services tax would not assist in improving California's tax code and will have dramatic negative consequences for all Californians.

Thank you for your consideration of our concerns and please contact us should you have any questions.

Respectfully,

Jason Fox,
Director, Government Relations

cc: Members, Senate Committee on Governance and Finance
Colin Grinnell, Staff Director, Senate Committee on Governance and Finance
Scott Chavez, Consultant, Senate Republican Caucus