EVALUATION OF ALTERNATIVES TO THE CITY'S GROSS RECEIPTS BUSINESS TAX

REPORT

TO

THE CITY OF LOS ANGELES
OFFICE OF FINANCE
TAX & PERMIT DIVISION

January 14, 2004

MBIA MuniServices Company

In Association With
Burr Consulting
Colantuono, Levin & Rozell, APC
Gary Painter
Robert E. Cendejas
Robert Wassmer
Ryan & Company
Stuart Gabriel

FORWARD

ACKNOWLEDGEMENTS

This report has been prepared by a panel of experts in accounting, economics, law and tax administration under the auspices of MBIA MuniServices Company (MMC). The panel has convened to review the full list of alternatives, to identify the alternatives that merit in-depth analysis, and to assess which alternatives merit becoming policy recommendations. The panel included the following individuals:

- Marc Herman, MMC President, Project Director
- Dave Boisselle, Municipal Audit Expert;
- Beverly Burr, Economist and Principal Author;
- Richard Carlson, State and Local Tax Accountant;
- Robert Cendejas, Transition Expert;
- Michael Colantuono, Municipal Finance Attorney;
- Stuart Gabriel, Real Estate Economist;
- Mark Mandell, Municipal Finance Attorney;
- Tom Mauk, Tax Administration Expert;
- David Naney, State and Local Tax Consultant;
- Gary Painter, Urban Economist; and
- Robert Wassmer, Tax Economist.

The opinions expressed in this report are solely those of the authors and do not necessarily represent the views of the University of Southern California, California State University—Sacramento, or Ryan & Company. The opinions expressed in this report provide the perspective of municipal tax and economic experts and should not be considered a substitute for the policy deliberations and decisions to be made by the City of Los Angeles Mayor and Council.

This evaluation was greatly aided by the guidance, interviews and data provided by the City of Los Angeles (hereafter, "the City") working group on tax reform, which includes representatives of the Mayor's Office of Economic Development, Office of Finance, Chief Legislative Analyst, City Administrative Officer and the Business Tax Advisory Committee. The working group members,

along with representatives of the City Attorney's office, participated in discussions of evaluation criteria, alternatives, and policy issues with the expert panel.

In addition to research conducted by the panel members, Lisa Boland and Beverly Raine of MBIA MuniServices Company coordinated and conducted municipal benchmark studies and a taxpayer survey, in addition to providing research, writing, and editing assistance throughout the report. Merrillee Fellows of Colantuono, Levin & Rozell drafted sections of the report, as did Natalia Golotvina of Burr Consulting. Annie Voy of Burr Consulting conducted the user fee benchmark study and municipal tax policy research. Humberto Macias and Cecelia Griego of Burr Consulting provided municipal tax policy and taxpayer research assistance.

GUIDE TO DOCUMENT

The Executive Summary provides a brief overview of the report findings and recommendations.

For readers interested in background, specifics, analysis, and references, please proceed to the body of the report where such issues are addressed:

- The first chapter provides the policy context and the purpose of the report;

- The second chapter provides an overview of the existing business tax, an orientation as to how the City's current business tax policy is structured, and a comparison of the City's business tax revenue reliance and rates with benchmark cities;

- The third chapter discusses the revenue-neutrality and legal constraints associated with designing tax alternatives. This chapter provides an analytical framework to promote consistency, intellectual rigor and objectivity in the evaluation of alternatives to the business tax. It explains how evaluation is performed in light of conflicting and competing policy objectives;

- The fourth chapter provides policy lessons from tax reform efforts in seven states. Further, it provides the results of two business community roundtables and a Los Angeles taxpayer survey. Finally, it discusses the panel's evaluation of the existing business tax;

- The fifth chapter explains the differences between various measures of economic activity. It includes an overview of business income explaining the accounting differences between income, value-added, and gross receipts. This chapter also explains and illustrates the differences between businesses in real estate usage, ownership, and costs—issues relevant to commercial occupancy taxation;

- The sixth chapter provides the long list of tax policy alternatives initially identified as well as the preliminary evaluation of these alternatives. Further, it provides explanation as to why the consultants rejected certain alternatives for purposes of in-depth study in this report;

- The seventh chapter provides in-depth analysis of the commercial occupancy alternative;

- The eighth chapter provides in-depth analysis of the net receipts alternative;

- The ninth chapter provides in-depth analysis of the net receipts classification ("modified receipts") alternative;

- The tenth chapter presents a hybrid net receipts and square footage approach;

- The eleventh chapter provides the consultants' analysis, evaluation results and policy recommendations;

- The appendix provides supplemental tables.

TABLE OF CONTENTS

FORWARD I

ACKNOWLEDGEMENTS I
GUIDE TO DOCUMENT II

GLOSSARY 5

EXECUTIVE SUMMARY 8

STUDY OBJECTIVES 8
STUDY PHASES 8
BUSINESS TAX OVERVIEW 9
EVALUATION APPROACH 11
REFORM PERSPECTIVES 12
POLICY EVALUATION 13
RECOMMENDATIONS 17
EXAMPLES OF EFFECTS ON TAXPAYERS 20

CHAPTER 1: INTRODUCTION 22

POLICY ANALYSIS PHASES 22
CAVEATS 24

CHAPTER 2: BUSINESS TAX OVERVIEW 25

BUSINESS TAX PRINCIPLES 25
BUSINESS TAX REPORTING 29
OUTSIDE-CITY TAXPAYERS 36
BUSINESS TAX IN NEIGHBORING CITIES 39
BUSINESS TAXATION IN LARGE CITIES 45

CHAPTER 3: EVALUATION APPROACH 47

REVENUE NEUTRALITY CONSTRAINT 47
LEGAL CONSTRAINTS 48
OPTIMAL TAXATION 53
EVALUATION CRITERIA 55

CHAPTER 4: POLITICS OF REFORM 59

BUSINESS TAX REFORM: LESSONS FROM THE STATES 59
BUSINESS COMMUNITY PERSPECTIVES 65
BUSINESS TAX EVALUATION 67

CHAPTER 5: MEASURES OF ECONOMIC ACTIVITY 73

VALUE PRODUCED 73
REAL ESTATE USAGE 76

CHAPTER 6: INITIAL EVALUATION OF ALTERNATIVES 81

BASE ALTERNATIVES 81
CLASSIFICATION ALTERNATIVES 88
INSTRUMENT ALTERNATIVES 90
RATE RESTRUCTURING 91
POLICY ADD-ONS 93
ALTERNATIVES SELECTED 94

CHAPTER 7: COMMERCIAL OCCUPANCY SCENARIOS 96

POLICY STRUCTURING CHALLENGES 96
COMMERCIAL RENTAL TAX 98
SQUARE FOOTAGE TAX 101
POLICY SPECIFICS 102
EFFECTS BY BUSINESS TYPE 105

Revenue Effect 106
Economic Effects 107
Evaluation 108

CHAPTER 8: VALUE-ADDED SCENARIO 110

Adapting the Tax to Los Angeles 112
Policy Specifics...112
Effects by Business Type..114
Revenue Effect 115
Economic Effects 116
Evaluation 117

CHAPTER 9: VALUE-ADDED PROXY ('MODIFIED RECEIPTS')..121

Policy Details...121
Effects by Business Type..122
Revenue Effect 125
Economic Effects 126
Evaluation 127

CHAPTER 10: HYBRID SCENARIO 128

Policy Details...129
Effects by Business Type..131
Revenue Effect 134
Examples of Effects on Taxpayers 135
Economic Effects 138
Evaluation 140

CHAPTER 11: CONCLUSIONS 142

Findings...142
Recommendations 143
Implementation Plan 146

REFERENCES 151

Books, Reports and Articles 151
Data...154

APPENDIX A: SUPPLEMENTAL TABLES 155

LIST OF TABLES & FIGURES

FIGURE 2-1: BUSINESS TAXPAYERS AND REVENUE BY TAX CATEGORY, 2003 25
FIGURE 2-2: GROSS RECEIPTS AND COMPARABLE (VALUE-ADDED) TAX RATES BY SECTOR....26
TABLE 2-3: LOS ANGELES TOP EXPORT INDUSTRIES, 2001 28
FIGURE 2-4: TAXPAYERS AND TAX REVENUE BY NUMBER OF TAX CATEGORIES, 2003 29
FIGURE 2-5: MULTI-CATEGORY FILERS AS SHARE OF TAXPAYERS AND TAX REVENUE, 2003 30
FIGURE 2-6: MULTI-CATEGORY FILERS ELIGIBLE FOR SINGLE-CATEGORY REFORM, 2003....30
TABLE 2-7: BUSINESS TAX RATES BY TAX CATEGORY, 2003....32
FIGURE 2-8: LATE PAYMENT PENALTIES: LOS ANGELES VS. CALIFORNIA....35
FIGURE 2-9: BUSINESS TAX BY ADDRESS LOCATION....36
FIGURE 2-10: OUTSIDE-CITY BUSINESS TAX REVENUE SHARE BY INDUSTRY, 2003 38
FIGURE 2-11: BUSINESS TAX BASE IN LA COUNTY CITIES....39
TABLE 2-12: CALIFORNIA CITY SQUARE FOOTAGE TAXES....40
FIGURE 2-13: CALIFORNIA CITY REVENUE AS % OF GENERAL FUND 42
FIGURE 2-14: MUNICIPAL REVENUE AS % OF GENERAL FUND, FY 00-01 43
TABLE 2-15: MUNICIPAL BUSINESS TAX AS % OF CITY OF LA BUSINESS TAX....44
FIGURE 2-16: U.S. CITIES BUSINESS TAX REVENUE SHARE, FY 2002-3 45
TABLE 4-1: GROSS RECEIPTS TAX RATES: WASHINGTON VS. LOS ANGELES....63
TABLE 4-2: GROSS RECEIPTS AND COMPARABLE (VALUE-ADDED) TAX RATES....70
FIGURE 5-1: BUSINESS RECEIPTS AS % OF TOTAL RECEIPTS BY INDUSTRY 73
FIGURE 5-2: RETAILERS GROSS MARGIN AS % OF BUSINESS RECEIPTS....74
FIGURE 5-3: WHOLESALERS' GROSS MARGIN AS % OF BUSINESS RECEIPTS....74
FIGURE 5-4: VALUE-ADDED AS % OF BUSINESS RECEIPTS 75
FIGURE 5-5: COMMERCIAL BUILDINGS OWNED BY PRIMARY OCCUPANT, 1999 76
FIGURE 5-6: TOP 10 OWNER-OCCUPIED SERVICE INDUSTRIES....77
FIGURE 5-7: SQUARE FOOTAGE PER WORKER....78
FIGURE 5-8: INDUSTRIAL ANNUAL LEASE RATE PER SQUARE FOOT....79
FIGURE 5-9: OFFICE ANNUAL LEASE RATE PER SQUARE FOOT....79
FIGURE 5-10: BUILDING RENT AS % OF RECEIPTS AND OPERATING EXPENSES 80
FIGURE 6-1: RATE COMPRESSION 91
FIGURE 6-2: MINIMUM TAX STANDARDIZATION....92
FIGURE 6-3: TAX CEILING....92
FIGURE 6-4: NON-LINEAR TAX RATE....92
FIGURE 7-1: HOME-BASED BUSINESS SHARE OF BUSINESS TAX ACTIVITY 97
FIGURE 7-2: SHARE OF BUSINESS TAX ACTIVITY BY BUILDING OCCUPANT TYPE 98
FIGURE 7-3: BUSINESS TAXPAYER-PARCEL MATCH RATES....99
FIGURE 7-4: SQUARE FOOTAGE TAX RATES 102
TABLE 7-5: SQUARE FOOT SCENARIO REVENUE IMPACTS BY INDUSTRY 104
TABLE 7-6: SQUARE FOOT SCENARIO REVENUE IMPACTS BY LOCATION....106
TABLE 7-7: SQUARE FOOT SCENARIO ECONOMIC IMPACTS ($MILLIONS)....107
TABLE 8-1: VALUE-ADDED SCENARIO IMPACTS BY TAX CATEGORY ($MILLIONS)....114
TABLE 8-2: VALUE-ADDED SCENARIO IMPACTS BY LOCATION ($MILLIONS)....115
TABLE 8-3: VALUE-ADDED SCENARIO ECONOMIC IMPACTS ($MILLIONS) 116
TABLE 8-4: VALUE-ADDED SCENARIO IMPACTS BY DETAILED INDUSTRY ($MILLIONS)....119
TABLE 9-1: MODIFIED RECEIPTS TAX CATEGORIES AND GROSS RECEIPTS TAX RATES....122
TABLE 9-2: MODIFIED RECEIPTS SCENARIO IMPACTS BY DETAILED INDUSTRY ($MILLIONS) 123
TABLE 9-3: MODIFIED RECEIPTS SCENARIO IMPACTS BY LOCATION ($MILLIONS)....125
TABLE 9-4: MODIFIED RECEIPTS SCENARIO ECONOMIC IMPACTS ($MILLIONS) 126
TABLE 10-1: HYBRID SQUARE FOOTAGE TAX RATES 130
TABLE 10-2: HYBRID SCENARIO IMPACTS BY DETAILED INDUSTRY ($MILLIONS) 132
TABLE 10-3: HYBRID SCENARIO IMPACTS BY LOCATION ($MILLIONS) 134
TABLE 10-4: EXAMPLES OF EFFECTS ON TAXPAYERS 138
TABLE 10-5: HYBRID SCENARIO ECONOMIC IMPACTS ($MILLIONS)....139
TABLE A-1: LOS ANGELES CITY AND COUNTY TRADE INDICATORS BY INDUSTRY, 2001....156
TABLE A-2: BUSINESS TAX BASE, LOS ANGELES COUNTY CITIES 160
TABLE A-3: GENERAL FUND REVENUES ($1,000S), SELECTED CALIFORNIA CITIES, FY 2000-01....161
TABLE A-4: REVENUE SOURCES AS % OF GENERAL FUND, SELECTED CALIFORNIA CITIES, FY 2000-01 162
TABLE A-5: PROTOTYPE BUSINESS FOR MUNICIPAL BUSINESS TAX COMPARISON....162

TABLE A-6: BUSINESS TAX FOR PROTOTYPE BUSINESS BY MUNICIPALITY 162

GLOSSARY

Apportionment: The division of activity within the City (taxable) and activity outside the City (nontaxable) when a business operates both inside and outside of the City. For example, a taxpayer with sales in both Los Angeles and Sacramento would deduct the Sacramento activity from its gross receipts to calculate the gross receipts taxable by the City of Los Angeles.

Benefit Principle: Equal taxation of taxpayers in the same economic situation based on the benefits that the taxpayer receives in terms of government services.

Business Tax Advisory Committee (BTAC): City of Los Angeles business tax advisory body constituted by Mayor and Council appointees.

Business Enterprise Tax (BET): Business tax policy approach with standardized minimum taxes on small businesses and a value-added approach to taxation of larger businesses. In the recommendations contained in this report, the Business Enterprise Tax also includes a square footage tax.

Department of Finance (DOF): California State agency responsible for the State budget, demographics and economic analysis.

City Administrative Office (CAO): City of Los Angeles department responsible for City management, financial advising, budgeting and revenue forecasting.

Chief Legislative Analyst (CLA): City of Los Angeles official responsible for policy analysis and research on behalf of Council members.

Cost of Living Adjustment (COLA): Increase over time in salaries, taxes or other payments to maintain the purchasing power of the payment despite reduction in the value of the dollar caused by inflation.

Cost of Goods Sold (CGS): Corporate income tax deduction for merchandise purchased by businesses like retailers for resale and for raw materials purchased by manufacturers.

Dormant Commerce Clause (DCC): The commerce clause of the U.S. Constitution requires that a tax not penalize businesses with locations outside the taxing jurisdiction or otherwise favor local businesses at the expense of outsiders.

EASE criteria: The criteria used in evaluating the tax alternatives, i.e., Economic benefits, administrability, revenue stability and equity.

Effective Tax Rate: Tax rate expressing the tax amount owed as a percent of total value-added; in this case, value-added is calculated from reported taxable gross receipts and excludes alcohol sales and the gross receipts of tax-exempt, tax-evading, and non-receipts taxpayers.

Entertainment Industry Development Corporation (EIDC): Non-profit agency that administers film permits for location filming in local jurisdictions in Los Angeles County.

General Excise Tax (GET): Hawaii's gross receipts tax.

Gross Receipts Tax: Tax collected from businesses on the tax base of total revenue received by the businesses without any deductions for business-to-business pass-throughs, such as an auto dealers' purchase of cars from importers or an architect's subcontractors. In the case of the Los Angeles gross receipts tax, there are only deductions for taxes imposed and refunds.

Horizontal Equity: Equal taxation of taxpayers in the same economic situation based on either the taxpayer's ability to pay or on the benefits that the taxpayer receives in terms of government services.

Hybrid Tax: Business tax that is based on more than one measure of the tax base, such as a hybrid tax on both square footage and net receipts.

Inflation: Increase over time in the prices of goods and services purchased by the typical consumer; typically measured with the Consumer Price Index for Urban Consumers (CPI-U).

Inflation-Indexing: Structuring a tax to maintain its purchasing power over time by automatically increasing tax policy components, such as the minimum tax, minimum tax threshold, or square footage tax rates.

MBIA MuniServices Company (MMC): City's contractor for this report and Project Manager of the City consultant team.

Minimum Tax Threshold: The threshold level in the tax base below which a taxpayer is simply required to pay the minimum tax and above which the taxpayer is required to pay a tax rate applied to a tax base such as net receipts or gross receipts. For example, professionals with less than $18,000 in gross receipts—the minimum tax threshold—pay only a minimum tax under current policy.

Modified Gross Receipts Tax: Business tax alternative with a gross receipts tax base; businesses are classified into rate categories based on the industry average ratio of value-added to gross receipts.

Net Receipts Tax: A tax collected by businesses on the portion of their gross receipts reflecting value-added under the deduction approach.

North American Industry Classification System (NAICS): Detailed industry description and categorization system first developed in 1997 and revised in 2002.

Office of Finance: City of Los Angeles department responsible for tax collection.

Panel: Panel of experts in accounting, economics, law and tax administration under the auspices of MBIA MuniServices Company (MMC). Also referred to as 'the team' or 'the consultants'.

Parcel Area: The square footage of the parcel calculated in two-dimensional space.

Payroll Tax: A tax paid by businesses as a percent of the compensation paid by that business to its employees and not deducted from the employees' pay, such as the State unemployment insurance tax or the San Francisco business tax.

Presumptive Tax: A tax that is structured as a proxy for what it is presumably attempting to tax, such as the presumptive tax charged on each lane at a bowling alley in lieu of a gross receipts tax.

Proposition 13: 1978 voter-approved California ballot measure limiting the ad valorem property tax rate, limiting growth of assessed value of property, and requiring voter approval of certain local taxes.

Proposition 218: 1996 voter-approved California ballot measure requiring voter- or property owner-approval of increased local taxes, assessments, and property-related fees.

Pyramiding Effect: Inclusion of certain economic activity multiple times in the tax base such that the economic activity is taxed multiple times, e.g. a gross receipts tax has a pyramiding effect on business-to-business transactions.

Revenue-Neutrality: In the case of business taxation, a tax policy with the same general fund revenue yield as the status quo business tax policy.

Square Footage Tax: A tax paid by businesses based on the square footage of the floor area owned or leased by the business, including improved structures and excluding unimproved land; in this case, the business square footage is derived from the total building square footage reflected on the County Assessor property tax roll.

Subcontractor: Partnership, limited partnership, corporation, business trust, joint stock company, trust, unincorporated association, joint venture, governmental entity or other entity of whatever nature hired by a vendor (other than employees) under separate contractual arrangements to perform portions of the work under an agreement.

Subcontractor Payment: Payments made by a prime contractor to another business for services rendered under a subordinate contract.

Tax Base: The measure of economic activity that is multiplied by the tax rate in order to calculate the tax liability, e.g. gross receipts.

Tax Reform Fund: City of Los Angeles special fund established in June 2001 to fund the direct costs of business tax reform measures from revenues received through business tax compliance efforts.

User Fee: Fees that users pay to cover the cost of a specific government service or program, such as state park entrance fees or garbage fees.

Value-Added: The portion of business receipts that reflects value-added by the particular business and excludes the portion of receipts that reflect business-to-business transactions, such as purchase of merchandise for resale, subcontractor payments, and purchase of materials.

Value-Added Tax: A tax collected by businesses on the portion of their gross receipts reflecting value-added and calculated under one of three methods: 1) Deduction approach with business-to-business transactions deducted from gross receipts; 2) Additive approach with payroll, profit and rent defining the tax base; or, 3) Invoice approach with consumer annual reconciliation statements filed.

Vertical Equity: Equity between taxpayers based on the tax burden as a share of the individual's disposable income; generally involves taxing low-income taxpayers at lower rates than high-income taxpayers.

EXECUTIVE SUMMARY

STUDY OBJECTIVES

This report provides an independent evaluation of alternatives to the City of Los Angeles' gross receipts business tax. It has been prepared under a contract with the City of Los Angeles for a multi-phase study that policymakers intend to result in meaningful business tax reform. This report provides a sound policy starting point and an analytical framework for the City and its constituents to consider as they debate and refine what policy will ultimately replace the City's current business tax system.

Although this report does provide tax policy recommendations, these recommendations are merely the opinions of experts in municipal finance, audit, law, urban economics, real estate economics, and public finance. The panel does not presume that its recommendations will indeed become City policy in the exact form presented in this report. The City's policymakers, business leaders, and administrators will undoubtedly refine the business tax policy recommended herein.

STUDY PHASES

The study was prepared in several phases:

1) **Identification of Feasible Alternatives**: The panel identified business taxation approaches relevant to the California legal environment.

2) **Initial Evaluation**: The panel researched the initial 'long' list of alternatives and evaluated each alternative based on the established EASE criteria: Equity, administrability, stability, and economic benefits. The panel evaluated all unique state and local business tax approaches potentially relevant within the California legal environment.

3) **Selection of Alternatives**: The panel met with the City working group to present its findings and to discuss the evaluation framework. The team then released a report recommending that three alternatives be selected for in-depth analysis. The City accepted the consultant's recommendation.

4) **In-Depth Evaluation**: Pursuant to the contract, the consultant proceeded with the analysis of those three alternatives—the topic of this report. The panel prepared a draft report with an in-depth evaluation of the general fund, economic, equity, administrative, compliance, legal and simplification effects of the three alternatives.

5) **Report Finalization**: The panel finalized the report after addressing comments from the City's administrators and tax policy experts.

6) **Taxpayer Survey**: Based on a taxpayer survey commissioned by the City, the team will provide a report to the City on pass-through activities in 30 industries. This study will

result in more refined figures on the revenue impacts of seemingly popular proposals to cease multiple taxation of pass-through activity.

7) **Scenario Analysis**: The City's policymakers—under advisement from business leaders, constituents, and administrators—will undoubtedly refine the business tax policy recommended herein. The City has requested that the panel be available to assess the revenue, economic, apportionment, administrative, transition and legal issues associated with tax policy alternatives of interest to City policymakers.

BUSINESS TAX OVERVIEW

THE CURRENT SYSTEM

Currently, the Los Angeles business tax is paid prospectively[1] for the privilege of doing business in the City in the current year.[2] The measure of the tax is the activity that occurred in the prior year and payment is due January 1.[3] About one in ten of the City's business tax dollars come from businesses with outside-City addresses.[4]

Under the existing system, businesses are required to keep track of their sales and production activity at each business site, based on different tax calculation rules for as many as 59 different tax categories. In addition, businesses must track the portion of economic activity that relates to sales and activity inside versus outside the City (i.e. apportionment) for each tax category.

Adding to the complexity of this tracking process, each of the 59 different tax categories has its own unique rules for what constitutes the tax base, tax calculations, and rules for apportionment of outside-City activity.[5] Although most categories require payment based on gross receipts, the City also uses a variety of other tax base measures, such as payroll, square footage, production costs, employees, seating capacity, flat rates, commissions, number of bowling lanes, and bus-miles.

In the case of apportionment, there are currently three factors used to determine the amount of tax that businesses within certain industries owe; these factors are payroll, property, and sales. The exact method of apportionment is determined using the rulings issued by the City, which are

[1] Prospective payment means that taxpayers pay at the beginning of the year for the privilege of doing business in the current year. By comparison, retrospective payment means that taxpayers pay for the privilege of doing business in the prior year.

[2] Nearly all taxpayers are required to file annually on the basis of gross receipts. However, there are taxes levied on a sub-annual basis, such as dance halls taxed on square footage. In addition, there are taxes levied on measures other than gross receipts; in the case of taxation of pool tables and amusement machines, the tax is paid on the number of machines or pool tables at the time of business start-up and for additional machines or tables acquired during the tax period.

[3] The tax is delinquent if not paid by March 1 of the particular tax year.

[4] Business tax estimate based on City of Los Angeles 2003 tax year business taxpayer database, with addresses geo-coded by County of Los Angeles Urban Research Division as well as MMC manual matches from Thomas Brothers and ZIMAS data sources.

[5] In practice, the maximum number of tax categories under which any individual taxpayer must file is currently eight, because no taxpayer happens to have more than eight tax categories of relevance. Currently, multi-category taxpayers constitute 12 percent of taxpayers and 33 percent of tax revenues. Recently enacted single category filing reform is expected to reduce the proportion of multi-category filers from 12 percent to 10 percent of taxpayers, based on MMC estimates from 2003 tax year data.

summarized in Chapter 2 of this report and are listed in the City's Business Tax Ordinance. While many business owners have complained that applying these rules is difficult, any simplification of these apportionment rules may result in legal risks and should be reviewed carefully by the City Attorney's Office.

Exemptions

Until recently, start-up companies were required in their first year of operation in the City limits to pay the minimum tax because their actual activity for the year is unknown at the time of start-up. Since tax year 2002, however, new businesses qualify for the start-up exemption, which enables them to avoid payment during the first two years of operation when three conditions are met:

1) The taxpayer's gross receipts are less than $500,000,[6]

2) The taxpayer files an exemption application within the first two months of forming the business,[7] and

3) The taxpayer is not a construction or motion picture business.

Businesses that do not have any activity under the non-receipts tax categories may be eligible for start-up, small business, empowerment zone, or multi-media activity tax credits.

Most businesses are required to hold a business license for each separate location doing business in the City limits, which means they must file a separate tax form for each site. However, commercial landlords, warehouses used in conjunction with a business in the City, and outside-City taxpayers are exempted from this requirement and are permitted to combine their sites for tax reporting purposes.

Comparisons to Surrounding Cities

The larger California cities, such as San Diego, San Jose, Long Beach, Anaheim, and Burbank, tend to levy the business tax on the basis of an employee-based tax rather than gross receipts. However, with the exception of Burbank and Glendale, Los Angeles' larger neighbors tend to tax on the basis of gross receipts. In all, the vast majority of LA County cities that levy taxes on businesses do so using either an employee or a gross receipts tax base.

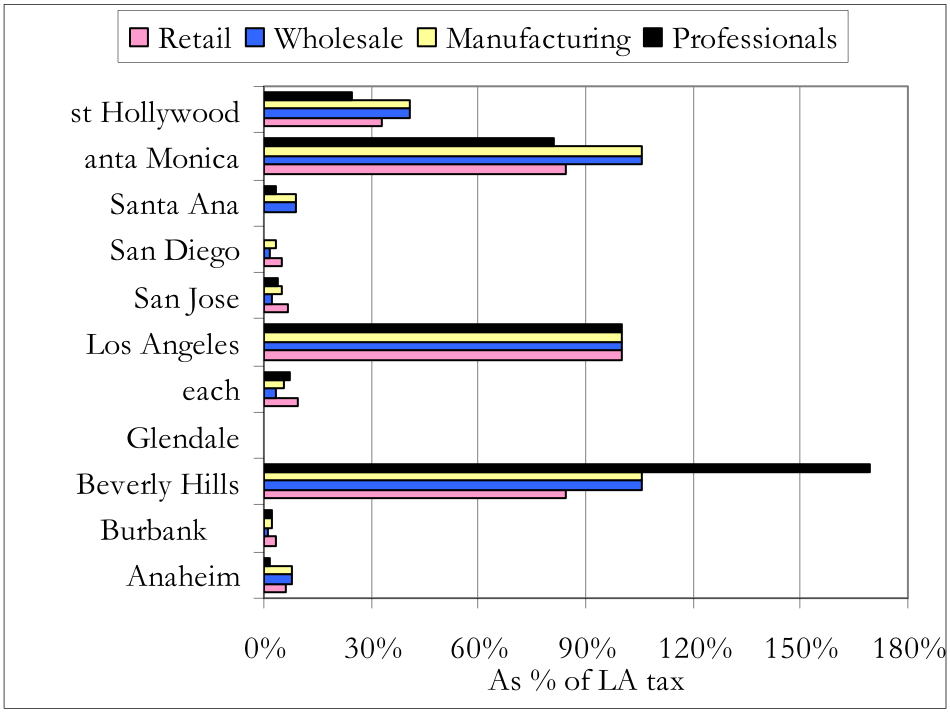
Several studies have documented the relatively high business tax rates levied in the City of Los Angeles compared with neighboring jurisdictions.[8]

[6] The second-year start-up tax exemption is scheduled to sunset at the end of 2006; however, it may be reinstated at the Council's option without voter approval.

[7] The Business Tax Ordinance provides a one-month period of time before the tax is due (21.13b), and another month before the tax is delinquent (21.05).

[8] Kosmont Companies, 2003; Loveman and Sales, 1997; Los Angeles Office of Finance, 2003; Los Angeles Economic Development Corporation, 2003.

The consultant team conducted a comparison of business taxes among larger Southern California cities based on the average business in the retail, the wholesale, the professional services, and the manufacturing sectors.[9]



Of those cities used in the comparison, only Beverly Hills and Santa Monica levy business taxes at the levels levied in the City of Los Angeles; however, Beverly Hills charges professional businesses significantly more than Los Angeles. In the case of manufacturers and wholesalers, Beverly Hills and Santa Monica levy a slightly higher rate than the City of Los Angeles. In the remaining cities, business taxes for each of the prototype businesses are modest, as depicted in the figure above. As shown, the City of Glendale does not levy a business tax.

Among the largest ten cities in the United States, Los Angeles vies with Detroit as the second or third most reliant on business taxes. Phoenix is the most reliant on business taxes of the top ten cities.[10] Other large American cities—New York, Chicago, Philadelphia and Detroit—rely less on business taxes than municipal income taxes while large Texas cities tend to rely primarily on property and sales taxes. As previously mentioned, San Diego and San Jose rely on employee-based business taxes while San Francisco relies on a payroll tax.

EVALUATION APPROACH

The analyses in this report focus on tax policy alternatives that meet various and competing goals, including the EASE evaluation criteria, which were established by the expert team:

- **Economic Benefit**: Emphasizes economic efficiency, promotion of the City's economic objectives, and minimum disruption as taxpayers make economic decisions.
- **Administrability**: Involves minimizing the cost of compliance to taxpayers, minimizing the cost to the City of enforcing tax policy, and maximizing taxpayer compliance.

[9] The average business is based on 1997 Economic Census industry data on payroll, receipts and employees for Los Angeles County. A separate prototype was established for the retail, professional services, wholesale and manufacturing sectors.

[10] Business taxes consist of local taxes paid by businesses in fiscal year 2002-3, and exclude state-levied sales taxes as well as property taxes paid by businesses. Analysis of large cities' business taxes was conducted by the MMC team based on municipal budgets and ordinances.

- **Stability**: Focuses on how the alternative would affect the volatility of the City's revenue portfolio as a whole rather than the volatility of a particular revenue stream.
- **Equity**: Emphasizes that the tax burden should be equally distributed, both horizontally and vertically, across all businesses and individuals.

In addition, the alternatives needed to be legal, feasible, and affordable, i.e. revenue-neutral. Revenue neutrality is defined very simply as raising an amount of tax revenue equal to that being raised under the status quo. In the context of the current State and local government budget crisis, the City is constrained to considering revenue-neutral tax reform policies at the present time. All of the alternatives considered have been structured to provide approximately the same general fund revenue yield as the existing policy.

The three major legal considerations to structuring and analyzing alternatives to the City's gross receipts tax include the following:

(i) The Dormant Commerce Clause,

(ii) The State Constitution's prohibition against property taxes, and

(iii) The State statutory prohibition against municipal income taxes.

REFORM PERSPECTIVES

STATE REFORM

In recent years, several states have reformed or considered reform of their business taxes to promote equity and simplicity; thus, the team studied those business tax reforms that have been contemplated and implemented in order to shed light on the successes and failures of business tax reform experiences.

The team found that many states have either eliminated their gross receipts taxes or rejected gross receipts proposals in recent decades, including Indiana, West Virginia, Nevada, Kentucky, and Ohio. The four states with a gross receipts tax—Washington, Hawaii, Delaware and New Mexico—have periodically evaluated reform, primarily focused on incremental reform to improve the equity of the receipts tax approach.

BUSINESS COMMUNITY PERSPECTIVES

The business community perceives the City of Los Angeles' business tax as uncompetitive, inequitable and overly complicated.[11] The Business Tax Advisory Committee has for several years criticized the tax as such, and has focused on incremental reforms to improve the tax. Both the

[11] Los Angeles Area Chamber of Commerce, 2003; Central City Association of Los Angeles, 2003; VICA newsletters and 2002 position paper; Kosmont Companies, 2003; Valley Vote, 2003; VICA Business Roundtable, August 2003; Business Roundtable, June 2003.

Valley Industry and Commerce Association and Valley Vote have focused on complexity and called for business tax simplification.

In the course of this study, the City, in conjunction with the research team, conducted an online survey of business taxpayers and hosted three roundtable sessions with the business community regarding alternatives to the City's gross receipts tax. From these activities, the team found that business people complained about the complexity of the existing tax. In particular, accountants and professionals complained that the apportionment rules are unclear and complicated. Furthermore, some asked for simple tax approaches, such as a flat tax or an employee tax, which could be easily apportioned.

Inequity was another issue raised by business community members. Several complained that the gross receipts tax base unfairly taxes subcontractor payments and commissions paid to talent agents. The Los Angeles Area Chamber of Commerce has identified business tax reform as its top legislative priority and is particularly concerned about the inequity of taxing business-to-business transactions multiple times.[12] Others complained that tax rates were not fair between industries.

POLICY EVALUATION

EXISTING BUSINESS TAX

There are a number of primary problems with the City's existing business tax policy:

1. The tax has a 'pyramid' effect on business-to-business transactions, meaning that certain economic activities are included in the tax base multiple times and are correspondingly taxed multiple times under the current system.[13] For example, a prime contractor with a number of subcontractors working for him must pay the tax on the receipts accruing to all of his subcontractors while the subcontractors must also pay tax on those receipts.

2. The business tax rates render the City less competitive than neighboring jurisdictions in attracting business.

3. The tax policy is overly complex, creating administration difficulties, confusion for taxpayers, and lower compliance rates.

4. The tax is not equitable, as certain industries pay a much greater share of their own 'value-added' in taxes than others.

[12] Hammer, 2003a and 2003b.

[13] For example, the receipts for a carpenter working for a general contractor, the receipts for an engineer subcontracting to an architectural firm, the auto importers' receipts for cars sold by auto dealers, the post-production firm's work for a motion picture studio, and the engine manufacturer's share of the engine wholesaler's receipts are transactions taxed multiple times under the gross receipts tax..

Initial Evaluation

Encompassed in the research, the panel evaluated all unique state and local business tax approaches potentially relevant within the California legal environment.[14] In addition, the expert panel reviewed numerous alternatives to the existing business tax base and classification scheme according to the EASE criteria. Upon completion, the team had a list of proposed alternatives from which to select those that should be analyzed in further depth.

The long list of alternatives included the following:

- Apportionment reform
- Employee tax
- Factor payments
- Flat tax
- Gross receipts tax simplification
- Gross receipts with sub-contractor deductions
- Gross receipts with energy and raw materials deductions
- Lump sum tax
- Modified receipts (net receipts classification alternative)
- Net income classification alternative
- Net receipts tax
- Operating costs
- Payroll tax
- Real estate rental receipts
- Status quo
- Square footage
- Utility users tax increase
- User fee approach
- Value-added

The panel ranked the alternatives based on the evaluation criteria using the criteria-alternatives mechanism, which led to the rejection of certain alternatives and the selection of others. Upon closer evaluation, any tax levied on business profits or depreciation—such as the factor payments tax—was deemed to be subject to legal challenge. Apportionment reform was found to be infeasible, as the City does not collect data needed to evaluate such reforms. The user fee approach was found to fail the revenue-neutrality test, as this approach could not replace existing revenue. The flat tax, lump sum tax, and utility usage tax failed to meet the equity criterion. The operating costs and real estate rental receipts taxes failed to meet the simplification criterion.

The panel ranked the alternatives based on their ability to meet the criteria, and selected the top three alternatives for in-depth analysis:

- **Square footage tax**: This alternative involves taxing businesses for the privilege of occupying commercial real estate in the City. The panel selected a square footage tax because it would improve the administrability of the tax and would present simplification. In addition, this approach improves the horizontal equity of the tax based on the benefit principle.[15]

[14] The net income tax and property tax failed to meet legal requirements. The City is precluded by State statute from levying a municipal income tax, and is precluded by the state Constitution from levying a property tax.

[15] The benefit principle refers to equal taxation of taxpayers in the same economic situation based on the benefits that the taxpayer receives in terms of government services.

- **Net receipts tax**: This alternative involves taxing businesses on their production activity and is calculated by deducting the major forms of pass-through activity from gross receipts. The efficiency of the business tax would be greatly improved by eliminating the double-taxation of raw materials, subcontractor payments, and other receipts that do not constitute any form of income for the business. This approach greatly improves the horizontal equity of the tax based on ability to pay.

- **Modified receipts**: This alternative would reclassify industries into equitable tax rate categories based on net receipts, would provide rate parity and simplification, and would retain the existing gross receipts tax base. This approach improves the horizontal equity of the tax based on ability to pay.

Commercial Occupancy Tax

In assessing a tax on commercial rentals, the panel found that 30-40 percent of business taxpayers are located in owner-occupied buildings and do not pay rent. The panel found that taxing owner-occupied businesses based on rent comparables—the rent they would receive if their space were leased to another party—is a legal approach. However, taxing owner-occupied businesses would be administratively cumbersome, requiring the City to conduct statistical modeling to estimate the tax owed by 30-40 percent of its taxpayers. This approach was rejected in favor of a square footage approach, which does not raise challenges in the taxation of owner-occupied businesses.

A pure square footage tax would involve businesses paying the tax based on the square footage used for business purposes in excess of 250 square feet. Business tenants would pay on the square footage leased within the structure as well as any leased outdoor space, such as parking. Home-based businesses would pay based on the portion of the home used for business purposes, as reported to the Internal Revenue Service. Landlords would pay the tax on common space, areas used for property management offices, and leasable space that is not occupied. The landlord could deduct the square footage of all space leased by tenants holding a business registration certificate or a business exemption certificate if they report the deducted tenants on their form, a requirement which is expected to promote compliance.

The panel evaluated the pure square footage approach and determined that the benefits of the square footage approach include simplicity, compliance improvements, revenue stability and improved equity based on the benefit principle. The drawbacks of complete reliance on a square footage tax involve significant reduction in the tax burden of taxpayers located outside the City limits and negative effects on vertical equity[16].

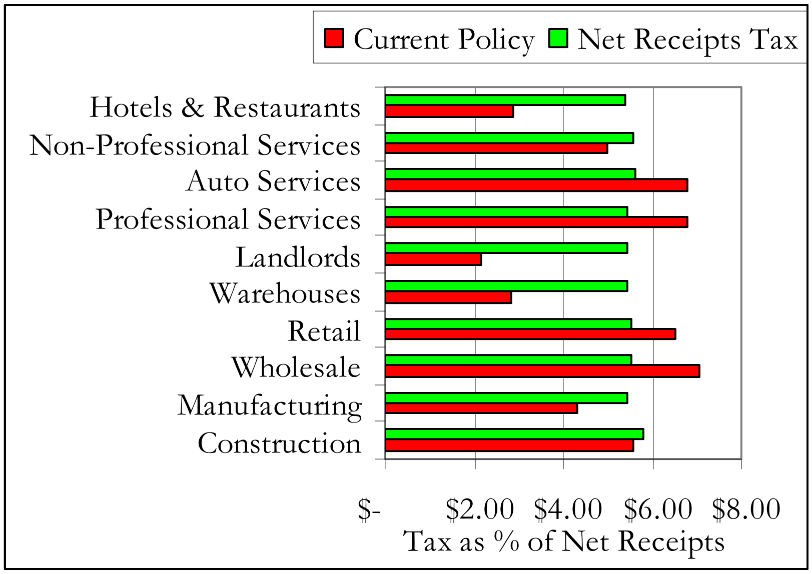
[16] Vertical equity between taxpayers refers to the progressive nature of that tax, as measured by the tax burden as a share of the individual's disposable income; this principle generally involves taxing low-income taxpayers at lower rates than high-income taxpayers.

NET RECEIPTS TAX

Under a pure net receipts tax, businesses with net receipts in excess of $30,000 would pay a uniform rate of $4.90 per $1,000 in net receipts.[17] The taxable base would be defined as gross receipts less deductions for cost of materials[18] and subcontractor payments[19]. The prime contractor would not receive the tax deduction for subcontractors without a registration or exemption certificate, and must report the subcontractor's name, address, and receipts. This requirement is expected to promote compliance and help the City identify businesses that are not currently complying with the business tax.

Approximately half of the businesses have net receipts less than $30,000, and would simply pay the $145 minimum tax. The remaining businesses would pay a tax on their net receipts in excess of $30,000.[20] Start-ups and small businesses with less than $5,000 in receipts would pay only a special filing fee of $25.

This policy alternative tends to benefit companies located inside the City with modest tax relief and increases the business tax liability of companies with addresses outside the City limits by about 20 percent. Outside-City business would pay more under this alternative because such businesses are concentrated in industries like construction that would face a tax increase under the net receipts approach.



The beneficiaries of this policy alternative are the industries that are currently taxed heavily under the gross receipts tax, such as law offices, management consultants, accountants and doctors' office, health maintenance

[17] The actual rate would most likely be significantly lower so long as taxpayers currently taxed on odd and presumptive tax rates are successfully converted to the net receipts tax base. A lack of meaningful receipts data on motion picture companies and amusements limits our ability to forecast scenario revenue for these industries; hence, this report erred on the side of caution and certainty.

[18] Materials deductions would include the cost of merchandise purchased from a separate company and resold to customers as well as the cost of raw materials that become an "identifiable element" of the goods or services sold directly by the taxpayer. Hence, the purchase of goods for resale by wholesalers and retailers would be deductible, the purchase of raw materials used as part of the manufacturers' final product would be deductible, and the purchase of raw materials resold by service sector companies would be deductible (e.g. hotel toiletries, Kinko's paper supplies).

[19] A subcontractor is a partnership, limited partnership, corporation, business trust, joint stock company, trust, unincorporated association, joint venture, governmental entity or other entity of whatever nature hired by a vendor (other than employees) under separate contractual arrangements to perform portions of the work under an agreement. Subcontractor payments are deductible in Bakersfield, Davis, Santa Ana, Stockton and Berkeley; but the term is not explicitly defined in their respective Municipal Codes.

[20] The source for these and all other estimates relating to the Los Angeles business tax is the MMC tax policy model, which is based on 2003 Los Angeles business tax data cross-matched by address with geographic identifiers and parcel data and cross-matched by business name and address with sales tax data, phone numbers and employment data.

organizations, and auto parks. The industries affected most adversely pay relatively low taxes compared with other industries under the current gross receipts tax system, such as landlords, phone companies, theaters, broadcasters and multi-media companies.

This type of tax would improve economic benefits as it eliminates the ability to tax businesses multiple times. Businesses with low profit margins but high gross receipts will no longer be discouraged from doing business because of inequitably large tax burdens. This alternative would reduce compliance costs for the half of the businesses that would be paying a simple minimum tax to recoup business license costs. For the 110,000 businesses with net receipts over $30,000 the business tax calculation would be less complicated in the sense that there are no separate tax categories and more complicated in that the taxpayer must account for and report deductions in order to benefit. This type of tax would improve horizontal equity, as businesses that have higher costs are not penalized.

Modified Receipts Tax

Under a modified receipts alternative, taxpayers would be assigned to one of seven tax categories, which are based on the portion of receipts attributable to net receipts in the particular industry, while continuing to pay the tax based on gross receipts. The taxpayer's industry would be the basis for assigning that taxpayer to a rate category. The tax rates are designed to be lower for industries with low net receipts (as a share of gross receipts) and to be higher for industries with higher net receipts.

The panel determined that the net receipts approach provides greater benefits than the modified receipts approach. The modified receipts alternative does not provide as great a degree of horizontal equity as the net receipts approach because taxpayers are classified in an approximate fashion based on the industry average net receipts.[21] Further, the modified receipts approach does not eliminate taxing business-to-business transactions multiple times at the taxpayer level as effectively as the net receipts approach. Finally, the modified receipts approach does not contain any provisions that would be expected to promote compliance.

Recommendations

The panel recommends that the City replace the existing tax with a Business Enterprise Tax (BET). The BET would raise three-quarters of revenue through a net receipts tax and the remainder through a square footage tax.

Net Receipts

A net receipts tax is collected by businesses on the portion of their gross receipts that reflects value-added under a deduction approach. Under the BET, the taxable base would be defined as

[21] Unlike the net receipts approach, the modified receipts approach does not recognize differences between taxpayers within a particular industry in reliance on business-to-business transactions. The modified receipts approach only approximately recognizes such differences at the industry level, because industries are classified into a discrete number of tax categories.

gross receipts less deductions for cost of materials[22] and subcontractor payments[23], with a uniform rate being applied across industries. In order to receive the subcontractor deduction, the prime contractor must report each subcontractor's identity and receipts to the City. This policy would ultimately restructure the minimum tax to recover the City's costs of administering the business license program while maintaining apportionment rules that are similar to the current system.

This approach has specific advantages over the current gross receipts tax, as it does the following:

1. Increases the tax's level of economic efficiency and reduces interference in economic decisions;
2. Reduces the number of tax classifications and promotes simplicity for small businesses, as they would be exempt from the tax;
3. Provides revenue stability;
4. Promotes equity as it allows businesses to deduct pass-through expenses from gross receipts and is based on the taxpayers' ability to pay; and
5. Promises future equity to the City's taxpayers, as the uniformity of the tax rate does not promote opportunities for the City to provide special rates to particular industries.

The revenue-neutral net receipts tax rate would be $3.50 per $1,000 in net receipts. Over half of the businesses would simply pay the filing fee or minimum tax because their net receipts are less than the $42,000 minimum tax threshold. These small businesses would simply pay the $145 minimum tax, while start-ups and businesses with less than $5,000 in receipts would only pay the $25 filing fee.

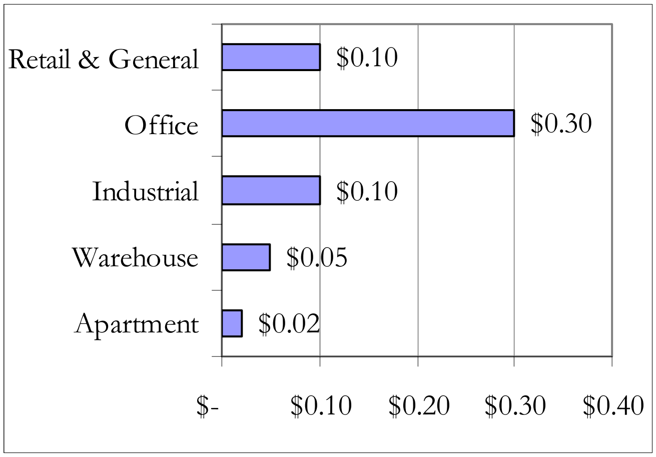
SQUARE FOOTAGE

The square footage portion of the BET is a tax upon the privilege of operating a business within the City. The tax base would include all improved space, including non-leasable space, such as common areas like elevators, and exterior space used for inventory, such as the outdoor portions of home improvement centers and car dealership lots. The measure of the tax would be the amount of square feet of building space (and outdoor space used to provide services or display inventory) used in the course of business, with the first 250 square feet being exempt. For those businesses with more than 250 square feet of space, the surplus area will be taxed at a rate based on the primary use of that building—retail, office, industrial, warehouse or apartments.

[22] Materials deductions would include the cost of merchandise purchased from a separate company and resold to customers as well as the cost of raw materials that become an "identifiable element" of the goods or services sold directly by the taxpayer. Hence, the purchase of goods for resale by wholesalers and retailers would be deductible, the purchase of raw materials used as part of the manufacturers' final product would be deductible, and the purchase of raw materials resold by service sector companies would be deductible (e.g. hotel toiletries, Kinko's paper supplies).

[23] A subcontractor is a partnership, limited partnership, corporation, business trust, joint stock company, trust, unincorporated association, joint venture, governmental entity or other entity of whatever nature hired by a vendor (other than employees) under separate contractual arrangements to perform portions of the work under an agreement. Subcontractor payments are deductible in Bakersfield, Davis, Santa Ana, Stockton and Berkeley; but the term is not explicitly defined in their respective Municipal Codes.

The tax rate for each type of commercial use was designed to be revenue-neutral.[24] The general tax rate would be 10 cents per square foot annually. For office space, the rate would be 30 cents per square foot annually. Whereas, warehouses and hotels would pay 5 cents per square foot and apartment owners would pay 2 cents per square foot annually. Most home-based businesses use less than 250 square feet, so most would not be required to pay on square footage, although they would be required to report the square footage amount on the tax form.



To promote equity, several rate categories have been proposed:

1. **Multi-Family Housing**: Residential landlords would pay at the lowest rate ($0.02 per square foot)
2. **Warehouse**: Warehouse occupants and hotels would pay at the second rate ($0.05 per square foot)
3. **Industrial/Retail/General**: Industrial, retail and general occupants would pay at the third rate ($0.10 per square foot).
4. **Office**: Office occupants would pay at the highest rate ($0.30 per square foot).[25]

The square footage tax would promote overall compliance and would charge businesses based on their occupancy of commercial real estate and use of City services. Commercial tenants would be required to pay on the square footage leased and commercial landlords would be allowed to deduct the square footage of their tenants holding business registration or exemption certificates.

POLICY EFFECTS

The hybrid policy would reduce the City's business tax revenues by zero percent. Had the policy been implemented in the current tax year, the City would have incurred a $0.9 million reduction in fiscal year 2002-03 business tax revenues. Notably, the hybrid alternative must be approved by the City voters and could not potentially become City policy until tax year 2006. By that time, the revenue impact in percentage terms would be expected to be a one percent increase.

The hybrid policy would not significantly affect the proportion of business tax revenues from outside-City taxpayers. Inside-City taxpayers would face a one percent tax increase, while outside-City taxpayers would receive a tax reduction of 11 percent.

The hybrid alternative would most benefit those who are currently paying high taxes relative to other taxpayers, i.e. grocery stores, grocery wholesalers, professionals, and auto dealers. Under this scenario, construction, gas stations, law offices, and doctors' offices would see a significant

[24] Within each square footage tax category, the tax rate was calculated to yield proportionally similar revenue as under the gross receipts tax, after adjusting for the revenue yield from the net receipts tax.

[25] Mixed-use landlords would pay on the primary use.

reduction in the business tax owed. On the other hand, apparel manufacturers, furniture stores, commercial landlords, parking garages, and restaurants would all see a significant increase in the business tax owed.

EXAMPLES OF EFFECTS ON TAXPAYERS

Explained in greater detail in the body of the report, the following table illustrates the practical implications of the hybrid tax reform approach using examples of actual business taxpayers without revealing the business' identity:

Example Business Description	Existing Gross Receipts Tax	Recommended Hybrid Tax	Net Receipts	Square Footage	Type of space
Construction business	$ 649	$ 501	142,480	298	Home
Apparel manufacturer (subcontractor)	$ 1,822	$ 1,473	179,560	17,172	Warehouse
Apparel manufacturer	$ 1,862	$ 2,847	644,769	6,175	Industrial
Toy manufacturer	$ 118	$ 145	6,056	225	Home
Rug importer	$ 1,966	$ 2,244	396,145	17,440	Warehouse
Surfboard wholesaler	$ 332	$ 297	70,138	1,321	Warehouse
Auto dealer	$ 42,344	$ 14,959	2,842,041	50,391	Service
Grocery store	$ 29,191	$ 22,875	5,414,155	39,528	Retail
Sound recording studio	$ 1,652	$ 2,481	609,711	3,741	Communication
Residential landlord	$ 527	$ 1,638	301,318	29,495	Multi-Family
Commercial landlord	$ 509	$ 1,077	290,883	855	Retail
Consulting firm (start-up)	$ -	$ 220	205,000	900	Office
Law office	$ 1,673	$ 1,241	270,068	1,243	Office
Full-service restaurant	$ 1,514	$ 2,739	647,230	5,008	Restaurant
Fast food restaurant	$ 2,162	$ 3,509	924,748	2,991	Restaurant
Hotel	$ 2,454	$ 6,693	910,534	70,420	Hotels
Auto body repair shop	$ 1,252	$ 1,186	235,853	3,880	Service
Dry cleaner	$ 500	$ 1,235	257,463	3,604	Service

ADMINISTRATIVE REFORMS

The panel recommends that the City implement several administrative reforms:

- Clarify and enforce situs reporting requirements;

- Track the actual parcel location of the taxpayer to boost the efficacy of computer techniques for auditing and identifying businesses not currently paying the business tax;

- Clarify and revise tax instructions and tax forms to reduce taxpayer confusion;

- Clarify apportionment rules to reduce taxpayer confusion;

- Require taxpayers to report receipts both before and after apportionment in order to more easily select taxpayers for audit and to generate data needed to study apportionment reform;

- Reduce the non-discretionary tax penalty cap from 40 percent to 25 percent so that the penalties are comparable to State penalties and not perceived as onerous.

CHAPTER 1: INTRODUCTION

This report provides an independent evaluation of alternatives to the City of Los Angeles gross receipts business tax. This report has been prepared under a contract with the City of Los Angeles for a multi-phase study that policymakers intend to result in meaningful business tax reform. Indeed, the City's Tax Reform Fund has financed the project for that very purpose.[26]

The City's elected leaders and administrators have expressed the following objectives for the ultimate policy that will replace the existing business tax:

- Simplification;
- Equity and elimination of double taxation;
- Encouragement of business retention, growth and creation;
- Business-friendly environment;
- Improved compliance and enforceability; and
- Protection of revenue stream for financing vital City services.[27]

The report only addresses the above-mentioned goals for reforming the existing business tax and does not address the City's relatively high current business tax rates.[28] The report has been prepared pursuant to a contract that required all alternatives evaluated in-depth to be revenue-neutral. Revenue-neutrality is defined very simply as raising as much in general fund revenue as the existing tax based on the 2003 tax year.[29] The City and State are currently facing significant budget deficit problems. The City may extend business tax relief in a rather straightforward process in the future, as revenue impacts are relatively simple to estimate and the political timeline is relatively short given that there is no ballot requirement.

POLICY ANALYSIS PHASES

In 1996, the City commissioned a series of studies of the business tax, the local economy, and policy alternatives. These studies culminated in two reports, which focused on the impacts of

[26] The Tax Reform Fund is a City of Los Angeles special fund established in June 2001 to fund the direct costs of business tax reform measures from revenues received through business tax compliance efforts.

[27] Mayor Jim Hahn press releases, August 5, 2002, February 24, 2003; City Council President Alex Padilla press release, March 6, 2003; Office of Finance Request for Proposal, November 15, 2002.

[28] See Chapter 2 section entitled "Business Tax in Neighboring Cities" for tax rate comparison and discussion.

[29] Revenue-neutrality is based on the goal of generating the same revenue as in the 2003 tax year. 2003 tax year revenue yield is based on 2003 business taxpayer data, with cash flow adjustments for late payments based on 2001 business tax payments through the beginning of calendar year 2003.

several policy alternatives, including a modified gross receipts approach, a payroll tax, and a flat tax.[30] Former Mayor Richard Riordan and former Council Member Richard Alatorre issued a proposal to adopt a modified gross receipts approach[31]; however, this proposal was not approved by the City Council. At that point, the City appointed a Business Tax Advisory Committee (BTAC) to study the issue and to formulate additional recommendations.

In September 2002, BTAC recommended that the City study various alternatives to the current tax, including an improved gross receipts system, a flat tax, a fee-based system and a commercial real estate rental fee.[32] In November 2002, the City solicited proposals for a consultant to study alternatives, but it did not constrain the consultant to studying the alternatives proposed by BTAC.[33] In February 2003, the City hired the MMC expert team to identify policy alternatives worthy of in-depth study and to perform such a study.

The study consisted of several phases:

1) **Identification of Feasible Alternatives**: The panel identified business taxation approaches relevant to the California legal environment.

2) **Initial Evaluation**: The panel researched the initial 'long' list of alternatives and evaluated each alternative based on equity, administrability, stability, and economic benefits.

3) **Selection of Alternatives**: The panel met with the City working group to present its findings and to discuss the evaluation framework. The team then released a report recommending that three alternatives be selected for in-depth analysis. The City accepted the consultant's recommendation.

4) **In-Depth Evaluation**: Pursuant to the contract, the panel proceeded with analysis of those three alternatives—the topic of this report. The panel prepared a draft report with an in-depth evaluation of the general fund, economic, equity, administrative, compliance, legal and simplification effects of the three alternatives.

5) **Report Finalization**: The consultant team finalized the report after addressing comments from the City's administrators and tax policy experts.

6) **Taxpayer Survey**: The team will be providing the City with a report on pass-through activity in 30 industries based on a taxpayer survey commissioned by the City. This study will result in more refined figures for the revenue impacts of seemingly popular proposals to cease multiple taxation of pass-through activity.

7) **Scenario Analysis**: The City's policymakers—under advisement from business leaders, constituents, and administrators—will undoubtedly refine the business tax policy

[30] UT Strategies, et al, 1997; Burr, Reardon and Coomes, 1997.

[31] Riordan and Alatorre, 1998.

[32] Selter, July 2002; Kohn and Walker, September 2002.

[33] City of Los Angeles Office of Finance, November 2002.

recommended herein. The City has requested that the consultant team be available to assess the revenue, economic, apportionment, administrative, transition and legal issues associated with tax policy alternatives of interest to City policymakers.

CAVEATS

The panel has prepared a framework, a tax policy model, and evaluation of three alternatives to existing policy. Although this report does provide tax policy recommendations, these recommendations are merely the opinions of experts in municipal finance, audit, law, urban economics, real estate economics, and public finance.

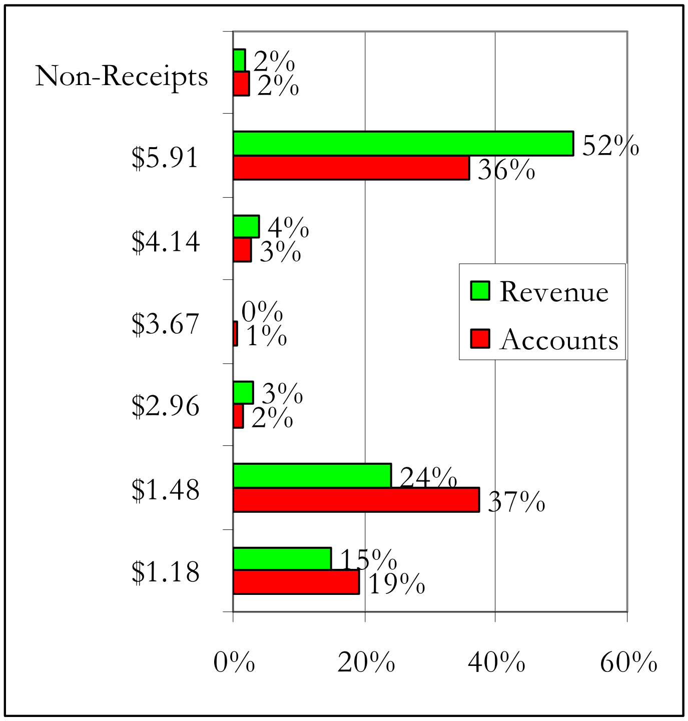
This report provides a policy starting point and an analytical framework for the City and its constituents to consider as they debate and refine what policy will ultimately replace the City's current business tax policy. The panel does not presume that its recommendations will indeed become City policy in the form presented in this report.

This report does not presume to provide the actual ballot measure, new business tax ordinance, or new tax forms associated with the recommendations contained herein. Once the City's policymakers determine the optimal business tax policy direction, the City will need to draft a business tax reform ballot measure. Similarly, the City will need to specify a number of specific details of that business tax policy in order to prepare a new business tax ordinance. This report aims to assist the City in deciding the optimal policy direction and to consider implementation issues in reaching that decision. Implementation decisions and policy details must be determined in light of the optimal business tax policy direction determined by the City's policymakers.

CHAPTER 2: BUSINESS TAX OVERVIEW

The City's business tax was established in the late 1800's as a flat tax and became a gross receipts tax in the 1940s. It has since evolved to become a rather complex set of ordinances that require most businesses to pay an annual tax on gross receipts for the privilege of conducting business within the City limits. The tax is one of the City's major revenue sources, providing as much revenue to the City's general fund as the City's share of sales and use taxes. For the most part, the City levies the tax on the gross receipts generated within the City limits net of inter-company transfers; however, certain segments of the economic base are taxed differently.

Figure 2-1: Business Taxpayers and Revenue by Tax Category, 2003



Nearly all the revenues generated by this tax emanate from tax categories based on gross receipts. As provided in Figure 2.1, the predominant tax rates (per $1,000 in gross receipts) among gross receipts taxpayers are $1.18 for manufacturers and wholesalers, $1.48 for retailers, and $5.91 for service providers.[34] In addition, there is a plethora of miscellaneous tax categories in which a tax is levied on square footage, production costs, concessions, machines, circus seats, payroll, or on a lump sum basis.[35] Furthermore, certain providers of local transportation services are taxed using special worksheets to determine activity within the City limits.

BUSINESS TAX PRINCIPLES

City policymakers appear to have followed various philosophical principles as they designed and reformed the City's business tax system over the last 80 years. These principles include the following:

[34] Standard economic data classifies businesses engaged primarily in producing goods as manufacturers, and classifies businesses primarily engaged in reselling goods to retailers as wholesalers. The City's business tax is imposed at the point of sale of the good, and is imposed on manufacturers even though the transaction is characterized as wholesaling.

[35] For example, dance halls are taxed on square footage, motion picture producers on production costs, carnivals on booths, arcades on machines, circuses on the number of seats, construction on payroll (in addition to receipts), and moneylenders on a lump sum basis.

1) Equity between sectors of the economy;

2) Relief for export-oriented businesses;

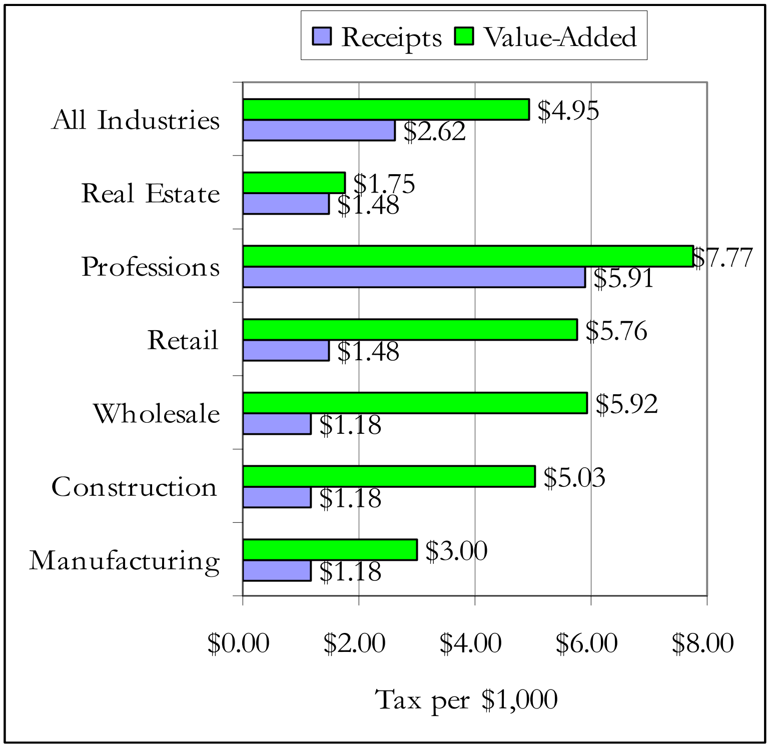
3) Relief for start-up businesses;

4) Special efforts to tax amusement-related businesses.

EQUITY

In general, there is a correlation between the gross receipts tax rate for an economic sector and that sector's 'value-added' or, in other words, its actual activity not including its pass-through receipts paid to other businesses serving as vendors or subcontractors.[36] Businesses like law firms with high value-added do not typically have most of their receipts tied up in materials or subcontracts. Thus, they are taxed at a relatively high gross receipts tax rate ($5.91 per $1,000 in gross receipts). In contrast, retail businesses typically must invest their receipts heavily in new inventory and, as a result, have much lower value--added. Their gross receipts are taxed at a lower rate ($1.48 per $1,000 in gross receipts).

Figure 2-2: Gross Receipts and Comparable (Value-Added) Tax Rates by Sector



The gross receipts tax rates are not comparable because gross receipts include pass-through activity, which varies significantly by type of business. In order to compare the tax rates between economic sectors, we must convert the gross receipts tax rates to a value-added basis.[37] The actual gross receipts tax rates and the comparable tax rates converted to a value-added basis are displayed in Figure 2-2.

The current gross receipts tax rates do not fully account for differences between sectors of the economy in value-added. The average gross receipts tax rates for all taxable businesses is $2.62 per

[36] "Value-added" is the value that is added by the particular business through the productive activity of its own employees, managers and entrepreneurs. Value-added is the total receipts of a business minus the part that the business pays to its vendors, subcontractors, and suppliers. For example, a clothes store adds value by arranging merchandise and assisting customers, but passes through the value of the clothes that was added by the clothes manufacturer.

[37] The gross receipts tax rates are converted to the comparable basis of value-added by dividing the gross receipts tax rate by the ratio of value-added to gross receipts for each industry. This calculation results in a tax rate expressed in $1,000s of value-added. The calculation is made using data on the ratio of value-added to gross receipts from 2000 corporate income tax returns. For the construction industry, the value-added tax rate is calculated as total taxes paid divided by value-added, because this industry is taxed based on gross receipts as well as payroll.

$1,000 in gross receipts, which is the same as $4.95 per $1,000 in value-added. The comparable (value-added) tax rates for professions, retail, wholesale and construction are higher than the average rate, while the comparable tax rates for real estate and manufacturing are lower than the average rate.

For comparable tax rates by industry, see Chapter 4.

Relief for Export-Oriented Businesses

Another principle embodied in the City's business tax policy is relief for export-oriented industries. Three reasons why the City may have structured lower tax rates for these industries in the past include the following:

1) Job creation: Export-oriented businesses create local jobs from revenue from customers outside the local area, according to the economic base hypothesis.

2) Geographic mobility: Export-oriented businesses compete in national markets and tend to be geographically mobile.

3) Cost sensitivity: Export-oriented businesses compete against other firms outside the Los Angeles area that are not paying the local business tax.

In comparing tax rates between economic sectors, researchers learned that the manufacturing sector is taxed at a relatively low level compared with retail, wholesale and professional services. Similarly, the large motion picture producers are taxed at a relatively low level.[38] Manufacturers and motion picture producers are the industries most extensively involved in producing for national and international markets outside the Los Angeles area, as indicated in Table 2-3.[39]

		2001 Private Sector Jobs (1000s)		Location Coefficient	
NAICS	Industry	USA	LA City	LA County	LA City
5121	Motion Picture & Video Industries	338	44	8.7	10.4
5122	Sound Recording Industries	29	4	5.5	9.8
3152	Cut & Sew Apparel Manufacturing	335	41	6.9	9.8
7115	Independent Artists, Writers & Performers	37	4	8.9	8.5
7114	Agents & Managers for Artists, Athletes, Entertainers, Public Figures	15	1	8.5	7.2
3159	Apparel Accessories & Other Apparel Manufacturing	30	2	3.5	5.3
4243	Apparel, Piece Goods & Notions Wholesalers	153	10	4.0	5.3
4239	Miscellaneous Durable Goods Wholesalers	270	11	2.4	3.2
5412	Accounting, Tax Preparation, Bookkeeping & Payroll Services	878	35	2.3	3.1
5161	Internet Publishing & Broadcasting	44	2	2.3	3.1
3133	Textile & Fabric Finishing & Fabric Coating Mills	93	3	2.2	2.7
5152	Cable & Other Subscription Programming	94	3	2.0	2.7
4883	Support Activities for Water Transportation	95	3	4.0	2.6

Sources: Bureau of Labor Statistics; CA Employment Development Department; Los Angeles County Urban Research Division

Location coefficient is the ratio of the industry-specific share of U.S. employment in LA City to the aggregate share of U.S. employment in LA City

[38] The business tax is capped at $12,712 for motion pictures producers with $4.2 million or more in production costs. The tax rates for this industry are not comparable due to the use of a different tax base and the fact that large studios have no need to apportion because of the tax cap.

Table 2-3: Los Angeles Top Export Industries, 2001

RELIEF FOR START-UP BUSINESSES

Another principle embodied in the Los Angeles business tax is relief for start-up businesses during their first two years of operation. The business tax ordinance encourages entrepreneurship and business formation by providing tax relief for start-up businesses during their first few years of operation.[40]

The start-up tax relief is relatively new. Since tax year 2002, new businesses are exempted from paying during the first two years of operation under three conditions:

1) If the taxpayer's gross receipts are less than $500,000;[41]

2) If the taxpayer files an exemption application within the first two months of forming the business;[42] and

3) If the taxpayer is not a construction or motion picture business.

More specifically, when a business first starts up, it does not typically have any revenues and no one knows how much revenue will materialize. Although the business owner may have projections of his future activity at the time of start-up, the owner cannot know with any certainty what the future will bring and must typically engage in marketing activities, such as creating a website, advertising, or distributing leaflets in order to attract potential clients and customers. In most cases, a business start-up involves the owner taking a gamble that the goods or services he has to offer will be purchased. For example, when a restaurant opens its doors, the owner must also engage in marketing activities; the new restaurant owner does not know how popular his restaurant may be and does not know what his future revenues will be at the time of start-up.

Taxpayers required to file on a quarterly or more frequent basis do not qualify for the startup exemption. For businesses in non-receipts tax categories, the start-up tax credit is calculated based on the gross receipts of the business without regard to their non-receipts activity.[43]

[39] Location coefficients measure the share of local employment in an industry compared with national employment. Where this ratio is high, that indicates that the local area is exporting to the rest of the country. This ratio is close to 1 when the industry is neither a significant exporter or importer. For location coefficients for all industries, see Appendix A.

[40] It is a fundamental microeconomic principle that reducing the costs of entry for start-ups encourages the formation of businesses at the margin.

[41] The second-year start-up tax exemption is scheduled to sunset at the end of 2006; however, it may be reinstated at the Council's option without voter approval.

[42] The Business Tax Ordinance provides a one-month period of time before the tax is due (21.13), and another month before the tax is delinquent (21.05) for annual taxpayers.

[43] For taxpayers taxed exclusively on non-receipts categories, the start-up tax exemption is provided without regard to the business' gross receipts. For taxpayers taxed on both receipts and non-receipts categories, the start-up tax exemption is provided with respect to gross receipts in the gross receipts tax categories and does not account for other receipts

SPECIAL EFFORTS

The Los Angeles business tax includes some relatively old provisions relating to taxation of amusement and recreation industries. For example, dance halls are taxed based on square footage, bowling alleys are taxed on the number of lanes, and arcades are taxed on the number of machines.

The reason for taxing these industries with special approaches is unknown, but may relate to historical difficulties with compliance in such industries. Another reason for special approaches with dance halls is that state law precludes cities from taxing the sale of alcoholic beverages, but dance halls do generate significant policing and traffic costs.

BUSINESS TAX REPORTING

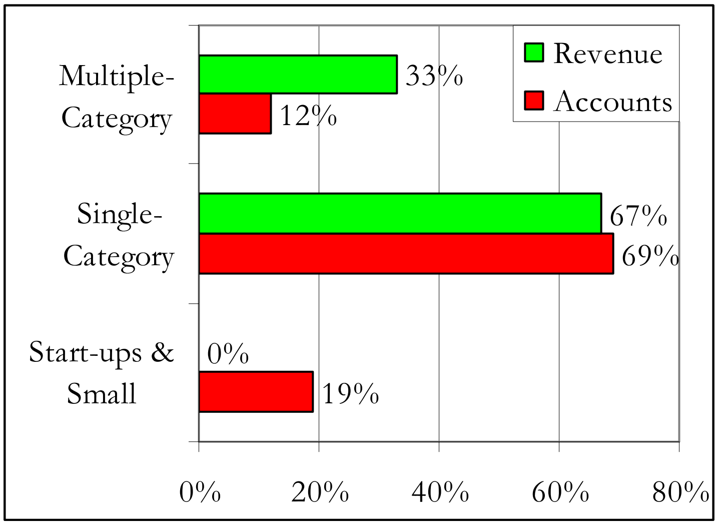
Under the existing business tax, businesses are required to keep track of their sales at each business site based on different tax calculation rules for as many as 59 different tax categories. The portion of activity related to sales inside and outside the City limits must be tracked for each tax category. After calculating the amount due for each tax category, the business makes additional computations to determine whether they are eligible to receive any special tax credits.

Tax Categories

Each of the 59 different tax categories has its own unique rules in terms of the tax base, tax calculations, and rules for apportionment of outside-City activity. Although most businesses pay taxes on gross receipts, the City uses a variety of other tax base measures for various tax categories, including payroll[44], square footage, production costs, employees, seating capacity, flat rates, commissions, number of bowling lanes, and bus miles. For each tax category, the business is required to monitor and to report on activity within that category, potentially needing to pay taxes on multiple categories. Each tax category is enumerated in Table 2.7.

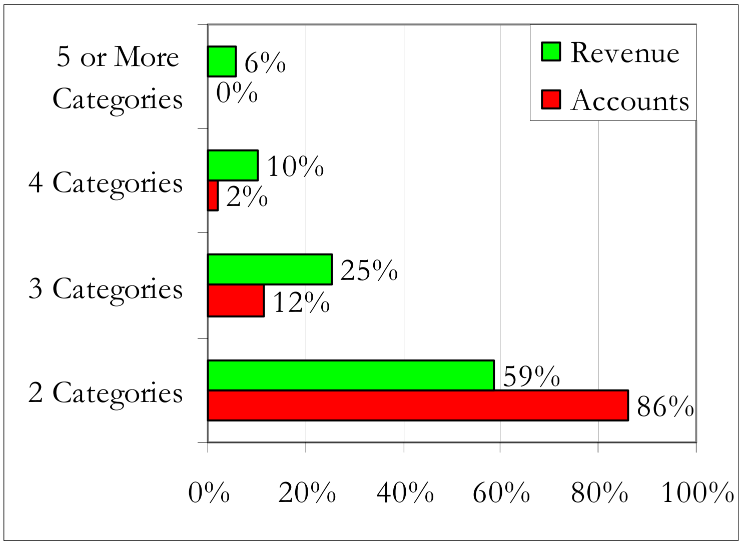
Businesses can and do pay taxes on multiple categories. In tax year 2003, 26,000 taxpayers filed business taxes on multiple categories, constituting 12 percent of taxpayers and 33 percent of business tax revenue. As indicated in Figure 2.4, single-category filers constitute 69 percent of the tax base while start-ups and small businesses exempt from the tax account for 19 percent of taxpayers.

Figure 2-4: Taxpayers and Tax Revenue by Number of Tax Categories, 2003



[44] Inside-City construction companies pay a hybrid tax measured on gross receipts as well as office payroll. The City does not refer to the tax as a payroll tax, but rather as a measure of gross receipts.

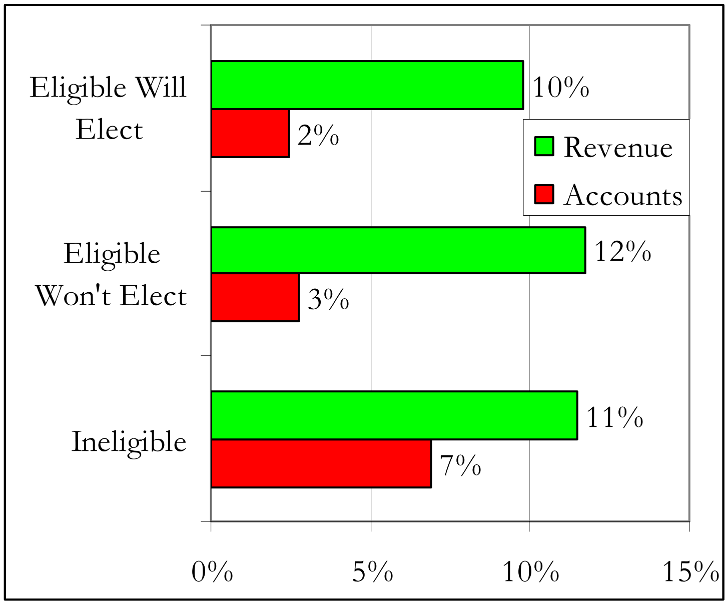
Figure 2-5: Multi-Category Filers as Share of Taxpayers and Tax Revenue, 2003



Most of the businesses paying on multiple tax categories file under two categories. As indicated in Figure 2.5, two-category filers constitute 86 percent of multi-category taxpayers and 59 percent of the tax revenue generated by multi-category taxpayers. In tax year 2003, there were 142 taxpayers paying on five or more tax categories. Of the three taxpayers paying on eight separate categories, there is one hotel and two bowling alleys.

One eight-category taxpayer is a bowling alley separately monitoring and paying tax on its lanes, its pool tables, its arcade games, its juke box, its dance floor, its gross receipts from food sales, its gross receipts from shoe rentals, and its receipts from leasing space to business tenants. Another eight-category taxpayer is a hotel required to itemize and pay separate tax rates on hotel room receipts, retail clothing sales, hair salon activity, shoe repair receipts, receipts from renting space to business tenants, its pool tables, its dance floor, and parking lot revenues.

Figure 2-6: Multi-Category Filers Eligible for Single-Category Reform, 2003



Effective in tax year 2004, businesses may pay taxes on fewer tax categories under the Single Primary Tax Classification Election reform. This reform relates only to annual gross receipts tax categories, and businesses may only elect to pay under a single receipts category if receipts under that category constitute 80 percent or more of the taxpayer's total receipts. Under this policy, 45 percent of multiple-category filers become eligible for paying on one tax category. However, 20 percent of multiple-category filers are expected to benefit from the policy and to elect to file under one category.[45]

As indicated in Figure 2.6, about seven percent of taxpayers are multi-category filers who would not be eligible for the single-category reform. Three percent of taxpayers are multi-category filers who would be eligible but would not elect to use single-category filing because it would raise their tax liability. About 5,800 would have elected to continue paying under multiple categories, as the tax rate in their primary category is

[45] Eligible multiple-category taxpayers are expected to elect single-category filing only if it reduces their overall business tax liability.

higher than the tax rate in the other categories. Two percent of taxpayers are multi-category filers who would be eligible for and likely to take advantage of single-category filing.

The single-category tax reform would have been elected by about 5,200 taxpayers had it been effective in tax year 2003, and about three percent of the beneficiaries would continue to pay under multiple categories for their non-receipts activity. For example, a hotel currently paying under seven categories would pay under two categories—its primary receipts category for hotel bed sales and its dance floor category. Hence, single-category reform is expected to reduce the percent of taxpayers filing under multiple categories from 12 percent to 10 percent of all taxpayers.

Table 2-7: Business Tax Rates by Tax Category, 2003

Los Angeles Business Tax Categories, 2003

Ordinance	Description	Tax Base	Minimum Tax	Min Tax Threshold ($1000s)	Tax Rate	Payment Frequency
21.53	Amusement Park	flat	$ 923.83	$ -	$ -	Quarterly
21.55	Auctioneer	flat	$ 886.88	$ -	$ -	Annual
21.56	Auto Park	receipts ($1000s)	$ 177.38	$ 30	$ 5.91	Annual
21.59	Sporting Events	receipts ($1000s)	$ 106.43	$ 36	$ 2.96	Annual
21.62	Billiards	machine	$ 106.43	$ -	$ 106.43	Annual
21.63	Amusement Machines	machine	$ 22.17	$ -	$ 22.17	Annual
21.64	Music Machines	machine	$ 22.17	$ -	$ 22.17	Annual
21.65	Vending Machines	receipts ($1000s)	$ 147.81	$ 25	$ 2.96	Annual
21.65.1	Coin-Operated Service Machines	machine	$ 22.17	$ -	$ 22.17	Annual
21.70	Bowling Alleys, Skeeball	per lane or table	$ 54.99	$ -	$ 54.99	Annual
21.74(b)	Circus--Temporary	seats			Schedule	Daily
21.74(c)	Circus--Permanent	flat	$ 887		$ -	Daily
21.75(a)	Carnival	ticket sales			Schedule	Daily
21.75(b)	Carnival/Side Show	booths			Schedule	Daily
21.75(c)	Circus Parade	procession	$ 4,434.00	$ -	$ -	Daily
21.78	Collection Agency	receipts ($1000s)	$ 886.88	$ 300	$ 2.96	Annual
21.79	Commission Broker	commissions ($1000s)	$ 91.64	$ 25	$ 3.67	Annual
21.80	Telemarketing	receipts ($1000s)	$ 91.64	$ 25	$ 3.67	Annual
21.83	Dance Hall	square feet			Schedule	Quarterly
21.85	Public Dance	flat	$ 177.38	$ -	$ -	Daily
21.94	Rides	flat	$ 443.44	$ -	$ -	Annual
21.98	Commercial Rental	receipts ($1000s)	$ 110.86	$ 75	$ 1.48	Annual
21.98.1	Swap Meet Operator	receipts ($1000s)	$ 110.86	$ 75	$ 1.48	Annual
21.98.1	Swap Meet Operator Space	space-days rented			$ 0.59	Monthly
21.98.2	Antique Show Promoter	receipts ($1000s)	$ 110.86	$ 75	$ 1.48	Annual
21.98.2	Antique Show Space	space-days rented			$ 0.59	Monthly
21.99	Hotel, Apartment	receipts ($1000s)	$ 110.86	$ 75	$ 1.48	Annual
21.102	Laundry/Cleaner/Shoe Repair	receipts ($1000s)	$ 110.86	$ 75	$ 1.48	Annual
21.108	Lending Money	flat	$ 2,660.63	$ -	$ -	Annual
21.109	Motion Picture Producers	production costs			Schedule	Annual
21.141	Storage, Freight Forward	receipts ($1000s)	$ 177.38	$ 60	$ 2.96	Annual
21.142	Stevedores	employees	$ 106.43		$ 8.87	Annual
21.143	Tugboat Operators	receipts ($1000s)	$ 106.43	$ 18	$ 1.18	Annual

Los Angeles Business Tax Categories, 2003 (continued)

Ordinance	Description	Tax Base	Minimum Tax	Min Tax Threshold ($1000s)	Tax Rate	Payment Frequency
21.147	Theater	admission fees ($1000s)	$ 66.52	$ 45	$ 1.48	Annual
21.166	Wholesale Sales	receipts ($1000s)	$ 118.25	$ 100	$ 1.18	Annual
21.166	Wholesale Sales—Blind	receipts ($1000s)	$ -	$ -	$ 1.18	Annual
21.167	Retail Sales	receipts ($1000s)	$ 110.86	$ 75	$ 1.48	Annual
21.167	Retail Sales—Blind	receipts ($1000s)	$ -	$ -	$ 1.48	Annual
21.167.1	Retail Firearms	receipts ($1000s)	$ 110.86	$ 75	$ 1.48	Annual
21.169	Christmas Trees	flat	$ 29.56		$ -	Quarterly
21.170	Christmas Tree Deposit	flat	$ 200.00		$ -	Quarterly
21.187	Common Carrier Bus	bus revenue miles	$ 14.78		$ 14.80	Annual or Quarterly
21.188	Contractor (Construction)	receipts ($1000s)	$ 177.38	$ 60	$ 1.18	Annual
21.188	Contractor—LA Business	payroll ($1000s)	$ -	$ -	$ 2.96	Annual
21.189.1	Miscellaneous Services	receipts ($1000s)	$ 49.67	$ 12	$ 4.14	Annual
21.189.2	Radio/TV Broadcaster	receipts ($1000s)	$ 110.86	$ 75	$ 1.48	Annual
21.189.3	Child Care Provider	receipts ($1000s)	$ 23.65	$ 20	$ 1.18	Annual
21.189.4	Multimedia	receipts ($1000s)	$ 118.25	$ 100	$ 1.18	Annual
21.190	Independent Contractors	receipts ($1000s)	$ 106.43	$ 18	$ 5.91	Annual
21.191	Health Maintenance	receipts ($1000s)	$ 106.43	$ 18	$ 5.91	Annual
21.192	Personal Property Rental	receipts ($1000s)	$ 177.38	$ 60	$ 2.96	Annual
21.193	Sale Real Property	receipts ($1000s)	$ 177.38	$ 60	$ 2.96	Annual
21.194	Transporting Persons	seating capacity per day	$ 54.99		Schedule	Annual
21.194(g)	School Buses—Special Events	seating capacity per day			Schedule	Annual
21.195(c1)	Trucking/Hauling	pounds hauled per day	$ 88.69		Schedule	Annual
21.195(c2)	Trucking/Hauling	days using a tractor			$ 0.78	Annual
21.196(c1)	Miscellaneous Trucking	pounds hauled per day	$ 88.69		Schedule	Annual
21.196(c2)	Miscellaneous Trucking	days using a tractor			$ 0.78	Annual
21.197	Telephone Service	receipts ($1000s)	$ 70.95	$ 60	$ 1.18	Annual

Notes:

(1) Each business tax category reflects a unique category based on tax rate, minimum tax, definition of tax base, or reporting requirements.

(2) Ordinance refers to section in the Los Angeles Municipal Code, Article 1, Chapter 2

(3) Minimum tax threshold indicates the level of activity at or below which a taxpayer pays only the minimum tax.

(4) Tax rate applies to activity in excess of the minimum tax threshold.

Apportionment

The Commerce Clause of the United States Constitution prohibits the City from levying its taxes in a manner that unfairly burdens interstate commerce. Consequently, where a business operates both inside and outside of the City, the activities of that business must be divided between activity within the City (taxable) and activity outside the City (nontaxable). This division is referred to as apportionment.

Not only must apportionment rules fairly tax interstate sales, but apportionment rules must also fairly tax activity that occurred outside the City but inside the State pursuant to case law. The case law establishes that the tax structure and apportionment rules must:

1. Be applied only to activity with a substantial nexus with the taxing city;
2. Be fairly apportioned as between taxable activity within a city and non-taxable activity outside that city;
3. Not discriminate against interstate (or intercity) commerce; and
4. Be fairly related to services provided by the city.[46]

For the City's business tax, the three apportionment factors—payroll, property, and sales—are used for certain industries. Under each tax category, businesses must keep track of their activity inside the City and outside the City. The taxpayer must apportion its gross receipts using the rulings issued by the City, which are listed in the City's Business Tax Ordinance.

While many business owners have complained that applying these rules is difficult, any simplification of these apportionment rules may result in legal risks and should be reviewed carefully by the City Attorney's Office.

Out-of-State Sales

Sales of goods to points outside California are explicitly exempted from the business tax. Hence, out-of-state sales are not taxed, whereas sales to points outside the City but within California are taxed more heavily than out-of-state sales.

Tax Credits

Businesses are required to track, report and calculate activity under each tax category to arrive at their gross tax liability.[47] After calculating the gross liability, the information is combined at the account level to determine whether or not the taxpayer is eligible for various tax credits. Businesses may be eligible for start-up, small business, empowerment zone, or multi-media activity tax credits.

[46] See Chapter 3 for in-depth discussion of the internal and external consistency tests with which the tax structure and apportionment rules must comply.

[47] Under the single-category tax reform effective in 2004, eligible businesses electing the single-category filing approach must only report the activity under the primary gross receipts tax category.

Situs Reporting

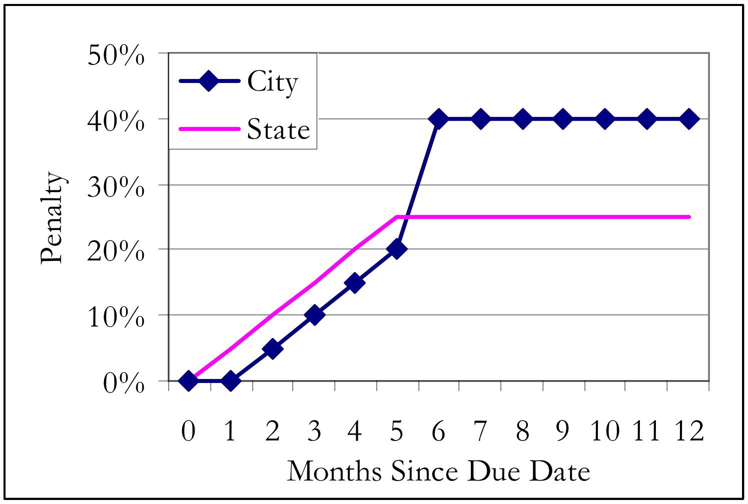
Most businesses are required to hold a business license for each separate location doing business in the City limits, which means they must file a separate tax form for each site. However, commercial landlords, warehouses used in conjunction with a business in the City, and outside-City taxpayers are exempted from this requirement and are allowed to combine their sites for tax reporting purposes.

Generally, businesses do not have incentives to adhere strictly to situs-based tax reporting because it generates additional compliance costs to spend the time separately tracking and documenting the activity of each location, and because it boosts the transparency of the taxable activity for potential audits. Nevertheless, situs-based reporting greatly enhances the ease of desk-auditing[48] taxpayers and using creative data analysis approaches to identify non-compliant and under-reporting taxpayers.

In cross-matching taxpayer records from the business tax, sales tax, property tax, and unemployment tax data files, the authors have found that certain taxpayers do not report all of their establishments for business license purposes. Taxpayer reporting practices differ among the different data sources even though the various tax authorities aim to get taxpayers to report on each individual location. Although some businesses do not comply with this requirement, they do run the risk of being required to report in this fashion in the event they are audited.[49]

PENALTIES

Figure 2-8: Late Payment Penalties: Los Angeles vs. California



Penalties for taxpayers filing the business tax after the due date are assessed based on how late the tax payment is received, taking into consideration that the City provides a grace period of nearly two months from the due date to the date of delinquency. Taxpayers making payments after the grace period must also pay penalties and interest. The penalty in the second month after the tax is due is 5 percent, whereas the penalty in the six month after the tax is due is 40 percent. The City's penalties are illustrated in Figure 2-8 along with State income tax penalties.

[48] "Desk-auditing" refers to audits that may be conducted at the auditor's desk, whereas "field-auditing" refers to audits that must be conducted at the taxpayer's site. Desk-audits consist of reviewing calculations reported on the tax form and comparing the reported tax base to independent information in other databases. Desk-audits are generally cheaper and more efficient than field audits, as no travel time is involved. While desk-audits can dramatically increase the audit rate, desk-audits do not typically yield as much revenue as field audits in the City's experience.

[49] The fact that some businesses are out of compliance with situs reporting is based on the panel's observations in reviewing cross-matched business tax and parcel data at the taxpayer level, and manual review of large taxpayers.

For both the City and the state, penalties for late payments increase by 5 percent monthly. The state penalties are capped at 25 percent[50], whereas the City's penalties are capped at 40 percent. The state allows up to a six-month extension, whereas the City allows up to 45 days for an extension. For taxpayers that do not file an extension, State penalties are the same as the City's penalties, except they are capped at 25 percent instead of the 40 percent cap used by the City.

Another type of penalty is assessed on taxpayers that are audited and found to be under-reporting or incorrectly reporting their gross receipts. If the taxpayer is found by the City's auditors to be under-reporting, the Director of Finance may assess the taxpayer with a 20 percent penalty called a 'deficiency determination'. The penalty is applied only after the taxpayer has failed to pay the deficiency within thirty days of notification.

If the taxpayer is found to be under-reporting subsequent to that, the taxpayer may be subject to a negligence penalty of 10 percent in addition to any deficiency determinations, late penalties, and interest. If the taxpayer is found to be under-reporting in a fraudulent fashion, the taxpayer may be subject to a 25 percent penalty in addition to any deficiency determinations, late penalties, and interest.

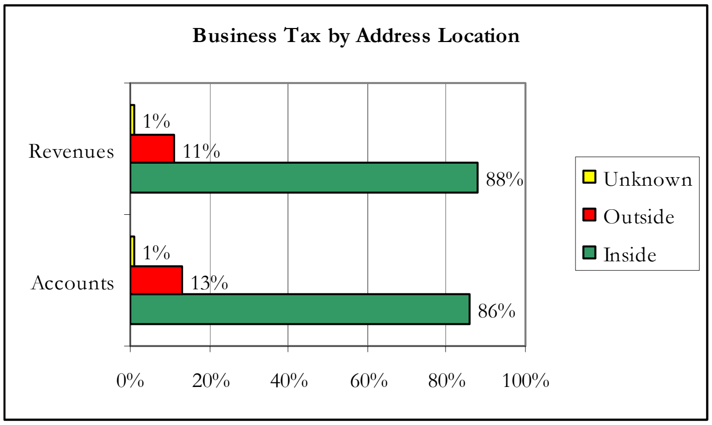
The City levies interest on the delinquent tax that was owed, but does not compute the interest on any penalties. By comparison, the California Franchise Tax Board charges interest on any penalties owed—a 20 percent penalty for inaccuracies and a 75 percent penalty for understated income attributable to fraud.

There are significant differences between the penalty percentage for non-discretionary penalties for delinquency and deficiency determinations in the City statutes and statewide statutes. In fact, in comparison with statewide penalties, the non-discretionary penalties are 'onerous' and are unnecessarily punitive.

It is recommended that the City of Los Angeles consider adopting more taxpayer-friendly penalties in line with State statutes. Generally, the penalty ranges in the State statutes are less broad.

OUTSIDE-CITY TAXPAYERS

Figure 2-9: Business Tax by Address Location



In structuring tax alternatives, one significant challenge is how to tax businesses located outside the City limits that nonetheless do business in the City and are therefore within its taxing jurisdiction.

About one in ten of the City's business tax dollars come from businesses with outside-City addresses. Figure 2-9 depicts the proportion of 2003 tax revenue and taxpayers with

[50] The source for California income tax penalties is Franchise Tax Board Publication 1140.

addresses located outside the City limits.[51]

This categorization overstates the proportion of outside-City taxpayers because some taxpayers use an outside-City address for the accounting or headquarters location despite having sites in the City limits.[52] The authors conducted a record-by-record review of large taxpayers with addresses located outside the City. It was discovered that most are using the outside-City address for accounting convenience and only report their inside-City locations for fire permit and occasionally minimum tax payment purposes.

For example, several oil refineries located in the Wilmington area report the vast majority of their activity through outside-City headquarters locations, and they do not maintain a business license for their in-City locations. Another example is a large space engine manufacturer with several campuses in the City limits; this manufacturer maintains a business license on each location, for which it pays the minimum tax and pays nearly all its tax through a license with the outside-City headquarters address. Yet another example is a major sports team that performs home games within the City limits, but maintains its offices outside the City limits. Even though the taxpayer may be reporting the proper tax, the tax is not reported at the situs of the business activity.

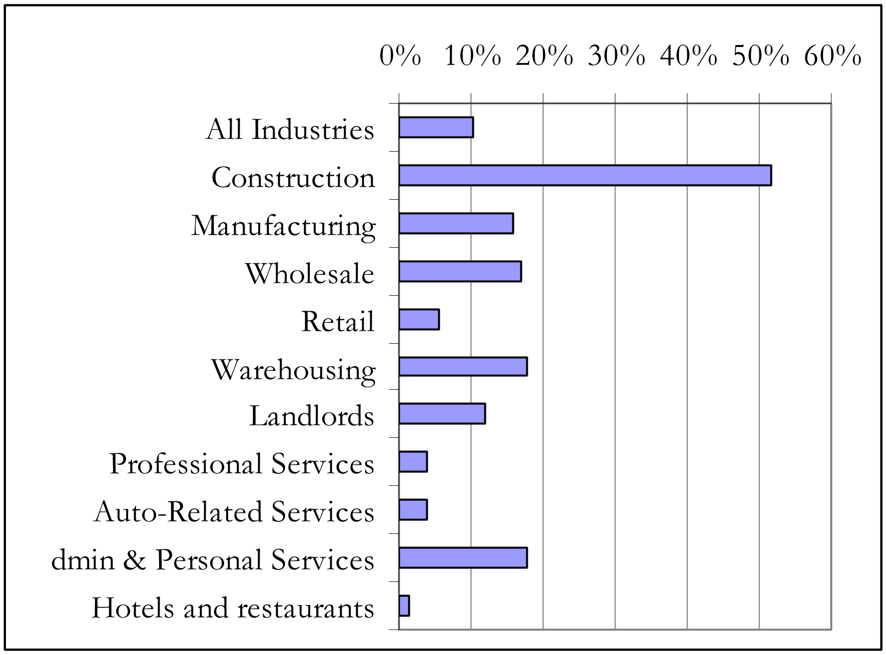
Outside-City taxpayers include motion picture companies. Many of the large studios are based outside the City in Burbank, Culver City and Santa Monica, but need film permits to conduct location filming within the City limits. When the City administered the film permitting, the Office of Finance was able to require outside-City companies to get a business license. Now, the Entertainment Industry Development Corporation (EIDC) administers the City's film permitting. An EIDC representative told the authors that a business license is not required for getting a film permit. While this practice means that outside-City film companies do not necessarily get a business license before filming, the Office of Finance reports that they are provided a list of film permit recipients from EIDC and may require a business license through the investigation process.

Outside-City taxpayers are particularly concentrated in the construction industry. The proportion of business tax revenue in tax year 2003 from taxpayers with outside-City addresses is depicted in Figure 2-10 by broad economic sector. Although landlords are not expected to pay taxes on buildings located outside the City limits, 12 percent of landlord tax revenue is received from landlords using outside-City addresses. This indicates that outside-City addresses are used for accounting convenience in some cases and for accurate representation of the business location in other cases.

[51] Primary data source is 2003 City of Los Angeles business taxpayer database. Addresses were geo-coded by County of Los Angeles Urban Research Division with manual geo-coding performed using Thomas Brothers and ZIMAS.

[52] The Business Tax Ordinance requires all taxpayers except landlords to hold a business license for each location in the city limits. Some businesses do not comply with this requirement, presumably for the sake of accounting convenience.

Figure 2-10: Outside-City Business Tax Revenue Share by Industry, 2003



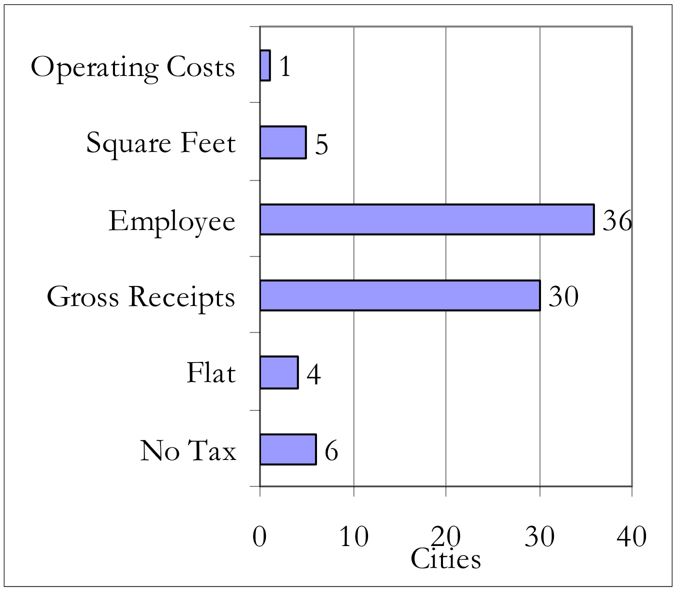
In addition to the construction sector, there are construction-related industries in which outside-City activity is relatively high. Relatively high concentrations of outside-City activity are also found in the engineering and architectural service industries. Those building in the City limits are required to comply with building regulations that in turn require a business tax registration certificate. Construction industry businesses may reflect such a large portion of outside-City taxpayers in part because their participation in a highly regulated industry makes tax evasion more difficult than it is in other lines of business.

Outside-City taxpayers also include the City's own vendors and contractors who are required to hold a City business license while working for the City. This may partly explain why outside-City activity is relatively high in the security services, custodial services, computer services, and telecommunications industries.

TYPICAL TAX BASE

Cities in LA County tax businesses in a variety of ways. Typically, a city will tax businesses using one or more of the following methods: Flat tax, gross receipts tax, employee tax, square footage tax, and a tax based on operating costs. The most common business tax base is the number of employees, followed closely by gross receipts. Figure 2-11 illustrates the degree to which each of business tax approach is used by city governments in Los Angeles County.[53]

Figure 2-11: Business Tax Base in LA County Cities



It is not uncommon for a city to tax different industries using different tax bases. The City of Beverly Hills, for example, taxes general and professional offices based on the number of employees; wholesaler, retailers and manufacturers, however, are taxed on gross receipts.

Cities that tax on the basis of square footage tend to combine the tax in hybrid form with another tax base. Each of the five cities using a tax based on square footage is also using a tax based on either employees or gross receipts.[54]

West Hollywood, which is the lone city in Los Angeles county using a tax based on operating costs, only taxes general office businesses using operating costs; all other industries are taxed on their gross receipts.

Six of the eight cities in the County that do not tax businesses using either a gross receipts tax or a employee tax do not levy a comprehensive tax on businesses[55]; only four cities in LA County—Agoura Hills, Bell Gardens, Cerritos and Rosemead—tax businesses using a flat fee.[56] Agoura Hills

[53] Municipal business tax bases documented from Municipal Codes or municipal finance departments for 67 of the 88 cities in Los Angeles County. The included cities had aggregate employment of 6,000 or more in the year 2000; the excluded cities had aggregate employment of less than 6,000. Some cities tax on multiple tax bases, and are counted multiple times in the figure; the appendix chart lists each city's tax approach.

[54] The five cities with some form of square footage tax are Cerritos, Commerce, El Segundo, La Mirada and West Covina.

[55] Glendale and Industry do not levy a business tax at all. Calabasas, Diamond Bar, Santa Clarita and Westlake Village require a County business license of adult businesses, gun dealers, taxicabs and other regulated businesses, but do not levy a broad-based business tax. Note that Agoura Hills and Malibu also require a County business license for selected businesses, but have fewer than 6,000 employees and are excluded from the scope of the review.

[56] Minimum taxes are not deemed to be a tax base. All cities with a business license tax levy a minimum tax in some form. If a municipality uses no tax base, it has been classified as levying the tax on a flat fee basis.

charges an annual registration fee of $35 to all businesses while the City of Rosemead charges businesses a flat fee ranging from $17 for ice cream trucks to $500 for fortune-tellers.

Thus, the vast majority of LA County cities that levy taxes on businesses do so using an employee or a gross receipts tax base.

UNIQUE TAX BASES

Many cities in California have come up with unique ways to tax businesses. Below is a sampling of unique tax bases and methods of calculating tax rates employed by select cities.

Square Footage

The cities of El Segundo, Commerce and Cupertino levy a general tax on businesses based on square footage or floor area. Both El Segundo and Commerce levy the tax in a hybrid fashion, combining the square footage tax with an employee tax. Cupertino taxes on square footage exclusively, without a hybrid form. Several cities levy a square footage tax on certain industries. Cerritos retailers and warehouses in Fontana, La Mirada, and Vernon are all taxed based on square footage. A number of cities, including San Jose, Anaheim, Alameda and San Leandro, levy a square footage tax on commercial landlords.

The City of El Segundo employs a hybrid business tax, taxing businesses based on the number of employees and the floor area. Each business charges a flat fee for up to ten employees ($103) and must pay an additional $127 per year for each employee in excess of ten. In addition to this, a business is taxed $0.25 per square foot of floor area occupied for a business purpose in excess of 5,000 square feet. Finally, the business is charged $11 per year for each additional business facility held within the City.

The City of Cupertino taxes businesses based on the number of square feet of 'floor area,' which is defined by the City as "the total floor space in terms of square footage occupied by an owner, lessee or tenant in a building, less fifteen percent. This adjustment allows for elevator shafts, stairwells, courts or atria (uncovered and open to the sky), and rooms exclusively housing building operating equipment."[57] Each business faces a basic tax of $75 per year, plus a tax on square footage based on the amount of floor area. Each tax is automatically increased each year by an index determined by the Bay Area Consumer Price Index.

Table 2-12: California City Square Footage Taxes

City	Affected Industries	Parking Areas	Common Areas
El Segundo	General		
Cupertino	General		
Commerce	General	Yes	Yes
Cerritos	Retail	Yes	
Fontana	Warehouse		Yes
La Mirada	Warehouse		
Vernon	Warehouse		
San Jose	Landlords	Yes	Yes
Anaheim	Landlords		Yes

[57] City of Cupertino Municipal Code §5.04.280.

Square footage is typically defined as the enclosed space. However, the cities of San Jose and Commerce include parking areas in the definition of square footage to the extent that the landlord charges rent for the space or it is included in the lease.

Most cities include common areas, such as elevators, in the definition of square footage and, as discussed above, El Segundo and Cupertino allow deduction of common areas.

Value-Added

Although both Berkeley and Oakland largely tax business upon gross receipts, they both allow a special value-added tax base calculation for select industries. In Berkeley, manufacturers are taxed on their value-added. Value-added in this case is defined by the City as "gross receipts, less the value of raw materials (including the cost of energy resources) or the value of the partially completed product at the time it enters the manufacturing process within the City." Oakland also allows manufacturing, processing businesses, retail, and wholesale businesses to subtract the value of raw materials from its calculation of gross receipts. This adaptation yields a valued-added tax base.

Value-Added Proxy

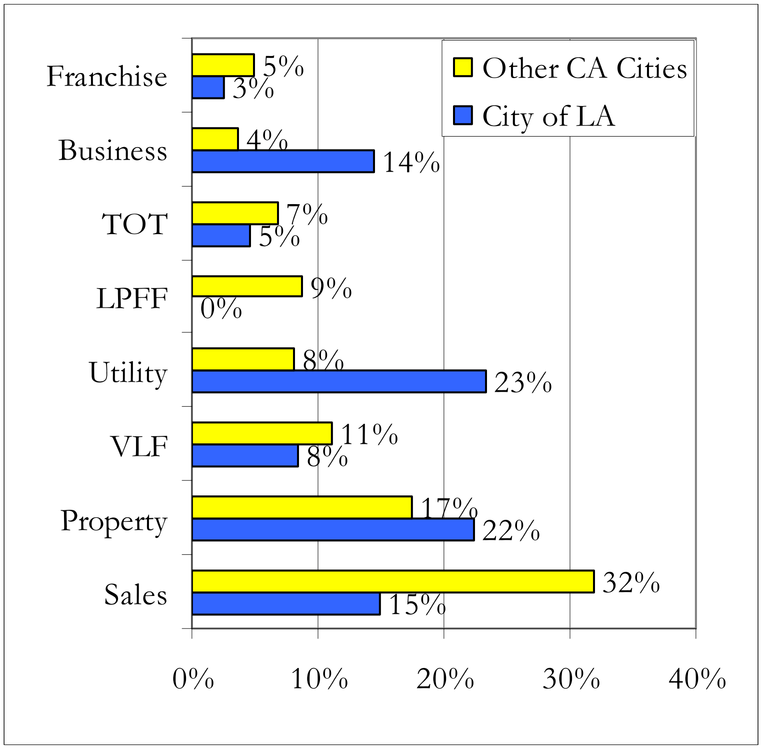
Both the cities of Merced and Vallejo tax businesses using a unique approximation of a value-added tax. Businesses in each city are taxed based on their gross receipts; however, their tax rate is loosely determined by estimates of value-added. For example, while Merced explicitly taxes businesses on gross receipts, the tax rate varies based on a business' classification. Merced classifies businesses in two ways: (1) A business' gross profit and (2) The industry with which it belongs. The City defines 'gross profit' as the difference between the revenues or sales of a business and the related costs and expenses of producing revenues or sales. The gross profit percentage, which is the measure explicitly used to classify businesses, is calculated by dividing gross profit by revenues or sales.

The business tax employed by the City of Vallejo uses an approach similar to that used by Merced. Vallejo taxes businesses based on their gross receipts; however, tax rates are set based on a business fee category that is determined by a business' net profit. If a business' net profit as a percentage of gross receipts is greater than 20%, that business is deemed a 'Fee Category A' business. A business with net profit amounting to between 10-20% of gross receipts is categorized as a 'Fee Category B' business. Finally, a business collecting net profit amounting to less than 10% of gross receipts is categorized a 'Fee Category C' business. Tax rates are highest for Fee Category A and lowest for Fee Category C. This modification of the gross receipts tax can be seen as a proxy to a tax on value-added.

Tax Rate Comparison

Several studies have documented the relatively high business tax rates levied in the City of Los Angeles compared with neighboring jurisdictions.[58]

Figure 2-13: California City Revenue as % of General Fund



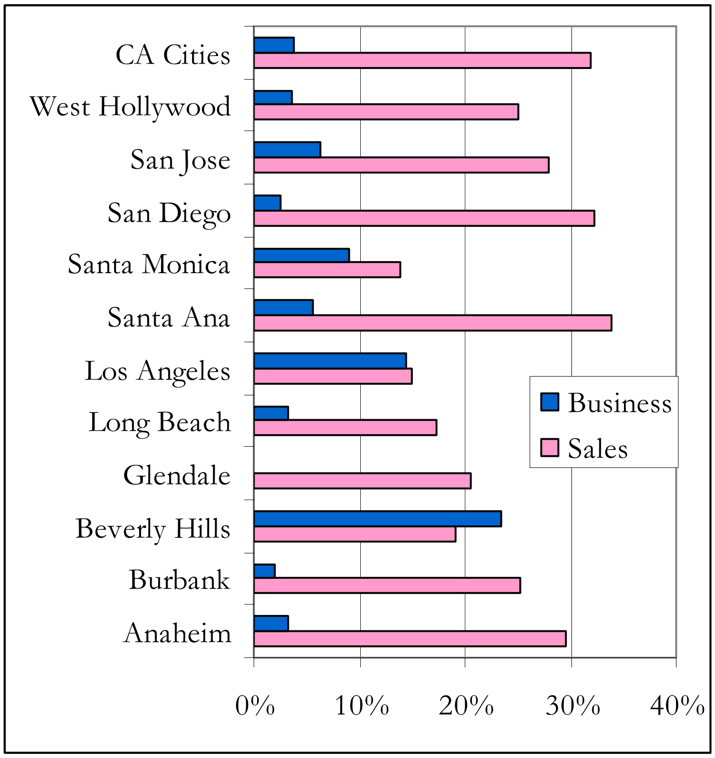
Before comparing Los Angeles business tax rates to neighboring jurisdictions, first it is instructive to review the contribution of major taxes to the City's general fund. The contribution of each major revenue stream to the City's general fund is depicted in Figure 2-13, where it is also compared with the State average.[59] Sales taxes constitute a significantly smaller share of the City of Los Angeles general fund (15%) than the typical California city (32%), as the City of Los Angeles relies more heavily on utility and business taxes compared to the average city.

Los Angeles relies to a lesser extent on vehicle license fees (VLF), with only eight percent of revenue provided compared with the State average of 11 percent. Similarly, Los Angeles relies to a lesser extent on transient occupancy taxes (TOT) on hotel bed sales. Additionally, licenses, permits, fees and fines (LPFF) are not a significant revenue source for the City of Los Angeles, but they contribute nine percent to the revenues of California cities as a whole.

[58] Kosmont Companies, 2003; Loveman and Sales, 1997; Los Angeles Office of Finance, 2003; Los Angeles Economic Development Corporation, 2003.

[59] Municipal revenue data in Figure 2-4 reflect fiscal year 2000-01 data as reported by California cities to the state Controller. The total for all other California cities excludes the City of Los Angeles as well as the City and County of San Francisco. TOT refers to transient occupancy tax. LPFF refers to licenses, permits, fees and fines. VLF refers to motor vehicle license fees.

Figure 2-14: Municipal Revenue as % of General Fund, FY 00-01



Los Angeles' reliance on the business tax is higher than the larger cities in California as well as the larger cities in the Los Angeles metropolitan area.[60] As indicated in Figure 2-14, only Beverly Hills relies more heavily on the business tax as a general fund revenue source, and only Santa Monica relies less than the City of Los Angeles on the sales tax.[61]

The comparison cities differ significantly in their tax bases and revenue-raising approaches. Anaheim, Beverly Hills, and West Hollywood receive relatively high transient occupancy (hotel) tax revenue. Glendale, Long Beach, Los Angeles, Burbank and Santa Ana rely heavily on utility user taxes. San Diego and San Jose rely more heavily on investments and rents, with franchise income being particularly important to the San Diego and Long Beach general funds. Glendale is the only comparison city with no business tax at all.

The larger California cities tend to levy the business tax on the number of employees rather than gross receipts. San Diego, San Jose, Long Beach and Anaheim all rely on an employee-based tax. The larger employment centers within Los Angeles County—Long Beach, Burbank, Torrance, and Pasadena—also tend to tax on the basis of employees. With the exception of Burbank, which also taxes on the basis of employees, Los Angeles' larger neighbors tend to tax on the basis of gross receipts.

In order to compare the business tax across these cities, it is necessary to use a prototype business due to the cities' different tax bases. In this comparison, the average sales, employees and payroll of a business in each industrial sector establish the prototype business of Los Angeles County.[62]

Of the cities compared, only Beverly Hills and Santa Monica levy business taxes at the levels levied in the City of Los Angeles. Beverly Hills charges business $1,043 per professional employed at the business, making Beverly Hills' business tax decidedly the most expensive among the cities compared. Also among manufacturers and wholesalers, Beverly Hills and Santa Monica levy a slightly higher rate than does the City of Los Angeles. Business taxes in the remainder of the cities

[60] Municipal revenue shares of general fund are based on municipal reports to the state Controller for fiscal year 2000-01.

[61] For precise figures, refer to supplemental tables in Appendix A.

[62] Prototypes were based on the Los Angeles County average for taxable businesses within a particular industrial sector based on 1997 Economic Census data.

are modest in comparison with Los Angeles. Table 2-15 provides the business tax owed by each of the industry prototype businesses in each of the comparison cities. Values are given as a percentage of the Los Angeles business tax for that industry.[63]

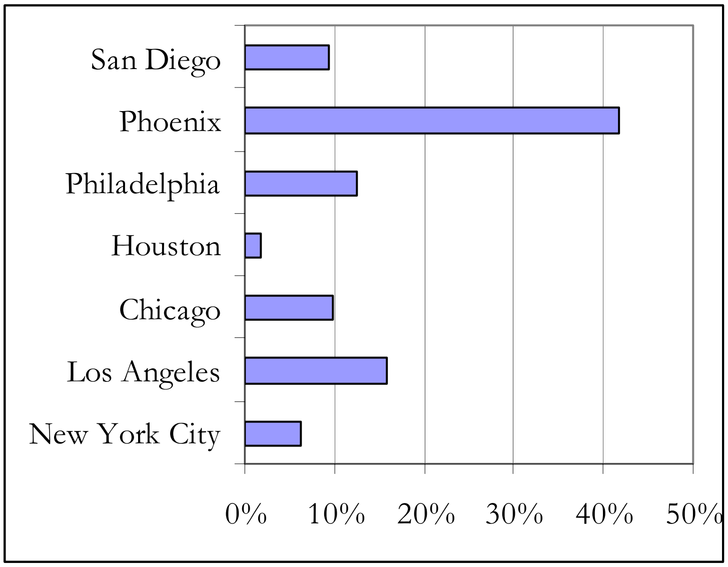
Table 2-15: Municipal Business Tax as % of City of LA Business Tax

	Retail	Wholesale	Manufacturing	Professionals
Anaheim	6%	8%	8%	2%
Burbank	3%	1%	2%	2%
Beverly Hills	84%	106%	106%	170%
Glendale	0%	0%	0%	0%
Long Beach	9%	3%	6%	7%
Los Angeles	100%	100%	100%	100%
San Jose	7%	2%	5%	4%
San Diego	5%	2%	3%	1%
Santa Ana	0%	9%	9%	3%
Santa Monica	84%	106%	106%	81%
West Hollywood	33%	41%	41%	25%

Source: Municipal Codes

[63] See Appendix A for table listing the numerical tax liability for each jurisdiction and industry.

Figure 2-16: U.S. Cities Business Tax Revenue Share, FY 2002-3



Among the largest ten cities in the U.S., Phoenix is the most reliant on business tax. Los Angeles and Detroit rank second and third in terms of reliance on business taxes.[64] The business tax reliance rates among the largest seven cities are depicted in Figure 2-16.[65]

Several large American cities—New York, Chicago, Philadelphia and Detroit—rely on municipal income taxes. Large Texas cities tend to rely primarily on property and sales taxes. San Diego and San Jose rely on employee-based business taxes, while San Francisco relies on a payroll tax.

New York City levies income taxes on corporations, banks and unincorporated businesses, generating about six percent of revenue. New York also levies a local tax on personal income that generated 9% of general fund revenue in fiscal year 2002-03.

Los Angeles raised about 16 percent of general fund revenue in fiscal year 2002-03 through the business tax, the transient occupancy tax, and the parking user tax. Los Angeles does not collect any type of tax on an individual's wages or income, though the City does collect significant revenue with its municipal sales and property taxes—11% and 19% of general fund revenue, respectively.

Chicago levies a business tax of $48 per employee, a rental car tax of $2.75 per customer, and a six percent tax on leased personal property. In addition, Chicago's businesses pay amusement, liquor, cigarette and related recreation taxes.

Houston, the fourth most populous city in the U.S., generates 46% of general fund revenue through its property tax and does not levy a business tax at all. Houston also relies, to a significant degree, upon sales tax revenue that generates 23% of general fund revenue. Houston's industrial district assessment and mixed beverage tax together account for less than two percent of revenue.

[64] Business taxes consist of local taxes paid by businesses in fiscal year 2002-3, and exclude state-levied sales taxes as well as property taxes paid by businesses.

[65] Dallas, San Antonio and Detroit budgets did not provide adequate data to estimate the business tax reliance rate for these cities with precision. However, Dallas and San Antonio do not rely on business taxation for more than one percent of revenue. Detroit's reliance on business taxes is 15-20 percent, and is not known precisely because municipal income tax revenues include both individual and corporate income taxes.

Philadelphia levies a business privilege tax at $2.30 per $1,000 in gross receipts and a 4.5 percent net profits tax. Philadelphia also levies a business use and occupancy tax based on a combination of square footage and assessed property value, a 15 percent parking tax, a 7 percent hotel tax, a 5 percent admissions tax, and a 2 percent car rental tax. In addition, Philadelphia employers withhold 4.5 percent from employee's earnings for a local wage tax, which amounts to 33% of general fund revenue. Philadelphia is currently reducing the rates of both the business privilege tax and the wage tax.

Phoenix levies a 1.8 percent gross receipts tax (locally called a sales and use tax), with higher rates for hotels and car rental companies; this tax generates 41 percent of the Phoenix general fund revenue. The tax base is essentially gross receipts, although certain deductions are allowed, such as construction subcontractor payments and taxes.

San Diego's hotel tax generates 8 percent of general fund revenue. San Diego's business tax is levied at a modest flat rate of $34 for small businesses, with a $5 per employee charge added for larger businesses. San Diego also charges rental unit taxes on apartment and hotel owners.

Dallas relies primarily on property and sales tax. Although Dallas levies a 7 percent hotel tax, the revenues are used to support the city's convention center and its visitor's bureau. Hence, the overall reliance of the general fund on business taxes is negligible. San Antonio also relies primarily on property and sales taxes and receives substantial revenue from its municipal utility enterprise fund.

Detroit levies a municipal income tax on corporations (1.2 percent) as well as individuals (2.5 percent). The City is currently phasing out the corporate income tax, with the tax likely to be fully phased out by 2009.

San Francisco levies a payroll expense tax at the rate of 1.5 percent; however, because San Francisco is organized both as a city and a county, its revenue composition is not directly comparable to Los Angeles.

In conclusion, Los Angeles relies more heavily on business taxation than the majority of the nation's largest 10 cities.

CHAPTER 3: EVALUATION APPROACH

The analyses in this report focus on tax policy alternatives that are both affordable (i.e. revenue-neutral) and legal. This chapter discusses the revenue neutrality constraint as well as the various legal constraints to be considered in evaluating tax policy alternatives. In addition, the panel selected the tax policy alternatives based on analysis of their ability to achieve various and competing goals, all summarized through the 'EASE' criteria of economic benefits, administrability, stability and equity.[66]

Revenue Neutrality Constraint

Revenue neutrality is defined very simply as raising an amount of tax revenue equal to that raised under the status quo. In the context of the current State and local government budget crisis, the City is constrained to considering revenue-neutral tax reform policies at the present time.

One requirement for each alternative considered by the MMC team is that the alternative, when considered as an overall revenue reform package, would replace existing business tax revenue. In order to accomplish this goal and to address inequities with the status quo business tax, this requires that the electorate approve the tax alternative.

As has been pointed out in numerous studies and by members of the business community, the City's business tax rates are higher than the business taxes levied in competitor cities.[67] This fact is clearly recognized by the MMC team, City officials, and the business community, who have repeatedly expressed their desire to reduce the City's dependence on the business tax over time.

Nonetheless, this study is being performed in the context of a massive State budget deficit and at a time of great uncertainty with respect to critical revenue streams, such as vehicle license fees. In the authors' opinion, achieving tax relief is a relatively straightforward matter of applying temporary credits or permanent across-the-board rate decreases, which does not require voter approval or raise any significant legal dilemmas. However, tax relief cannot fix the outdated nature of the City's business tax code, the patchwork of inequities that have been built into the business tax over the last 60 years, or the complexity of the business tax and related reporting requirements.

In order to provide the business community with equity, economic benefits, and simplification, and in order to provide the City with revenue stability, tax alternatives must increase the tax burden of some taxpayers and decrease the burden of other taxpayers. Of course, the overriding goal is always to make the City and its residents and businesses better off overall. In staying with this goal, it is anticipated that the tax alternative suggested here is more likely to be approved by City policymakers as well as the electorate. Preparing and analyzing an overhaul of the business tax does not preclude the City from reducing tax rates in the future or from building into a ballot measure assurances to the business community that the inflation-adjusted current revenue will not increase.

[66] The panel developed the EASE criteria. For evaluation criteria used in other tax policy studies, see chapter 4.

[67] See Chapter 2 for a comparison of the City of Los Angeles business tax to rates in neighboring jurisdictions.

This section, presents the major legal considerations to structuring and analyzing alternatives to the City's gross receipts tax. The laws governing taxation are quite a nuance. Consequently, while attempting to summarize the main considerations here, the specifics of any tax plan should be carefully analyzed for legal compliance. Three constraints especially relevant to this project are: (i) the Dormant Commerce Clause, (ii) the State constitution's prohibition against property taxes, and (iii) the statutory prohibition against municipal income taxes.

Dormant Commerce Clause

The commerce clause of the U.S. Constitution requires that a tax not penalize businesses with locations outside the taxing jurisdiction or otherwise favor local businesses at the expense of outsiders. Indeed, if a single taxpayer with locations outside the jurisdiction could potentially owe a higher tax than a comparable taxpayer located inside the jurisdiction, then the tax alternative would fail the extremely rigid Dormant Commerce Clause test presently in force in the federal case law.

The California Constitution does not include a provision parallel to the Commerce Clause. Nonetheless, California courts have held that a variety of constitutional provisions, acting in concert, "prohibit local taxes which unfairly discriminate against intercity business by subjecting such businesses to a measure of taxation which is not fairly apportioned to the quantum of business actually done in the jurisdiction." As a result, even a tax that exempts inter*state* transactions must satisfy the requirements of the Dormant Commerce Clause with respect to inter*city* transactions within California.

As is more completely explained below, the Dormant Commerce Clause requires that every municipal tax:

- Be applied only to activity with a substantial nexus with the taxing city;
- Be fairly apportioned as between taxable activity within a city and non-taxable activity outside that city;
- Not discriminate against interstate (or intercity) commerce; and
- Be fairly related to services provided by the city.

With respect to reasonable taxes on business activities occurring at least partially within a city, the second and third parts of Dormant Commerce Clause test are most important. These prohibit taxes that (i) are likely to lead to double taxation by different jurisdictions of the same activity ('misapportioned taxes') or (ii) cause a transaction to be taxed more heavily when it crosses state lines than when it occurs entirely within the State ('discriminatory taxes').

It is important not to read the Dormant Commerce Clause too broadly. The Dormant Commerce Clause does not prohibit a tax merely because it is one of several successive taxes on distinct taxable events. Thus, for example, there is no conflict between the gross receipts tax (as applied to retail businesses) upon the privilege of doing business and the sales tax upon the privilege of selling tangible property. Similarly, different jurisdictions may choose to tax activities at different rates.

However, to meet the requirements of the Dormant Commerce Clause, a tax must have both 'internal consistency' and 'external consistency'. A tax is said to be *internally consistent* where, if the identical tax were levied in two hypothetical jurisdictions, a company that splits different aspects of its operations (*i.e.* manufacturing, assembling, wholesaling, retailing) between the two jurisdictions would owe the same tax as a company that operates wholly within either of the two jurisdictions. A tax is *externally consistent* if, based on the economic justification for the City's claim upon the value taxed, there is not an actual or likely risk that double taxation will result.

Internal Consistency Test

The 'internal consistency' test requires a court to evaluate a taxing scheme by assuming "that all other jurisdictions have a taxing scheme exactly the same as the taxing scheme under review." A tax fails the test if such analysis shows that "an additional tax is imposed because, and only when a sale crosses the city's boundaries." Note that this test is conducted in the abstract, so a court will invalidate a tax that has failed the internal consistency test even where no other jurisdiction *actually* imposes the tax that would cause duplicate taxation.

The principal California case applying the internal consistency test is *General Motors Corp. v. City of Los Angeles* (1995) 35 Cal.App.4th 1736. *General Motors* concerned a challenge to the City of Los Angeles's business license tax. Under the taxation scheme in effect at the time, manufacturers within the City of Los Angeles were taxed on gross receipts from both *intra*city and *inter*city sales, while sellers who did not manufacture within the City were taxed only on the gross receipts from their sales within the City. The *General Motors* court held that this scheme was impermissible because, were Los Angeles and a hypothetical 'City X' both to levy these taxes, a company manufacturing a product in City X and selling the product in Los Angeles would pay two taxes[68], while a company that both manufactured and sold the product in Los Angeles would pay only one tax.[69] The tax thus favored in-City businesses over outside-City competitors in violation of the Dormant Commerce Clause. The City's business tax ordinance has since been amended to redress this issue. San Francisco recently faced a similar Dormant Commerce Clause challenge to its gross receipts tax and amended its business tax as well.

A second California case applying the test is *Union Oil Co. v. Los Angeles* (2000) 79 Cal.App.4th 383. *Union Oil* considered a challenge against a taxing scheme pursuant to which the City of Los Angeles imposed a payroll tax *and* a gross receipts tax, but provided that businesses subject to the payroll tax would be exempt from the gross receipts tax and visa versa. The *Union Oil* court held that this scheme was impermissible under the internal consistency test because a company with large manufacturing payroll costs in one city, but large sales in another, would effectively pay two taxes, while a company doing all of its business within a single city would only pay one tax.

As these two cases show, it is possible to violate the internal consistency test not only with a tax that on its face applies only to businesses based outside of a city, *but also* with a tax that only incidentally has a discriminatory effect. Therefore, the internal consistency test must be rigorously applied to an entire scheme of taxation. Some of the proposals under review by the BTAC, such as a credit against business license taxes for sales taxes paid to the City would appear vulnerable under

[68] The two taxes are the manufacturing tax to City X and the selling tax to Los Angeles.

[69] The one tax is a manufacturing tax to Los Angeles. *Id.,* at 1745

this analysis, because they treat businesses that sell within the City more favorably than businesses that sell elsewhere.[70]

External Consistency Test

The ‘external consistency’ test asks whether a taxing entity has taxed “only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed.”[71] This test has been explained by one California court as follows:

> “‘External consistency’ does not look to the abstract and purely logical consequences of an imagined cloning of the challenged tax. Rather, it looks to those "‘less tidy"’ issues which concern the actual economic justification for the state's claim upon the value taxed and the actual or likely risk that the challenged tax will result in multiple taxation. [The external consistency test] inquires as to whether a challenged tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing state. If it does, the apportionment prong of the … test is violated. If one state's act of overreaching combines with the possibility that another state will claim its fair share of the value taxed, then that portion of value by which the first state exceeded its fair share is taxed a second time by a state properly claiming it. Such double taxation constitutes an impermissible burden upon, and discrimination against, interstate commerce.”[72]

Examples of the application of the external consistency test have only infrequently been included in the case law, and the cases tend to cite the external consistency test far more often than they apply it. However, the test does appear to encompass a number of older cases, which held that a common carrier, traveling through a taxing entity, may be taxed only on the portion of operations that occur in that state. The key strategy for preventing a violation of the external consistency test is now, and will likely continue to be, to allow taxpayers to apportion their gross receipts as between those generated within the City and those generated elsewhere.

Strategies

While by no means the only methods for avoiding internal and external consistency violations, two strategies are often used in drafting taxes to prevent successful commerce clause challenges.

The first strategy is to provide a credit against a tax for amounts paid to another jurisdiction for the same activity. Such credits, common in the field of sales and use taxation, permit the taxation of almost every type of sale or use, without risk of double taxation.

The second strategy is to avoid the bundling of taxes or cross-credits between taxes (such as payroll and gross receipts or sales and gross receipts). It is doubtful, for example, that the court in *General Motors* would have reached the conclusion it did if all sellers, whether of products manufactured in Los Angeles or elsewhere, were subject to the same tax on their gross receipts from

[70] This is the case because the City does not receive sales taxes on sales that occur outside its boundaries and thus would provide little credit against business license taxes paid by businesses located in the City that sell elsewhere.

[71] *Goldberg*, at 262.

[72] Yamaha, at 367.

sales in Los Angeles, while manufacturers in Los Angeles were *also* subject to an additional tax based on their manufacturing activities.

A third strategy involves better understanding how outsiders come to be taxed, and then seeking user fees to obtain equivalent revenue from them in a form less amenable to attack under the Dormant Commerce Clause. Many of the outsiders are construction-related business and are heavily regulated already, which creates opportunities to raise fees from such businesses. However, it is difficult to structure fees affecting outside developers and construction-related businesses without penalizing construction-related businesses located within the City.

Property Tax Prohibition

With the exception of taxes related to the repayment of bonded indebtedness and certain special taxes whose proceeds are earmarked for a specific purpose, cities may not levy any new tax "whose imposition is triggered merely by ownership of property." Referred to in the legal doctrine as "property taxes," these sorts of taxes are prohibited by the California Constitution.

The bar against the levy of property taxes derives from the interaction of two provisions of the California Constitution. The first provides that, with limited exceptions not relevant here, "all property … shall be taxed in proportion to its full value."[73] The second provision, adopted by voters in 1978 as part of Proposition 13 fixes the ad valorem tax at 1% of value, except for taxes to repay certain bonded indebtedness. Because cities are, on the one hand, prohibited from levying any property tax other than the ad valorem tax, and, on the other hand, prohibited from increasing the rate of the ad valorem tax, these two constitutional provisions combine to bar cities from levying new, general, property taxes.

The key to understanding the scope of this prohibition lies in the meaning of the term 'property tax.' Cities may not raise general fund revenues through a tax on property ownership per se. They may, however, levy taxes upon the use of property or upon the exercise of privileges associated with ownership of property. These types of taxes are referred to as 'excise taxes.' Examples of excise taxes include business license taxes[74], real property transfer taxes[75], and transient occupancy taxes.[76] Indeed, the courts have intimated that it may be possible to legally structure a tax "on the use of city services" as a parcel tax.

The challenge for a city in designing a new tax relating to property is to ensure that the new tax is indeed an excise tax and not a prohibited property tax. There is no bright line demarcating the boundary between excise taxes and property taxes. Indeed, in recent years the courts have invalidated several taxes that had been cast by cities as excise taxes. A number of important guidelines can be gleaned from these cases. Specifically, an excise tax should meet the following guidelines:

[73] This provision bars any general property tax other than the ad valorem tax.

[74] Business license taxes are often triggered by the exercise of the privilege of operating a business that leases real property.

[75] The transfer of real property to a new owner triggers property transfer taxes.

[76] Transient occupancy taxes are triggered by the exercise of the privilege of occupancy in a hotel.

- Clearly state the use or privilege which is being taxed (*i.e.,* the privilege of doing business in the City);

- Tax an actual use or privilege and not some aspect of land ownership that is inseparable from mere ownership by a passive owner;

- Be calculated according to a schedule that is rationally related to the taxed use or privilege (and proportionate to the taxed use or privilege);

- Exempt owners of vacant parcels, unless the owner either makes use of the vacant parcel in the manner that is subject to the tax or exercises the privilege being taxed (such as a license tax on Christmas tree lots);

- Be levied against any person, potentially including both occupants and tenants, who engage in the taxed use or exercise the taxed privilege; and

- Be a personal obligation of the property owner, rather than an obligation that runs with the land and that is charged on the annual property tax bill.

The case law interpreting the distinction between property taxes and excise taxes do not single out any particular basis for tax calculation (such as square footage or gross receipts) as being an impermissible attribute of excise taxes. Indeed, even parcel taxes are not categorically prohibited by the cases. Instead, both the cases stress that "the primary test for determining whether a tax imposed on real property was an excise tax or a property tax was an analysis of [the] incidents and practical effects of the imposition of the tax." In other words, the courts look at whether a tax is upon use, privilege, or mere ownership.

In sum, a tax measured by the amount or type of property used by the taxed business can be crafted in order to avoid running afoul of the constitutional prohibition against property taxes. Moreover, if the City proposes to tax the privilege of conducting business within its boundaries by a measure which looks to the amount or value of real estate used in the conduct of that business, such a measure can be crafted as a valid excise tax although drafting such a tax to avoid a successful Dormant Commerce Clause attack will be challenging, especially if an advantage to economically disadvantaged districts of the City is to be included in the design of the tax.

Municipal Income Tax Prohibition

California cities are precluded from taxing incomes; Revenue & Taxation Code Section 17041.5 prohibits a city from levying or collecting a tax upon the income of any person, resident or nonresident and further states that "[t]his section shall not be construed so as to prohibit the levy or collection of any otherwise authorized license tax upon a business measured by or according to gross receipts." This prohibition does not apply to a payroll tax (a tax upon the amount of payroll--one of the costs of running a business) or to an employee licensing tax (a tax upon the wage income earned in the City by workers. However, it likely would apply to a tax against all elements of the income of a business.

Other Legal Prohibitions

State and federal law has established provisions that preclude cities from taxing financial institutions, insurance companies, and sales of alcoholic beverages, tobacco, and gasoline.

Optimal Taxation

Economic theory about optimal taxation and applied studies of actual tax reform efforts both shed light on the criteria by which tax policy alternatives might best be evaluated.

Traditionally, economists have focused on efficiency in the analysis of competing tax alternatives. Simply put, efficiency means that a tax policy changes the behavior of individuals, businesses, governments, and other economic actors as little as possible. More formally, efficiency means that a tax policy minimizes the distortion of economic decisions and maximizes market competition. Economic decisions are decisions such as whether and how intensely to work, what to buy, how much to save, and whether to hire permanent staff or to use subcontractors. A tax policy might interfere with economic decisions when the tax is significantly higher after a certain economic decision is made, and significantly lower when another economic decision is made. A tax policy might also interfere with market competition when it rewards large, established firms with proportionately lower tax burdens. For example, a tax policy with a lower tax load for established businesses compared with recent start-ups might tend to reduce healthy competition between firms. Another example is that a tax policy with a burden falling heavily on a particular industry would tend to increase the cost of whatever that industry produces or drive that business out of the taxing jurisdiction.

Macroeconomic growth is another economic benefit used as an evaluation criterion for certain policies. For example, tax relief would be expected to leave business taxpayers with greater resources that could be used for hiring additional workers.

Another facet of optimal taxation often considered by economists and political scientists is equity, which can be measured in a 'horizontal' or 'vertical' fashion. Horizontal equity refers to treating taxpayers in the same economic situation the same. Vertical equity refers to treating taxpayers in different economic situations differently. In the everyday world of politics, equity is essential to garnering political support for a reform package. To the economist, the notion of equity may be based on the taxpayer's ability to pay or on the benefits that the taxpayer receives in terms of government services. Horizontally equitable tax policy is applied at the same rates to taxpayers of equal income or cost to the government. Vertically equitable tax policy charges lower rates to those with small incomes and a lesser ability to pay compared with high-income taxpayers. A tax policy with lower rates for those with less income would be progressive, whereas a tax policy requiring a greater percentage of a less well off person's or business' income to be paid than the well-to-do would be regressive. For example, sales taxation—particularly when applied to groceries and medical care—is perceived as regressive, whereas higher marginal income tax rates for the rich is progressive.

Certain researchers focus on tax compliance as an important goal of tax policy. Increased audit rates, higher penalties, tax simplification, and self-policing taxes tend to increase tax compliance.[77]

[77] Alm, 1996; Slemrod, 1992.

Policies that effectively boost tax compliance also improve equity when dishonest taxpayers pay as much as honest taxpayers. Although audit and penalty rates improve compliance, there are limits to optimal audit and penalty rates.[78]

Closely related to compliance are administrative considerations, such as the tax administration's ability to collect and enforce a particular tax policy. Certain tax policies may prove difficult or costly to enforce compared with other tax policies. For example, it is difficult and costly to tax something that cannot be readily observed and measured, such as the rental value of owner-occupied factories or the difference between wages and profits among sole proprietors. Another example is that a policy with many different tax rates is more costly to administer than a simpler tax system.[79]

Tax simplification and transparency are considerations often raised in tax policy analysis. Both of these issues were raised as evaluation criteria by the Washington legislature in its direction to a tax reform study committee. The premise behind these concepts is that a good tax system is designed to ensure that tax burdens are clear and evident, and that taxpayers are not burdened with unnecessary record keeping and calculations beyond the typical taxpayer's math skills.[80]

Revenue stability is also a consideration in applied tax policy analysis. Stability refers to tax policy that generates revenues that reliably generate tax revenue through the ups and downs of the business cycle and through the evolution of the economy towards increased global, Internet, and service sector activity. For example, a square footage tax is expected to be rather stable due to the fact that building square footage does not vary significantly over the business cycle. Stability may also be used to refer to the adequacy of the growth in the tax base compared with the demand for government services. For example, a square footage tax would not be expected to grow with the overall economy except to the extent that the tax rate is indexed to keep pace with inflation.

Another consideration used in evaluating tax policy is political feasibility. Tax reform is unlikely to occur unless the new tax policy's advantages are real and substantial enough for ordinary people to see past the disadvantages. [81] Further, tax reform must receive wide political support in order to interest policymakers in championing a change in policy.

Other tax policy objectives may include tax exporting, which means that a tax is borne more heavily by outsiders. For example, a tax on rental cars would tend to be borne by outsiders traveling into the taxing jurisdiction. Yet another tax policy objective may be to promote home ownership, to stimulate certain industries, or to rid a jurisdiction of businesses disliked by residents, such as gun dealers.

[78] Slemrod and Yitzhaki (2002) argue that "the harsher the penalty, the more damage that can be inflicted by a corrupt administrator or, in the case of an honest mistake, the more capricious the system is". Regarding audit rates, the authors argue that tax enforcement activities should be limited to avoid a socially excessive amount of resources devoted to enforcement and compliance.

[79] Slemrod, 1990.

[80] Washington State Tax Structure Study Committee, 2002.

[81] Bird, 2003.

EVALUATION CRITERIA

Most of the considerations discussed in the prior section have been included in the conceptual framework for evaluating tax policy. Several of the criteria discussed above were grouped together, while other criteria such as political feasibility are being left for evaluation by the City's policymakers and business community leaders.

The MMC team has focused on four major categories of evaluation criteria. In order to satisfy all economic agents, policymakers should take into consideration the evaluation criteria of economic benefit, administrability, revenue stability, and equity (the "EASE criteria"). However, it should be noted that these criteria will conflict. For example, what is considered equitable will not necessarily result in stable revenues and satisfy growth and development objectives.

Economic Benefit

The economic benefit criterion emphasizes economic efficiency and promotion of the City's economic development objectives.

The efficiency principle is based around the economic principle that whenever possible, taxes should be designed in such a way that they cause minimum disruption in the economic decisions of taxpayers. For example, imposition of a flat tax (like a simple business license fee) would increase the tax burden of small businesses and reduce the tax burden of large businesses; such a policy would discourage small businesses, which is not considered economically efficient.

It is important to contemplate the efficiency principle in the existing institutional context of current California government. Inefficient incentives may have been instituted as a result of tax policy decisions made by the City or the State. For example, Proposition 13 encourages property owners not to sell real estate or to do so in a manner that escapes reassessment (as by a sale of stock in an entity which owns land rather than sale of the land itself), and tends to benefit businesses in existence prior to 1978. A tax policy aimed at promoting housing development would counterbalance the inefficiencies imposed by Proposition 13.

The optimal tax system should also address economic development objectives, such as promotion of export industries, job creation, and housing growth. A well-designed tax system can help to stimulate the development of specific regions in a local jurisdiction and decrease unemployment.

There can be conflicts between economic efficiency goals and promotion of the City's economic development objectives. The City's economic development objectives include the promotion of growth and export-oriented industries;[82] however, providing tax benefits to such industries is not necessarily economically efficient. Thus, both aspects of the economic benefit criterion should be considered in evaluating the economic benefits.

[82] Source is MMC interview with City of Los Angeles Mayor's Office.

Administrability

The administrability criterion involves three principles: Minimizing the cost to the taxpayer of compliance, minimizing the cost to the City of enforcing tax policy, and maximizing taxpayer compliance.

Taxpayers' costs of tax compliance

It is not costless for firms to pay taxes.[83] Keeping records and completing tax forms add to the cost of doing business. When tax policy requires business to track activity in a manner already being tracked for some other purpose, this reduces the cost of compliance. A greater number of tax categories will tend to increase the cost of compliance due to the requirement to track and report activity by these categories, whereas a system involving relatively fewer categories will tend to reduce the cost of compliance. When tax form instructions are clear, this tends to reduce the cost of compliance.

Governmental costs

Government agencies also incur costs to collect and enforce taxes. In general, complexity in tax policy increases the cost of enforcement.[84]

The City's costs of enforcing the tax are largely driven by the same factors that affect the taxpayer's cost of compliance. Greater transparency in the tax policy rules and instructions will tend to decrease enforcement costs due to fewer phone calls and confused taxpayers. Tax policies with a greater frequency of tax payment (*e.g.*, monthly rather than annual filing) tend to increase collection costs. A tax policy requiring fewer taxpayers to remit the tax would tend to reduce governmental costs. Tax forms that require taxpayers to report their calculations will tend to decrease enforcement costs by creating greater opportunities for desk audits, which are less expensive than field audits. Cooperation and information sharing with other government agencies tends to reduce administrative costs.

Tax compliance

When the tax base is self-reported by taxpayers and not easily verified, opportunities for non-compliance are increased. When the tax base is verifiable through alternative data sources and when the taxpayer is required to report its calculations on tax forms, opportunities for non-compliance are reduced.

Tax compliance depends, in part, on audit and penalty rates: The higher the probability of being audited and the greater the penalty for evasion, the less tax evasion is observed.[85] However, increased audit rates will generally increase the City's enforcement costs and, moreover, will increase

[83] Taxpayer compliance costs for the federal income tax are about ten cents per dollar collected (Slemrod and Yitzhaki, 2002).

[84] Administrative cost is an increasing function of the complexity and lack of clarity of the tax law (Slemrod and Yitzhaki, 2002). Tax complexity also increases non-compliance. Empirical research indicates that complexity increases the reliance on paid preparers, and that average non-compliance is higher on forms prepared by tax practitioners (Alm, 2001).

[85] The basic theory of tax evasion concludes that compliance depends on audit and penalty rates. Empirical research has concluded that higher audit rates increase compliance, as do higher penalty rates; however, audit rates should be reasonable to avoid socially excessive commitment of resources to compliance (Alm, 2001; Slemrod and Yitzhaki, 2002).

the burden and compliance costs for taxpayers in providing and reviewing records with auditors. Thus, there is a tradeoff in establishing audit rates that increase compliance and minimize the burden of the tax on businesses. Similarly, penalty rates should be reasonable to avoid both capriciousness and administrative corruption.

Stability

A stable revenue source is less vulnerable to business-cycle fluctuations and State policy changes outside the control of City policymakers.

When tax policy is based on economic activity that fluctuates significantly over the business cycle, municipal revenues will decrease during recessions and rise during the expansion phase of a business cycle. Cyclical revenue streams, such as the documentary transfer tax, may not be deemed desirable to the extent that the City's expenses are relatively stable over the business cycle unless they are part of a portfolio of revenue sources that, taken as a whole, has an acceptable degree of volatility.

The stability of a tax alternative also depends on its vulnerability to State fiscal policy decisions. Future tax decisions made by the Legislature or by ballot measures may jeopardize certain tax alternatives, such as the recent reduction in the vehicle license fee, a substantial contributor to the City's general fund and one of the few that correlates well to population growth and concomitant service demand. If the City were to increase its reliance on sales tax revenues and if the State were to expand sales tax exemptions (such as the current State and federal prohibitions on taxation of internet transactions), the City's future sales tax revenues would decline. Another example relates to real estate alternatives. Policymakers in Sacramento are currently considering the adoption of a split-roll property tax that would allow the base of business property taxation to be its market value, while the residential portion of the property tax base would still be calculated based on acquisition value. If the California electorate were to adopt this proposal, it could affect voters' perceptions of the equity of a real estate rental alternative to the business tax.

Another aspect of revenue stability relates to the reliability of pre-reform revenue estimates. There may be more reliable data for measuring the impacts of certain tax policies, such as a payroll tax, than for other tax policies not currently in existence.

In measuring stability, the study focuses on how a business tax alternative would affect the volatility of the City's revenues. This approach takes the view that the City's major revenues constitute a portfolio, and that the key issue to the City is the volatility of its overall revenue portfolio rather than the volatility of a particular revenue stream. Indeed, certain revenue streams such as property-based taxes are more volatile than the gross receipts tax, but their volatility does not follow the business cycle in the same fashion as other revenue streams. Hence, a property-based tax ends up offsetting volatility in other revenue streams to yield greater stability in the City's portfolio of major general fund revenue streams.

Equity

The equity criterion posits that the tax burden should be distributed equally across all businesses and individuals in two senses, horizontal and vertical equity.

Horizontal equity

Horizontal equity requires that those with equal status—whether measured by ability, income or use of City services—pay the same amount of tax and receive the same amount of benefits. There are two principles for assessing horizontal equity: Ability to pay and the benefit principle. The ability-to-pay principle calls for all businesses with the same income level to pay the same tax. The benefit principle calls for each taxpayer to contribute according to the benefit received from the services provided by government agencies.

In this study, greater weight is given to the ability-to-pay principle than to the benefit principle because ability-to-pay is more concrete, simpler to measure, and serves as the primary horizontal equity concern raised by the business community.

Vertical equity

Vertical equity, which most interpret as progressivity, favors those with less ability to pay or lower profitability, as well as businesses located in areas where low-income customers and workers are concentrated. Progressive tax policy is based on the notion that low-income individuals and businesses have a lesser ability to pay because they must devote a greater share of income to necessities, whereas higher-income individuals and businesses have a greater ability to pay because they spend a greater share of income on other things. For taxation of businesses, evaluating vertical equity requires consideration as to which businesses have greater needs as well as who is truly bearing the burden of the tax. To the extent that neighborhood businesses pass the tax on to customers, vertical equity requires us to consider how a tax alternative affects residents of low-income neighborhoods, such as South Los Angeles, compared with residents of wealthy areas, such as Brentwood.

CHAPTER 4: POLITICS OF REFORM

In this chapter, there are several perspectives relating to tax reform. The chapter reviews business tax reform studies and legislation in states with gross receipts taxes and in states precluded from imposing income taxes. The Los Angeles business community perspectives on the tax from business roundtables and a business survey are also presented. Finally, an independent evaluation of the City's current business tax is provided.

BUSINESS TAX REFORM: LESSONS FROM THE STATES

In recent years, several states have reformed or considered reform of their business taxes to promote equity and simplicity. In this section, a review of the business tax reforms that have been contemplated and implemented, with a particular focus on jurisdictions with gross receipts taxes and jurisdictions precluded from imposing income taxes, is given. The purpose of the section is to shed light on the successes and failures of business tax reform experiences.

Indiana and West Virginia have eliminated their gross receipts taxes in recent decades. The Nevada and Kentucky legislatures rejected their governor's respective gross receipts tax proposals in the last fiscal year. The four states with a gross receipts tax—Washington, Hawaii, Delaware and New Mexico—have periodically evaluated reform. Reform efforts in these states have primarily focused on incremental reform to improve the equity of the receipts tax approach.

All but six U.S. states tax corporate income, the exceptions being Michigan, Nevada, South Dakota, Texas, Washington, and Wyoming, which have no corporate income tax. These six states have relatively unique tax approaches and have studied tax reform over the years. The state of Michigan imposes a value-added tax. Washington, Texas and Nevada are precluded by their state constitutions from taxing income and have all considered value-added taxes in recent years. Faced with a budget deficit, Nevada reformed its business license tax this year, converting it from an employee tax to a payroll tax.

Hawaii

Hawaii levies both a corporate income tax and a gross receipts tax, although it does not levy a retail sales tax. The corporate income tax generates relatively modest revenue for the general fund.[86] Hence the gross receipts tax is the major source of business tax revenue, constituting half of general fund revenue. The tax, officially called the General Excise Tax (GET), is a business privileges tax measured on gross receipts from sales or gross income. The tax is applied at every step in the distribution chain, from production to retail. Limited deductions are allowed for construction subcontracting and narrow wholesaling activity. Wholesalers and manufacturing are currently taxed at $5 per $1,000 in receipts. Retailers and services are taxed at $40 per $1,000 in receipts, with recently enacted opportunities for paying on certain limited activity at the wholesale rate.

[86] Hawaii's corporate income tax generated less than 2 percent of general fund revenue—the lowest of any state levying a corporate income tax (Honey, 2002).

Over the years, Hawaii has explored the idea of reforming the tax, as the tax structure is often perceived as being inequitable due to tax 'pyramiding': Because a gross receipts tax does not allow deductions for raw materials or cost of goods sold, such costs are essentially taxed each time the good passes through to another manufacturer, wholesaler, or retailer. Due to the tax being imposed at each step, the tax 'pyramids' so that the tax paid by the consumer is significantly larger than the 4 percent tax rate.

In 1997, the state formed an Economic Revitalization Task Force to study competitiveness measures with a working group specifically devoted to taxation issues. The Task Force focused on the pyramiding effects of the tax. The Task Force recommended that taxing inter-business transactions at the wholesale rate be instituted in order to reduce the pyramiding effects.

In 1999, the state adopted tax reform to exempt exports from the tax base and to reduce the pyramiding effect of the gross receipts tax. The reform allows retailers and service providers to be taxed at the lower wholesale rate for the portion of goods resold to customers. For example, the sale of paper to a copy center, the sale of toiletries to hotels, and the sale of accountant services to law offices are taxed at the lower wholesale rate. The tax reform measure is being gradually phased in over a seven-year period, with ½ percent annual reductions in the rate for double-taxed transactions subject to pyramiding effects.

The Hawaii Tax Review Commission has continued to study problems with the state tax structure. The commission's 2003 report recommended that the legislature codify the goal of taxing only once business-to-business transactions, and that the tax administrators work with industry groups to solve the problem.[87] The commission criticized the recent proliferation of tax credits and incentives as poorly conceived and a contributing factor to recent revenue shortfalls. The legislature has subsequently debated limiting tax incentives recently given out; the state's budget deficit currently precludes elimination of double-taxation of business-to-business transactions.

Indiana

Indiana repealed its gross receipts tax in 2003. The gross receipts tax had been the primary business tax up until several decades ago when the tax was replaced with a three-part corporate income tax, with the gross receipts tax constituting one of the three components of the tax.

The Indiana Supreme Court mandated a new property assessment system, providing the impetus for evaluation and reform of the state's tax structure. A study group of independent experts was formed that recommended complete elimination of the gross receipts tax, among other measures. The gross receipts tax repeal was financed by an increase in the corporate income tax. The reforms became effective in January 2003.

Michigan

Michigan adopted the Single Business Tax Act on January 1, 1976, which replaced the corporate income tax, the local property tax on business inventory, the corporate franchise tax, and several other smaller taxes with the country's first state levied value-added tax. It was intended to be revenue neutral and to distribute the tax burden differently among different types of businesses.

[87] Hawaii Tax Review Commission, 2003.

Since its implementation, the tax has been greatly modified as a result of complaints from those claiming to be unfairly burdened by this Single Business Tax (SBT).

The SBT differs from standard corporate income taxes in two ways: Firstly, it applies to all business entities, not only corporations, and secondly, it is a tax on value-added rather than income. In the original design of the SBT, taxpayers could deduct capital expenditures from the SBT base, but complications stemming from the taxation of multi-state businesses ultimately dictated a regime in which expenditures on capital located in Michigan cannot be deducted but are instead eligible for investment credits.

While the evidence suggests that the SBT has generated a more stable revenue stream than that produced by the corporate income taxes of other states, investment incentives under the SBT differ significantly from those produced by textbook value-added taxes. The SBT also has the vexing property of imposing significant taxes on firms that lose money. In the wake of multiple tax reforms, the SBT became sufficiently unattractive to enough of the state that legislation (passed in the summer of 2002) mandated its removal by 2010.[88]

Problems with the Single Business Tax emerged in the 1990s due to the multi-state nature of many of Michigan's businesses. Michigan legislators were understandably concerned that investment incentives under Michigan's Single Business Tax might reward Michigan firms for investing outside of Michigan. The SBT was designed to minimize the extent to which firms could obtain Michigan tax deductions for out-of-state investment expenditures, but this design feature came under increasing fire from those who maintained that such provisions violate the Interstate Commerce Clause of the U.S. Constitution.

The Single Business Tax was amended in 1995 (effective starting in 1997) to permit favorable treatment only for assets put in place in Michigan, but legal challenges to this provision prompted the elimination of capital acquisition deductions in 1999 (effective starting in 2000), and their replacement with a new system of investment tax credits. Among the costs of these frequent changes, however, were political compromises and an emerging viewpoint that the tax was overly complicated, anti-competitive, and a burdensome tax that penalizes job creation and discourages economic development.[89]

As a result, the Governor signed legislation in 1999 to phase-out the SBT by the year 2010. The phase-out halted per legislative provision once revenue losses caused the rainy day fund to dip below $250 million. Indeed, the revenue losses have now triggered this provision; no other tax instrument to replace current SBT revenues upon phase-out has yet been proposed. Consequently, the SBT continues to be Michigan's only generally levied value-added business tax.

Nevada

Nevada's constitution precludes a state income tax. Sluggish construction and falling sales tax revenues recently led to a budget deficit. Faced with inadequate funds for Nevada's growing schools, the state recently enacted business tax reform and raised excise taxes on cigarettes and alcohol.

[88] Hines, 2002.

[89] House Legislative Analysis Section, 1999.

Nevada Governor Kenny Guinn formed a Task Force on Tax Policy in Nevada in 2001. The Task Force assessed payroll, gross receipts, and employee taxes. The Task Force released its final report in Nov. 2002, recommending a gross receipts business tax with exemptions for small business and the gaming industry.[90] The Task Force gave high ratings to the receipts tax for its revenue-generating ability, revenue stability and ease of compliance, while the receipts tax was rated poorly on equity and transparency grounds. The Governor subsequently proposed a gross receipts tax levied at $2.50 per $1,000 in receipts for businesses with $450,000 or more in receipts.

The Las Vegas Chamber of Commerce and other business interests opposed the Governor's proposal. Critics of the proposed business tax reform pointed to the tax pyramiding problems of a receipts tax, inequitable impact of the proposal on retailers, the complexity and unpopularity of a similar tax in the state of Washington, and concern that the proposed flat rate of 0.25 percent would morph into a Washington "Swiss cheese-like code riddled with exemptions, carve-outs and a multiplicity of rates".[91]

Legislators enacted a 0.7 percent tax on payroll with deductions for employer health care payments. The payroll tax became effective October 1, 2003, and replaced the state's business license tax on employees.

New Hampshire

In 1993, the State of New Hampshire introduced a Business Enterprise Tax to finance a rate reduction for the existing Business Profits Tax. The Business Enterprise Tax is an addition-method value-added tax on wages, rent, profit and other forms of compensation.

Although the Business Profits Tax continues to raise the majority of business tax revenue for the State, the Business Enterprise Tax rate has been increased from its original rate of 0.25% to 0.75%. The tax is assessed on the enterprise value tax base, which is the sum of all compensation paid or accrued, interest paid or accrued, and dividend paid by the business enterprise, after special adjustments and apportionment. Only businesses with more than $150,000 of gross business receipts from all their activities or an enterprise value tax base more than $75,000 are required to file a return.

Overall, the Business Enterprise Tax has compared favorably to the Business Profits Tax in terms of perceived equity, stability, efficiency, simplicity, growth, and competitiveness.[92] The success of New Hampshire's Business Enterprise Tax, compared to that of the value-added tax in Michigan, can be attributed to its relative simplicity and to the fact that the tax was introduced as a supplement, not a replacement, for the state's existing Business Profit Tax, phased in gradually over several years.

New Mexico

New Mexico imposes a business gross receipts tax, a corporate income tax and a franchise tax on businesses. The gross receipts tax is levied on most businesses and even certain government transactions. The tax rate varies from 5.0% to 7.25% depending on where the business is located,

[90] Governor's Task Force on Tax Policy in Nevada, 2002.

[91] Henderson (2003) indicated that Washington's gross receipts tax pyramids 2.5 times, and that the Washington gross receipts tax regulations are 800 pages long.

[92] Kenyon, 1996.

with the difference due to gross receipts taxes imposed by counties and municipalities. There are various exemptions and credits.

In 2003, the State formed a Blue Ribbon Tax Reform Commission to study tax reform, with particular interest in addressing the regressive nature of the tax and its impact on low-income individuals. The Commission was charged with completing its work within a 120-day period. The Commission recommended that instead of exempting food transactions from the gross receipts tax base, relying on a low-income tax credit on the personal income tax would be less expensive. Further, the Commission recommended various exemptions and credits within the gross receipts tax structure to reduce tax-pyramiding effects and promote greater equity. The Commission did not assess comprehensive reform to the gross receipts tax, such as changing to another tax base.[93]

The Commission's recommendations were reviewed in special legislative session in early November. No gross receipts tax reform measures were adopted.[94]

Washington

Washington's constitution precludes income taxation, and a solid two-thirds of the electorate has repeatedly rejected corporate income taxation most recently in 1982. Instead, Washington levies a gross receipts tax officially called the Business and Occupation Tax (B&O). The Washington Department of Revenue describes the tax with the euphemism of a 'gross income' tax; however, businesses are not allowed to deduct subcontractor payments, costs of doing business, materials used, labor, or taxes. The major B&O tax classifications and rates are depicted in Table 4-1. The tax owed is computed by multiplying the tax rate by the amount of gross receipts, by gross volume of sales, or other taxable amounts. A separate tax calculation and set of rules apply to each of 61 tax categories.

Table 4-1: Gross Receipts Tax Rates: Washington vs. Los Angeles

Gross Receipts Tax Rate (per $1,000)		
	LA	**WA**
Retail	$ 1.48	$ 4.71
Professional	$ 5.91	$ 15.00
Manufacturing	$ 1.18	$ 4.84
Wholesale	$ 1.18	$ 4.84

Businesses must report and pay B&O tax under each appropriate classification. For instance, a floor-covering store may sell carpet directly to homeowners for their use (a retail sale) and may also sell carpet and tile to construction companies that resell the items to the homebuyer (a wholesale transaction).

In 1987, the U.S. Supreme Court ruled that the B&O tax was unconstitutional with respect to certain interstate transactions. In response, the Washington Legislature implemented several credits to reduce the possibility of double taxation for manufacturing firms that do business in other states. Exemptions currently apply to health maintenance organizations, property managers, farmers, and certain wholesalers, while tax credits are available for software developers, small businesses, and research companies, among others.

In late 2001, the Washington State Legislature commissioned a committee to study the State's tax structure and evaluate revenue-neutral alternatives other than an income tax. The legislature

[93] Blue Ribbon Tax Reform Commission, 2003.

[94] A tax reform bill proposed in the House to allow certain deductions and exemptions was not acted upon by the House Appropriations and Finance Committee; no Senate tax reform bills were proposed.

instructed the committee to use five principles to guide its evaluation: Simplicity, economic neutrality, fairness, stability and transparency. Further, alternatives were to be designed to increase harmony with neighboring tax systems, promote business creation, and encourage home ownership.

The committee concluded in its 2002 report that the tax is regressive, that it is inequitable as it penalizes new and growing businesses, that it distorts economic decisions due to its tax-pyramiding effects, that it generates volatile revenues, and that it is complicated due to a lack of uniformity of tax definitions and apportionment rules. The committee recommended that the State replace its gross receipts tax with a subtraction-method value-added tax,[95] and made other recommendations of incremental reforms. The legislature has focused on incremental reforms, and adopted municipal level uniformity in gross receipts taxation as well as sales tax simplification and review of tax incentives.

West Virginia

West Virginia formerly relied heavily on a business gross receipts tax. The tax became unpopular because it was not based on businesses' ability to pay. In 1985, the State enacted broad business tax reform. Most businesses became subject to a franchise tax (on net equity) and a corporate income tax, in addition to licensing fees. In the late 1980s, generous business tax incentives were enacted and financed by including groceries in the sales tax base.

West Virginia's former Governor Cecil Underwood appointed a Commission on Fair Taxation in 1997. The Commission reviewed the State's tax structure and assessed alternatives based on numerous criteria including equity, consistency, simplicity, competitiveness, revenue yield, and enforceability. The Commission's 1999 report criticized the State's existing tax structure as regressive, overly complicated, inequitable due to excessive use of special tax breaks, and uncompetitive due to a high corporate income tax rate. The report encouraged the State to switch to a broad-based business tax with low rates and few tax preferences. Specifically, the Commission recommended that the State enact a value-added tax to replace the corporation net income tax, business franchise tax, business registration tax, corporation license tax, insurance premiums taxes, and the property tax on tangible personal property.[96]

The State proceeded to develop informational tax returns so that specific tax rates and revenue impacts could be assessed before enacting tax reform. The 2000 election ushered in Governor Bob Wise, who rescinded the requirement for businesses to file informational tax returns. The chair of the Commission on Fair Taxation is campaigning to further the business tax reform agenda if elected governor in November 2004.

[95] Washington State Tax Structure Study Committee, November 2002.

[96] Governor's Commission on Fair Taxation, 1999.

BUSINESS COMMUNITY PERSPECTIVES

The business community perceives the City of Los Angeles business tax as uncompetitive, inequitable and overly complicated.[97] The Business Tax Advisory Committee has for several years criticized the tax as such, and has focused on incremental reforms to improve the tax.

In the course of this study, the City, in conjunction with the research team, conducted an online survey of business taxpayers and hosted three roundtable sessions with the business community regarding alternatives to the City's gross receipts tax.

At each of the business tax roundtables, the City presented the policy context for the meeting and the MMC team presented the alternatives under consideration. The business community members then engaged in discussion and asked questions, requesting tax rate relief and pointing to lower tax rates in neighboring jurisdictions. The Valley Industry and Commerce Association, Valley Vote and Kosmont Companies have focused on uncompetitive tax rates, and called for business tax relief.[98]

Almost as often, the business people complained about the complexity of the existing tax. In particular, accountants and professionals complained that the apportionment rules are unclear and complicated. Furthermore, some asked for simple tax approaches, such as a flat tax or an employee tax, which could be easily apportioned. Both the Valley Industry and Commerce Association and Valley Vote have focused on complexity and called for business tax simplification.

Another issue raised by business community members was inequity. Several complained that the gross receipts tax base unfairly taxes subcontractor payments and commissions paid to talent agents. The Los Angeles Area Chamber of Commerce has identified business tax reform as its top legislative priority, and is particularly concerned about the inequity of taxing business-to-business transactions multiple times.[99] Others, including Valley Vote, complained that tax rates were not fair between industries.

Business community members also raised concerns in regards to their particular industries. Independent contractors argued that they should not be subject to the business tax while a restaurant owner argued for tax relief for small businesses. The Building Owners and Managers Association (BOMA) raised concerns about a square footage tax or a commercial rental tax, argued that high-rise office building tenants are in compliance with the business tax, and that taxing real estate usage would not improve compliance. A motion picture industry representative inquired as to whether the current cap on business taxes for large studios would be retained under the value-added and modified receipts tax alternatives.

The online taxpayer survey was a collaborative effort of the Mayor's office and the MMC team. Although the survey response rate was relatively small, the results indicate that taxpayers dislike the current tax, believe the tax is unfair, and tend to find the tax difficult to understand. Although the

[97] Valley Vote, 2003; VICA newsletters and 2002 position paper; Kosmont Companies, 2003; VICA Business Roundtable, August 2003; Business Roundtable, June 2003.

[98] Various articles in the *Mini Advocate Newsletter,* 2003.

[99] Hammer, 2003a and 2003b.

entire Los Angeles business community was encouraged to participate in the survey, the number of responses was not as expansive as the team hoped it would be. Nevertheless, the response patterns further support the comments, complaints, and requests that have been heard from the business community over the years. Following are survey responses of representative interest:

- 92% of respondents are strongly opposed to leaving the current gross receipts business tax as it currently stands;

- 72% of respondents strongly believe that their business is being taxed at a higher level than their profitability warrants;

- 84% of respondents strongly believe that the business tax is unfair and does not tax comparable businesses equally; the remaining 16% responded with a 'disagree' rather than a 'strongly disagree';

- 56% of respondents strongly believe that the business tax does not treat different industries fairly; 16% responded with a 'disagree' rather than the 'strongly disagree' while 24% had no opinion;

- 56% of the respondents reported that it is difficult to understand the categories under which they are taxed while 40% of the respondents reported that it was not difficult. The remaining 4% had no opinion;

- 44% of the respondents reported that they do not fully understand how and when to file their business tax payment while 56% reported that they do;

- Just over 50% of the respondents reported that they need to hire an accountant to assist them in filing their business tax payment;

- 56% of the respondents reported that most of the other business owners they know pay the tax.

MMC and the City team responded to these comments, questions, and concerns in a manner that assured the business community that their voices were being heard and would be reflected in the manner that the research was conducted. Specifically, the MMC team emphasized that the level of complexity would be reduced, starting with the number of business categories, that simplification for small businesses was being considered, and that apportionment and pass-throughs were two important issues being researched and discussed in light of each of the proposed alternatives.

The fundamental policy problem that the City of Los Angeles posed to the MMC team is to look for feasible alternatives to the City's current business tax. The team evaluated the City's current business tax using the policy constraints and evaluation criteria discussed in chapter 3.[100]

The existing approach is a common approach to business taxation in California and is used in a number of other cities, including Fresno, Stockton, Bakersfield, Santa Monica, El Monte, Inglewood, and Culver City.

LEGALITY

The City's business tax has been successfully challenged at least twice in the past due to violations of the Dormant Commerce Clause.[101] These challenges have caused the business tax to evolve from a maximum hybrid tax on receipts or payroll to its current form as a tax on receipts.

ECONOMIC BENEFIT

Neutrality

The City's existing tax is primarily levied on a tax base of gross receipts or, in other words, the taxpayer's total receipts or total revenues. The City of Los Angeles does not include dividends, capital gains, and inter-company transfers in the definition of gross receipts. The City does not currently allow businesses to deduct from their receipts such cost components as the cost of goods sold by another business and used as an input by the taxpayer.

Due to the business tax being levied on gross receipts at every stage of production, the tax is in practice higher than the stated tax rate. The very nature of the tax is that it applies whenever gross receipts are generated. For example, if a product is manufactured in Los Angeles, sold by the manufacturer to a wholesaler, by the wholesaler to a retailer, and by a retailer to a customer, the business tax applies to the gross receipts generated by each transaction. By taxing goods and services at every stage of production, a portion of the tax paid 'cascades' into the price of each taxed item. Economists refer to this multiple taxation as tax pyramiding, because the tax is levied multiple times on business-to-business transactions. To understand the pyramiding effect, consider a dress sold by a local manufacturer to a wholesaler, then sold by the wholesaler to a costumer, then sold by the costumer to a motion picture producer; the sale of the dress is taxed four times in this example.

The tax is inefficient in that it distorts the incentives of businesses to use the goods and services of other Los Angeles businesses, and penalizes businesses that rely on local suppliers. The tax is not structured to provide deductions to businesses that purchase services from subcontractors, to retailers buying goods for resale from local wholesalers, or to leasing companies providing services

[100] The policy constraints are legality, revenue-neutrality potential, and feasibility of revenue modeling; the evaluation criteria are economic benefits, administratibility, stability and equity.

[101] The Dormant Commerce Clause is discussed at length in chapter 3.

to Los Angeles businesses. This approach taxes more heavily businesses relying on local suppliers than businesses relying on external suppliers. In general, the gross receipts tax rewards vertically integrated[102] conglomerates and penalizes smaller businesses that rely on more business-to-business transactions in the production chain.[103]

For the reasons just described, the gross receipts tax is decidedly not neutral with respect to economic behavior.

Competitiveness

Los Angeles business tax rates are significantly higher than in neighboring jurisdictions, with the exception of Beverly Hills. The City of Los Angeles relies on the business tax for approximately four times as much revenue as a typical California city, based on the revenue's contribution to the general fund. For a comparison of business tax rates with neighboring jurisdictions, see chapter 2.

The business community's perceptions of the lack of competitiveness are most likely overstated due to focus on the comparison of the business tax to neighboring jurisdictions rather than a focus on operating costs as a whole. In particular, businesses that are tenants rather than building owners may not be aware of the lower utility costs within the City, which are not as transparent to them as they are passed through to the tenant in the form of lease costs.

Business tax rates compose only one of many operating expenses for a typical business. Other operating expenses that vary across municipalities include utility costs and utility taxes. While the City's utility tax rates are higher than in neighboring jurisdictions, water and electric rates in the city limits tend to be less expensive than in neighboring jurisdictions.

A preliminary study provided by the Mayor's office indicates that the lower utility costs do not compensate for the higher business and utility tax rates in the City of Los Angeles.[104] Hence, overall the City's business tax rates contribute to a fiscal environment that is not competitive in comparison with most neighboring jurisdictions.

ADMINISTRABILITY

The gross receipts measure of the business tax is relatively straightforward for auditors to observe and does not require the taxpayer to analyze deductions, which provides simplicity. The business tax classification and apportionment policies are complex for taxpayers as well as administrators. This complexity imposes costs on taxpayers for complying with the business tax and imposes high costs on administrators for enforcing the business tax.

The level of complexity renders it difficult and costly for taxpayers to track and report activity as requested by the City. Particularly among taxpayers with only one location and only one tax category, Office of Finance audit data indicate a relatively high level of calculation error—about 15

[102] Vertically integrated businesses are those that provide in-house multiple stages of work in the production chain. For example, a business that imports, wholesales and retails its products is vertically integrated, whereas it may be competing against retailers that rely on other businesses for importing and wholesaling activity.

[103] Fisher, 1996.

[104] Email correspondence from Assistant Deputy Mayor, March 7, 2003.

percent of receipts are under-reported and about 8 percent of receipts are over-reported in this group.

Under current business tax policy, taxpayers are required to report receipts under multiple tax categories. For taxpayers paying under multiple categories, the different definitions of the tax base and apportionment formulas require the taxpayer to undertake costly reporting and accounting work.

Current policy applies an apportionment formula to each tax category on differing bases.[105] The apportionment formulas are, in part, based on payroll activities performed in the City versus outside the City. Virtually no taxpayer has readily available apportionment data relevant to municipal boundaries. Taxpayers generally do not track the percentage of time a sales representative or delivery person spends in the City versus outside the City because they view Los Angeles as a region, not as a collection of cities. The City has attempted to rectify the complexity of apportionment by issuing rulings addressing specific tax categories; however, the City has not yet attempted to address apportionment universally across all taxpayer categories.

STABILITY

The City's business tax has consistently provided general fund revenue in a relatively stable fashion through the ups and downs of the business cycle. The tax is relatively stable in its current form.

[105] Some apportionment rulings apply to groups of tax categories; for example,

EQUITY

Horizontal Equity

The policy goal of horizontal equity requires that similar taxpayers owe a similar tax amount. Similarity among taxpayers, however, should not be gauged based on gross receipts but on either a business' demand for municipal services or a business' ability to pay.

In order to compare tax rates across industries, we must convert the gross receipts tax rates to a comparable measure of value-added so as not to consider pass-through receipts for subcontractors, vendors and suppliers. In Table 4-2, the value-added tax rate is comparable across industries, whereas the gross receipts tax rate is not.

Even within an economic sector taxed at the same rate, certain businesses are taxed more heavily than others due to the amount of business-to-business transactions. For example, auto dealers who operate on low margins are taxed at the same rate as apparel stores who operate on larger margins. Similarly, general contractors are implicitly taxed at a much higher rate than the construction trades primarily due to high levels of subcontracting activity.

Table 4-2: Gross Receipts and Comparable (Value-Added) Tax Rates

Industry	Income as % of Receipts	Gross Receipts Tax Rate	Value-Added Tax Rate
Manufacturing—Average	39%	$1.18	$3.00
Oil Refinery	31%	$1.18	$3.75
Apparel Manuf.	39%	$1.18	$3.01
Medical Equipment	57%	$1.18	$2.08
Wholesale—Average	20%	$1.18	$5.92
Wholesale Oil	10%	$1.18	$11.91
Wholesale Apparel	31%	$1.18	$3.85
Construction—Average	36%	$1.18	$3.23
General Contractor	29%	$1.18	$4.05
Construction—Trades	44%	$1.18	$2.69
Retail—Average	26%	$1.48	$5.76
Retail—Auto Dealer	12%	$1.48	$11.98
Retail—Apparel	45%	$1.48	$3.32
Retail—Furniture	39%	$1.48	$3.76
Restaurant	63%	$1.48	$2.34
Hotels	65%	$1.48	$2.29
Auto Leasing	66%	$2.96	$4.49
Storage Leasing	85%	$2.96	$3.48
Real Estate Leasing	85%	$1.48	$1.75
Video Rental	77%	$2.96	$3.84
Telephone Service	77%	$1.18	$1.54
Broadcasters	76%	$1.48	$1.95
Professions—Average	76%	$5.91	$7.77
Architects & Engineers	69%	$5.91	$8.53
Scientific Research	73%	$5.91	$8.07
Law Firms	96%	$5.91	$6.18
Doctor's Offices	96%	$5.91	$6.17
Advertising Agencies	70%	$4.14	$5.89
Auto Repair	59%	$5.91	$9.93
Travel Agency	63%	$4.14	$6.55
Temporary Help	72%	$4.14	$5.72
Laundry & Cleaners	76%	$1.48	$1.94

Various industries have successfully lobbied for special reforms to refine the measure of ability to pay, leading to a plethora of categories, special rules and inequities. For example, advertising agencies are taxed at a rate of $4.14 per $1,000 in receipts, although their value-added is no different from architects who are taxed at $5.91 per $1,000 in receipts. This tendency is driven by the inaccuracy of the underlying tax measure in capturing the two notions of tax fairness based on businesses paying in accordance with the municipal service benefits they receive and with their ability to pay. Such tax incentives do reduce the revenue yield of the tax, reduce the size of the taxable base, and render it difficult for tax rates to be reduced. Overall tax rate relief could be provided if the tax base were expanded by more consistent definition of the tax base.

The use of presumptive taxes for a number of industries also violates the equity principle.[106] The presumptive rates are levied regardless of actual economic activity of the businesses. The derivation of the presumptive rates is not clearly related to the tax rates levied on similar businesses. Presumptive taxation violates both the horizontal and vertical equity principles.

Non-Compliance

Non-compliance also contributes to the equity of the tax. The tax is self-reported and taxpayers are not required to demonstrate their calculations for apportioning activity conducted outside the City. To the extent that honest taxpayers shoulder the tax burden of non-reporters and under-reporters, the business tax is not equitable among taxpayers.

Indeed, there is a relatively high level of non-compliance. A 1997 study found that about 20 percent of economic activity is not reported by taxpayers.[107] Office of Finance audit data indicate that 8-28 percent of gross receipts are not reported by taxpayers, with higher rates of under-reporting among businesses that file under multiple tax categories and businesses with multiple locations. However, this problem also relates to problems with the tax form itself. In particular, the tax form does not require taxpayers to reveal their calculations for apportioning their gross receipts, rendering it difficult for the administrators to spot unusually high apportionment.

In addition to taxpayers' under-reporting the tax base, there are also a significant number of taxpayers not reporting at all. A prior study found that 15-30 percent of business taxpayers do not file at all.[108] Non-reporting rates have not been reassessed since early 2003 when the Office of Finance started receiving a list of all businesses filing State income tax returns. Although many of these taxpayers may now be filing returns, the fact that they were previously failing to file raises the chances that they may now be under-reporters. Although the non-reporting rate has most likely been reduced, the under-reporting rate among existing taxpayers has most likely increased.[109]

Vertical Equity

The business tax currently includes several measures intended to provide some progressivity from the perspective of businesses. The start-up exemption and the geographic tax relief for businesses located in economically distressed areas (the empowerment zone) do tend to make the business tax slightly more progressive from the perspective of businesses.

Receipts taxes, just like sales taxes, tend to be regressive because low-income consumers spend a greater portion of their incomes on the receipts tax than do higher-income consumers. As a gross

[106] Presumptive taxes are levied in lump-sum amounts based on the presumed economic activity of a business activity. For example, money lending is taxed at a lump–sum amount of $2,661 annually, while bowling alleys are taxed at a presumptive rate of $55 per bowling alley lane.

[107] Burr and Cragg, 1997.

[108] Burr and Cragg, 1997. Note that non-reporting rates have not been reassessed since early 2003 when the Office of Finance started receiving a list of all businesses filing state income tax returns.

[109] The Office of Finance received in 2002 a list of all businesses filing income tax returns with the California Franchise Tax Board, and subsequently notified those businesses of the business tax. To the extent that the City's recent notification of these businesses has boosted the proportion of businesses filing the tax, this would tend to increase the proportion of tax-resistant businesses among those filing taxes. To the extent that the City's business taxpayers now include a greater proportion of businesses with low compliance rates, one would expect the under-reporting rate among existing taxpayers to have increased.

receipts tax, many businesses pass the tax on to customers in the form of higher prices. Retail and neighborhood businesses tend to have the greatest ability to pass the tax on to consumers because their competitors are also paying the tax. By comparison, businesses competing with companies located outside the city limits have a lesser ability to pass the tax on to consumers. Other than geographic tax relief for businesses located in the empowerment zone, there are no provisions to limit the regressive effects of the receipts tax on low-income consumers.

CONCLUSION

In conclusion, the status quo tax policy was evaluated as follows:

- The status quo is inefficient in that it penalizes firms that purchase a larger share of inputs from other businesses and rewards firms that produce a greater share of the resources needed for production in-house.[110]

- The status quo is complex, leading to significant costs for businesses in terms of compliance and for the City in terms of enforcement. The self-reported nature of the tax leads to compliance problems.

- This revenue source is relatively stable in that it is not affected by significant volatility over the business cycle.

- This type of tax places a greater tax burden on businesses that use many inputs or expensive inputs in their production process. Additionally, the existing tax is not equitable in the sense that it does not take into consideration either a taxpayers' ability to pay or the size of benefits received by the taxpayers. Finally, the tax structure includes special incentives for certain industries and taxes certain industries more intensively than others.

[110] The gross receipts tax is levied each time a business sells a product to another business, but does not levy the tax on multiple transactions for businesses that are vertically integrated and produce more of the inputs needed in-house.

CHAPTER 5: MEASURES OF ECONOMIC ACTIVITY

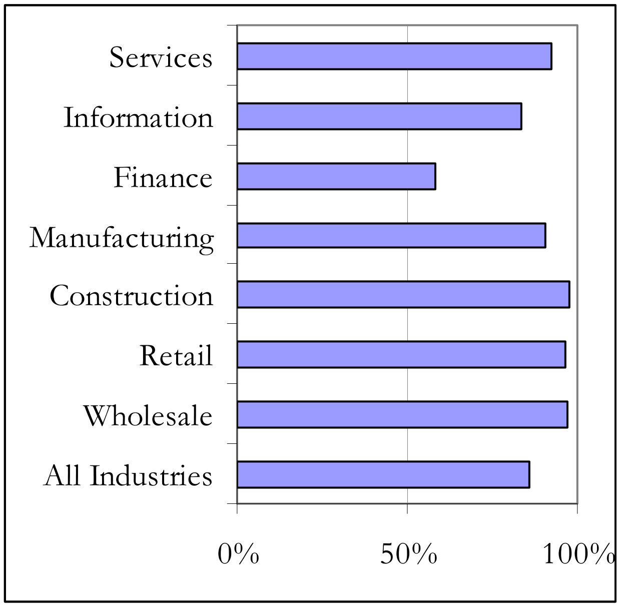
In order to assess alternatives to the business tax, it is important to understand the meaning of gross receipts—the existing tax base. By understanding various measures of economic activity, one can better assess alternatives to the tax base and how they affect different sectors of the economy. This chapter provides an explanation of the differences between business receipts, value-added and income. Further, it explains real estate usage and how it differs across business types.

VALUE PRODUCED

GROSS RECEIPTS

The total receipts of businesses include all sources of revenue—business operating receipts and investment income. Revenues from investment income, such as interest, dividends and capital gains are included. Royalties from intellectual property rights are included in total receipts. In addition, rents received from leasing buildings and equipment are included in total receipts.

Figure 5-1: Business Receipts as % of Total Receipts by Industry



The measure of business receipts includes all receipts accruing to a business from its operations, and excludes investment income, royalties and rents. After deducting investment income, royalties and rent, business receipts constitute 86 percent of total receipts. As indicated in Figure 5-1, the information and financial sectors of the economy derive a significant share of receipts from investment activities.[111] In the financial sector, about half of the total receipts of banks and securities dealers come from investment activities. In the information sector, investment income contributes about 15 percent of total receipts.

The concept of gross receipts used for business tax purposes is closer to the concept of business receipts than total receipts. Although taxable receipts include rents and royalties, the base excludes dividends, interest and capital gains.

[111] The percent of total receipts that consists of business receipts is provided by U.S. Internal Revenue Service, Statistics of Income, and reflects U.S. corporate income taxpayers in 2000.

Gross Margins

Gross margins are relevant to industries that hold inventories and resell merchandise. Particularly in the retail and wholesale trade industries, business receipts include receipts for merchandise being resold by the business. Gross margins represent business receipts less cost of goods sold, i.e. the value of merchandise that is purchased from other businesses and resold.

Merchandise is resold throughout the production chain. An example of a production chain through which merchandise is resold is the auto industry. When an auto dealer sells a car, it is reselling merchandise that has passed through many separate businesses between the rubber tree plantation or the steel factory and the showroom floor. Auto dealers purchase cars from wholesalers and importers, and are not involved in producing the cars. The wholesalers transport and distribute cars that they purchase from auto manufacturers. Auto manufacturers purchase steel, tires, glass and leather. The radial tire producer purchases rubber from rubber manufacturers, who buy the bark from rubber tree plantations.

Gross margins represent 31 percent of business receipts in the retail sector of the economy. In other words, 69 percent of retail receipts are used to pay wholesalers for merchandise that is being resold. Gross margins vary among retailers, as represented in Figure 5-2. Auto dealers operate on the slimmest margins, where clothing stores and restaurants operate on the largest margins within the retail sector.[112]

Figure 5-2: Retailers Gross Margin as % of Business Receipts

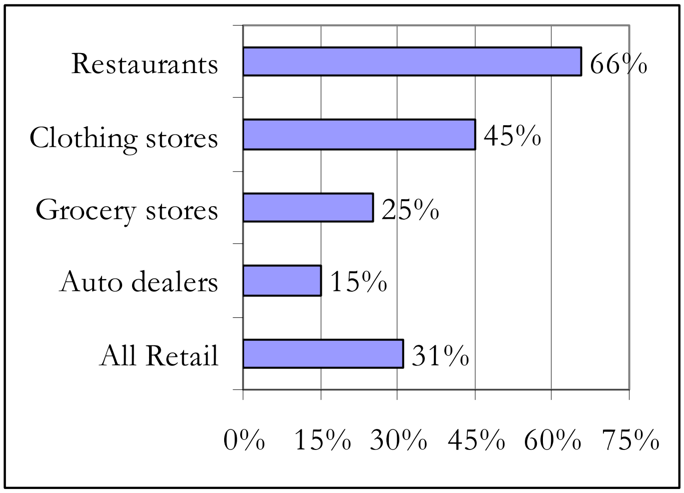
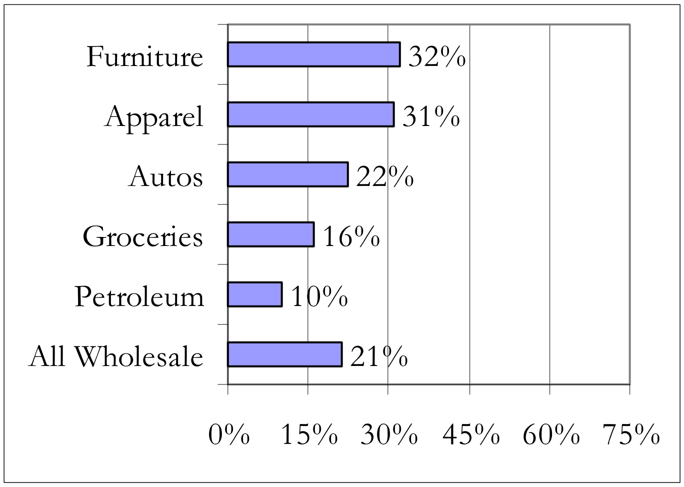


Figure 5-3: Wholesalers' Gross Margin as % of Business Receipts



As depicted in Figure 5-3, gross margins represent 21 percent of business receipts within the wholesale sector. In other words, 79 percent of wholesale receipts are used to pay manufacturers for merchandise that is being resold. Furniture and apparel wholesalers operate on the largest margins, whereas grocery and petroleum wholesalers operate on more narrow margins.[113]

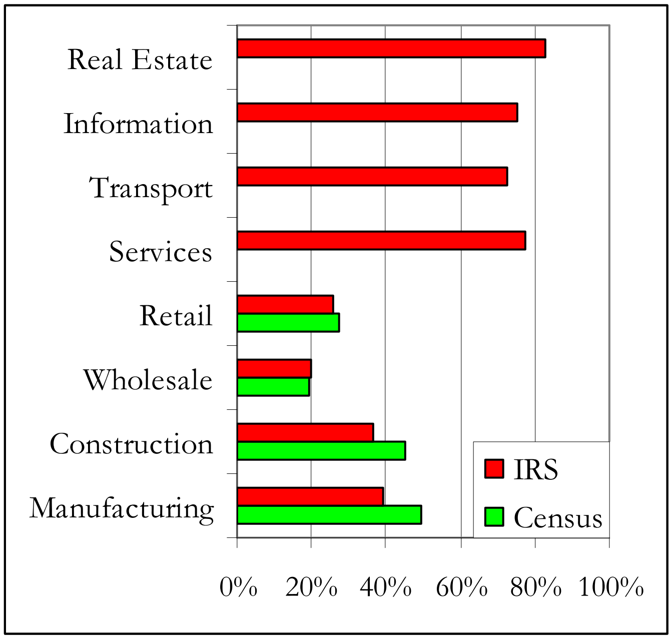
[112] U.S. Census Bureau, 2000.

[113] U.S. Census Bureau, 2000.

VALUE-ADDED

Value-added represents the value that is added by the particular business, and can be calculated by adding up all forms of compensation—payroll, employee benefits, profits and rent. Value-added may also be calculated by subtracting business-to-business transactions from receipts. Regardless of the calculation approach, the result represents the portion of receipts that was actually produced by the particular business and not the portion that represents pass-through from other businesses.

Figure 5-4: Value-Added as % of Business Receipts



Value-added constitutes about 42 percent of business receipts for the economy as a whole.[114] The portion of business receipts that actually constitutes value-added varies considerably across industries, as indicated in Figure 5-4.[115]

In both the wholesale and retail sectors, about 75-80 percent of sales revenues are used to purchase product for resale. For wholesalers, value-added is only 20 percent of business receipts. In the retail sector, the value-added share is 26 percent of business receipts.

Within the construction sector, value-added constitutes 36-45 percent of business receipts. General contractors purchase a relatively large volume of materials and supplies used in the construction process, and also rely on subcontractors. Nearly half of sales made by general contractors involved in building structures are passed through to subcontractors.[116] Contractors involved in infrastructure construction spend a larger share of receipts on building materials compared with building contractors, but spend significantly less on subcontracted labor. The specialty trades like carpenters, painters, and concrete workers tend to use a substantial share of materials, but also do not rely nearly as much as building contactors on subcontracted labor.

In the manufacturing sector, 52-60 percent of receipts are used for purchasing goods and services from other businesses, with the remainder constituting value-added.[117] At petroleum

[114] U.S. Internal Revenue Service, Statistics of Income, 2000 Corporation Income Tax Returns.

[115] With the 2000 IRS data, value-added reflects business receipts less cost of goods sold, where cost of goods sold reflects manufacturing production costs, merchandise purchased for resale, materials, and subcontractors, but does not include any direct payroll expenses. In the 1997 Census data, value added reflects the gross margin less the cost of containers, supplies, materials, fuel and other energy. The IRS concept is subtractive, whereas the Census concept is additive.

[116] U.S. Census Bureau, Operating Expenses by Type and Kind of Business, 1997.

[117] Manufacturing value-added statistics are based on 2000 corporate income tax returns with detailed expense information from the Census Bureau's 1997 operating expenses survey.

refineries, the value-added constitutes only 31 percent of receipts. By comparison, the value-added for medical equipment manufacturers constitutes 68 percent of receipts.

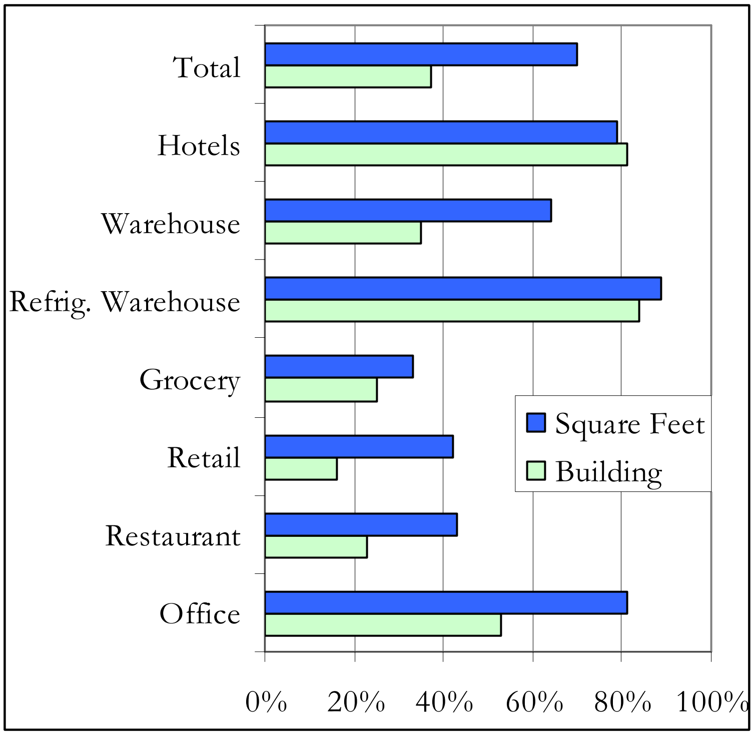
In the service sector, 23 percent of receipts are used for purchasing good and services from other businesses, with the remainder constituting value-added. Hotels and repair services rely more extensively on other businesses for supplies. Health care services have a relatively high value-added at approximately 89 percent of business receipts.

For value-added ratios by detailed industry, please refer to the supplementary tables in Appendix A.

Real Estate Usage

Real estate usage varies significantly between different types of businesses.

Figure 5-5: Commercial Buildings owned by Primary Occupant, 1999



Tenure

Businesses are most likely to own their site when they need a specialized space, when they plan to renovate the space, and when their long-term space needs are predictable and can be accommodated on a particular piece of land. Owner-occupied businesses tend to be the only user of the particular building. Institutions like schools, hospitals, churches, public assembly spaces and government agencies are most likely to own the space they occupy.[118]

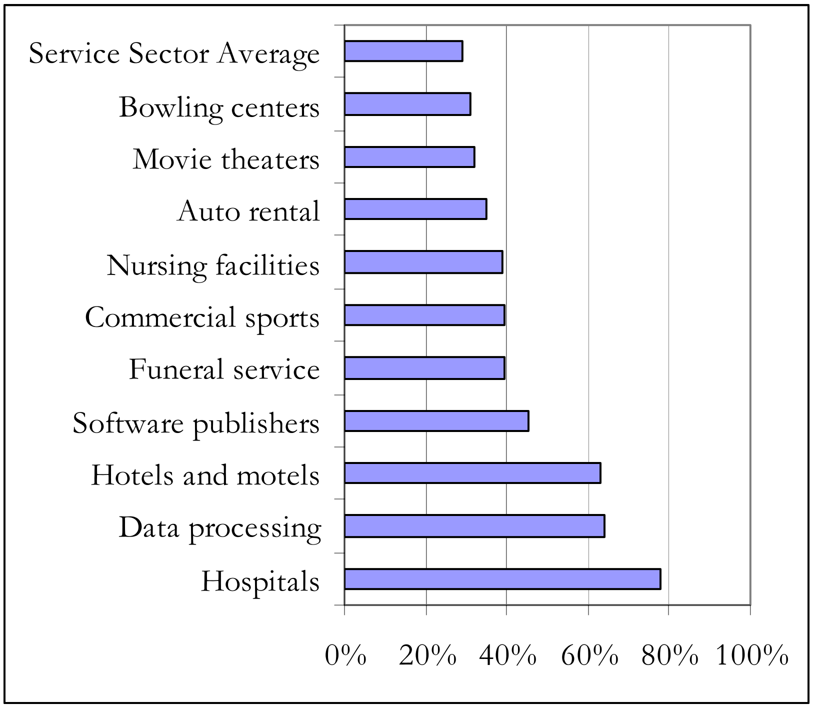
The primary occupant in California owns about two in five commercial buildings. However, owner-occupied buildings tend to be large, so about 70 percent of commercial square footage is owned by the primary occupant. Figure 5-5 shows the proportion of buildings and square footage owned by the primary occupant in the Pacific Gas and Electric Company's service area in 1999.[119] Hotels and refrigerated warehouses are most likely to be owner-occupied, whereas grocery stores, restaurants and retail are more likely to be occupied by tenants than the owner. The PG&E data indicate that large offices, retail and restaurants are more likely to be owner-occupied than smaller

[118] U.S. Department of Energy, Commercial Buildings Energy Consumption Survey, 1999.

[119] Pacific Gas and Electric Company, 1999. The PG&E service territory includes most areas of California north of Los Angeles and Ventura. Buildings represent the number of separately metered electric customers, and sometimes include separately metered customers in the same building.

buildings. Similarly, schools, colleges and hospitals—most of which are exempt from the business tax—are also typically owned by the primary occupant.

Figure 5-6: Top 10 Owner-Occupied Service Industries



Within the service sector, there are detailed building rent and depreciation expenses that shed light on which businesses are most likely to be owner-occupied.[120] Figure 5-6 provides the ten service industries most likely to own their own business location, based on business expense data. Hospitals, data processing, and hotels spend more on owner-related expenses than building rents.

The offices of lawyers, accountants, doctors, engineers, architects and advertising agencies are most likely to rent their space.[121] Over 90 percent of economic activity in these industries is in tenant-occupied businesses, based on building expenses. Motion picture producers, video rental, auto service shops and drycleaners have mid-range ownership rates. In these industries 70-80 percent of building expenses are rental costs, with the remaining 20-30 percent constituting owner costs.

Grocery stores, gas stations, car dealers, department stores and lumberyards are the retail industries with relatively high ownership rates within the retail sector. Clothing, shoe, appliance, and liquor stores are much more likely to rent their space.

SPACE OCCUPIED

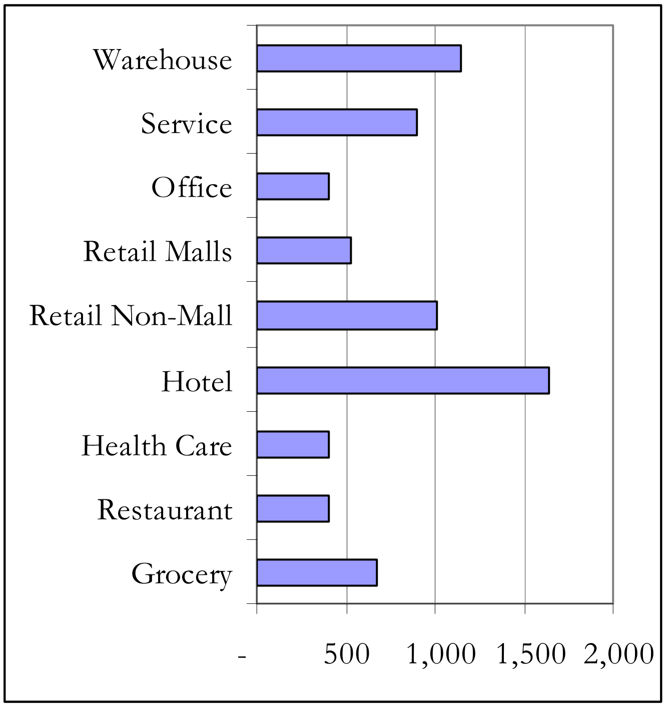
Square footage requirements vary significantly by building age and business type. The general trend is toward a reduction in the amount of space used. In newer buildings, square footage per worker is significantly lower than in older buildings. In buildings constructed before World War II, square footage use may be as much as double the space used in recently constructed buildings.

In an office setting, the minimum space needed to accommodate a worker in an office is about 200 square feet, whereas about 80 square feet is needed for a worker cubicle. An employee parking space requires on average about 325 square feet. In addition, common space is needed within each office and office building.

[120] U.S. Census Bureau, 2000.

[121] Ibid.

Figure 5-7: Square Footage per Worker



As indicated in Figure 5-7, the typical office building uses about 400 square feet per worker. Businesses with many customers, such as hotels and grocery stores, tend to use more square footage per employee. Businesses with equipment and storage needs, like warehouses and manufacturing, also use significantly more square footage.[122]

The actual leased space is lower than the figures depicted above, as tenants do not lease common spaces in buildings. Typically about 15 percent of building square footage consists of common space, such as elevators, halls, lobbies and restrooms. Professional and managers are typically allocated more space than clerical occupations. Professional service firms use more office space per worker than do business services and government organizations.[123] Architectural design guidelines suggest about 275 square feet per worker for law firms and accounting offices and 300-450 square feet for physicians' offices.[124]

The amount of space used in smaller buildings tends to be greater than in larger buildings because a greater proportion of common space is needed in smaller buildings. Further, office space used per worker in expensive locations tends to be lower. Average leased office space in large Class A and Class B buildings is about 230 square feet per worker and has generally been declining since the recession in the early 1990s.[125]

[122] Figures represent median square footage per worker based on CBECS data, adjusted to represent the lower square footage used in the Pacific region of the country.

[123] U.S. Department of Energy, CBECS.

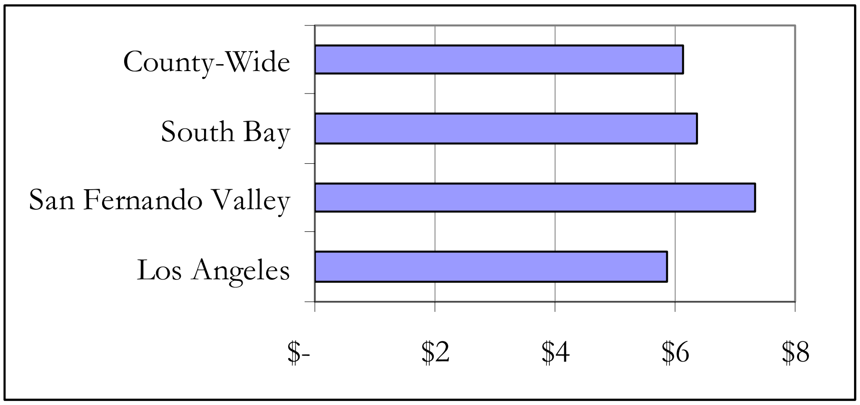
[124] Ragas, 1993.

[125] International Facility Management Association, Project Management Benchmarks, 2003.

RENTS

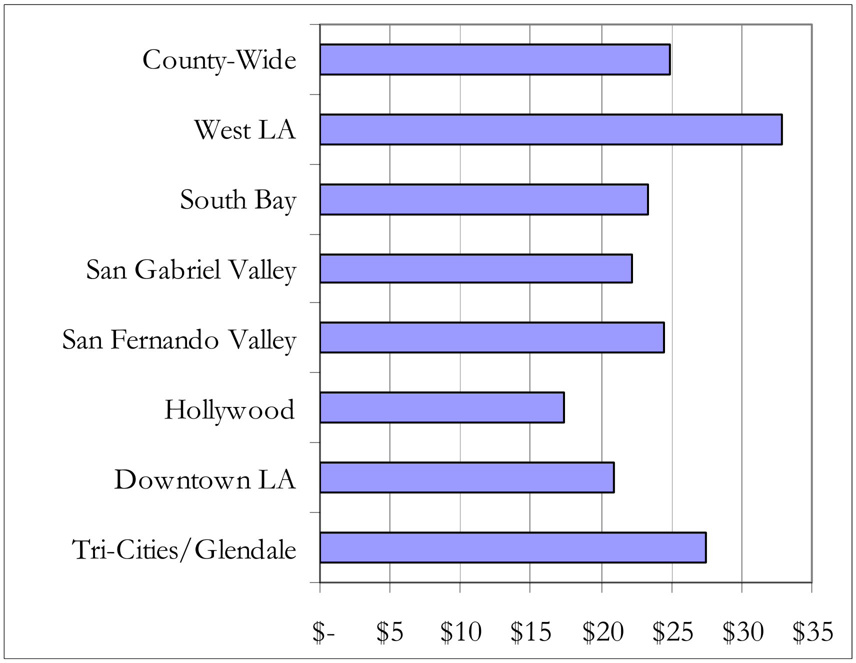
Average annual lease rates in Los Angeles County are $6.12 per square foot for industrial space.[126] Lease rate in the City of Los Angeles are nearly equivalent to the countywide average lease rate, except that industrial lease rates in the San Fernando Valley tend to run about 20 percent higher than the county average. Warehouse and manufacturing rents tend to be similar in the Los Angeles market.

Figure 5-8: Industrial Annual Lease Rate per Square Foot



In the office sector, lease rates are significantly higher than in the industrial sector. The average annual lease rate is $24.84 per square foot countywide. The West Los Angeles area is the most expensive, costing on average 32 percent more than the county average. The downtown and Hollywood areas are less expensive than the county average, while San Fernando Valley office space leases at about the same rate as the county average.[127]

Figure 5-9: Office Annual Lease Rate per Square Foot



In the retail market, average annual lease rates are $22.88 per square foot.[128] Rates vary significantly by type of retail outlet. Average rates are $14.50 per square foot for neighborhood retail and $42.00 for space in regional malls.[129]

[126] CB Richard Ellis, 2003 3rd quarter. Lease rates include rent, property taxes, building insurance and maintenance costs.

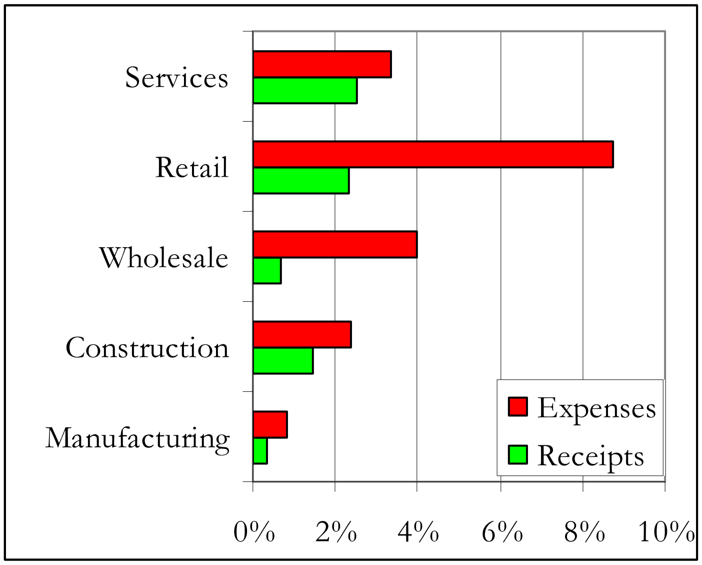
[127] CB Richard Ellis, 2003 3rd quarter. Office buildings include Class A and B buildings with over 30,000 square feet.

[128] Marcus & Millichap, 2003.

[129] NAI Capital Commercial, 2003.

BUILDING EXPENSES

Figure 5-10: Building Rent as % of Receipts and Operating Expenses



Building rent expenses as a share of receipts represent all the factors discussed above—ownership rates, space needs, and lease rates. As depicted in Figure 5-10, retailers spend the greatest share of operating expenses on building rent. Services and wholesalers rent expenses are comparable. Construction and manufacturers spend the lowest portion of their total operating expenses on renting building space.[130]

[130] U.S. Census Bureau, 2000.

CHAPTER 6: INITIAL EVALUATION OF ALTERNATIVES

The evaluation of the existing business tax (Chapter 4) motivates the policy question as to whether or not there is a better alternative to the existing tax approach.

This section describes the different types of alternatives to the existing tax and provides an initial evaluation of alternatives to identify those meriting in-depth evaluation in this report. By contract, the initial evaluation objective was to select three alternatives meriting in-depth evaluation. The team focused on comprehensive reform approaches rather than incremental reform in selecting the alternatives, based on the premise that in-depth analysis of comprehensive reform approaches would deliver greater value to the City than in-depth analysis of minor and incremental reform approaches.

There are numerous types of alternatives to the City's existing business tax. The major alternatives to the existing tax are base and classification alternatives. The minor variations to the existing tax base involve instrument alternatives, rate restructuring, and special incentives that could potentially be built into nearly any major tax realignment alternative.

In order for a tax alternative to be deemed feasible in this report, the alternative must be able to be structured in a legal and affordable fashion. For an alternative to be deemed affordable, that alternative must lend itself to being structured in a revenue-neutral fashion. As long as a tax alternative is expected to be placed on the ballot and is not limited by State law, policymakers have the opportunity to set rates at the level appropriate for maintaining revenue neutrality.[131]

BASE ALTERNATIVES

Base alternatives involve a change in the explicit measure by which the tax is levied. The current tax is predominantly levied on a gross receipts tax base. A base alternative is a tax reform that involves changing the explicit measure of the tax base.

The most common tax bases used in California cities are gross receipts, number of employees and square footage of the business. However, other unique tax bases are used by California cities, including payroll, operating costs, and gross profit.

Not under consideration were income and property tax bases, as California municipalities are precluded from taxing these bases. For in-depth discussion of the legal constraints, refer to Chapter 3.

Not discussed in this section are the many potential hybrid approaches of combining tax bases. Multiple-base hybrid approaches are utilized by several jurisdictions. Under a multiple-base hybrid approach, a taxpayer pays a tax on both tax bases. For example, El Segundo levies a hybrid tax on both square footage and the number of employees.

[131] To the extent that policymakers are concerned about the revenue risk of tax alternatives, they may opt to place a measure on the ballot at a relatively high tax rate and rebate any excess revenues initially through refunds and subsequently through a downward adjustment in tax rates.

Gross receipts with sub-contractor deductions

A pure gross receipts tax is based on the entire revenues of a business, including those that are passed through to yet another business. Included in the tax measure are payments made by businesses to subcontractors, vendors and other service suppliers that do not constitute part of their incomes. Allowing for the deduction of sub-contractor payments would eliminate a portion of the tax-pyramiding problem associated with gross receipts taxation.

Within the construction industry, Hermosa Beach, Brisbane (San Mateo), Stockton and San Bruno (San Mateo) define gross receipts to exclude subcontractor payments to subcontractors who are paying the business tax. These jurisdictions require the general contractor to provide the names and addresses of subcontractors. This approach is also used in gross receipts taxation in other states, such as New Mexico, Delaware, and South Dakota. The deduction may be accorded to either the sub-contractor or the prime contractor, depending on the particular State statute.

A clever compliance approach to accommodating subcontractor deductions is to require the taxpayer to report the business tax registration number associated with any subcontractors for which deductions are made. This approach would presumably expand the Los Angeles tax base, as many subcontractors located outside the City limits may not currently be paying the tax. Further, it would reduce non-compliance opportunities associated with offering a subcontractor deduction.

The panel identified inadequate data as a barrier to analyze this alternative. The U.S. Internal Revenue Service includes subcontractor payments in a miscellaneous deduction category along with other deductions; hence, the IRS data do not accommodate precise identification of industry-average subcontractor reliance rates. The City of Los Angeles determined that a taxpayer survey should be conducted to identify the magnitude of subcontractor usage as well as other business-to-business transactions. That survey is to be conducted following release of this report. Future analysis of this alternative may be conducted following completion of the taxpayer survey.

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- If accompanied by rate realignment, this alternative would promote economic efficiency by eliminating the current disincentives for engaging subcontractors. However, this approach would not eliminate the tax-pyramiding problem associated with other types of business-to-business transactions.

- This alternative would impose an additional reporting burden on the taxpayer; however, that burden would be voluntary. If the taxpayer chooses to track deductions, the taxpayer would receive a lower tax burden. This approach would strengthen the City's tax enforcement capabilities to the extent that prime contractors report the activities of their subcontractors (which may include outside-City companies not currently paying the business tax). From a tax administration standpoint, this approach would not promote simplification.

- This alternative would have no impact on revenue stability, because subcontractor usage is no more cyclical than gross receipts.

- If accompanied by rate realignment, this type of tax would improve horizontal equity because subcontractor payments would no longer be taxed multiple times.

Gross receipts with energy and raw materials deductions

Energy and raw materials constitute another type of business-to-business transaction that is currently taxed multiple times under the gross receipts tax base.

Under this alternative, businesses would be allowed to deduct energy, raw materials costs, and the cost of partially completed goods from total receipts. This approach is used in the cities of Oakland and Berkeley for business taxation of manufacturing firms.

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- If accompanied by rate realignment, this alternative would promote economic efficiency by reducing the over-taxation of businesses purchasing relatively large amounts of raw materials and of utility-intensive businesses.

- This alternative would impose an additional reporting burden on the taxpayer; however, that burden would be voluntary. If the taxpayer chooses to track deductions, the taxpayer would receive a lower tax burden. From a tax administration standpoint, this approach would not promote simplification or enforcement.

- This alternative would have no impact on revenue stability because raw materials usage is no more cyclical than gross receipts.

- If accompanied by rate realignment, this type of tax would improve horizontal equity because the City would no longer be taxing raw materials usage multiple times.

Operating costs

Another alternative involves defining the tax base to include operating costs, such as payroll, utilities, rent, and depreciation. Operating costs may or may not be defined to include the cost of partially completed products or sub-contractor costs. In California, this approach is used in the City of Gardena, as well as in Berkeley and Oakland for manufacturing businesses. In Berkeley and Oakland, operating costs are used as an alternative tax base to the gross receipts measure when it is impossible to calculate gross receipts (e.g. a product is produced, but not sold, or sale occurred outside of taxing jurisdiction and hence the sale proceeds cannot be taxed).

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- This type of tax would improve economic benefits by eliminating the taxation of business-to-business transactions multiple times.

- This alternative would complicate the existing tax further and would not promote simplification or compliance.

- This alternative would have a negative impact on revenue stability, as the taxation of depreciation could potentially be challenged.

- This type of tax could improve horizontal equity if it is accompanied by rate realignment, to the extent that the approach eliminates the tax-pyramiding problem in the existing tax.

Factor Payments

Similar to operating costs, factor payments can be used as a tax base for a business license tax. In general, all factors of production can be classified as labor and capital. Payroll and employee benefits are payments to labor while rent, utilities, and depreciation are payments to capital. The sum of payroll, rent, utilities and depreciation is used as a tax base. In California, this approach is used in Ventura, Ontario, and West Hollywood to tax corporate headquarters.

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- This type of tax would not distort economic decisions.

- This alternative would have positive and negative effects on administrability and compliance. While this measure would be easier to audit, it would impose a greater reporting burden on the taxpayer.

- This alternative would have a negative impact on revenue stability. This approach may be subject to legal challenge, as taxing payments to capital may be construed as an impermissible municipal income tax on business income.

- This type of tax would improve horizontal equity.

Value-Added

A value-added tax is a tax on the value added by the taxpayer directly. This approach would eliminate taxing business-to-business transactions multiple times.

There are three approaches to taxing value-added: The additive approach, the invoice approach and the subtractive approach. All three approaches capture the same tax base, but there are different administrative and definitional approaches. Under the additive approach, the tax base is defined as all forms of compensation paid by the taxpayer, including payroll, rent, interest paid, depreciation, and profit; this approach is used in Michigan and New Hampshire. Under the invoice approach, taxpayers submit invoices on business-to-business transactions in a year-end reconciliation process. The invoice approach is used in Europe and tends to reduce tax evasion but to increase administrative costs.

The subtractive method involves deducting business-to-business transactions from gross receipts. In a recent tax reform study of the Washington gross receipts tax, the subtractive method was identified as most compatible with the existing tax approach.[132]

The team identified the subtractive method as the optimal value-added alternative due to compatibility with the existing tax approach. The additive approach could be construed to represent

[132] Washington's constitution precludes incomes taxation, and presents a policy environment similar to that faced by Los Angeles. See chapter 4 for a discussion of Washington's business tax.

a legally impermissible income tax due to taxation of profit. The invoice approach was rejected, as it is not currently used in the United States, and would impose heavy administrative and compliance costs.

The expert panel evaluated the subtractive value-added alternative according to the EASE criteria and reached the following conclusions:

- This type of tax would be economically neutral, and would eliminate the current practice of taxing business-to-business transactions multiple times. The approach would not impose disincentives on local businesses from using local suppliers and subcontractors.

- This alternative would impose an additional reporting burden on the taxpayer; however, that burden would be voluntary. If the taxpayer chooses to track deductions, the taxpayer would receive a lower tax burden. From a tax administration standpoint, this approach would not promote simplification, but would promote enforcement to the extent that prime contractors would report their subcontractors.

- This alternative would have modest positive effects on revenue stability because employee compensation (the major component of value-added) is less cyclical than gross receipts.

- This type of tax would provide horizontal equity, as businesses that have higher costs are not penalized.

Payroll Tax

Another alternative is a business tax on payroll for workers located within the City limits. The City of San Francisco imposes its business tax on payroll. In the 1997 study, the Milken Institute found that a 1.1 percent payroll tax would be revenue-neutral policy. Such a policy would increase the taxes paid by manufacturers, motion picture producers, and broadcasters, and would decrease the taxes paid by doctors' offices, construction, and auto services.[133]

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- This type of tax would improve economic benefits by removing penalties on businesses that purchase a relatively large amount of inputs from other businesses.

- This alternative would have positive effects on administrability and compliance, as tax administration could potentially piggyback off of the State's taxation of payroll for unemployment insurance purposes.

- This alternative would have modest positive effects on revenue stability because payroll is less cyclical than gross receipts.

- This type of tax would improve horizontal equity; however, the tax would not be equitable to the extent that it fails to capture compensation accruing to the business owner.

[133] Burr, Reardon and Coomes, 1997, page 11.

Employee Tax

Another alternative is a business tax on the number of employees located within the City limits. Newport Beach and many other California cities impose a business tax on employees.

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- This type of tax would improve economic benefits by removing penalties on businesses that purchase a relatively large amount of inputs from other businesses.
- This alternative would have positive effects on administrability and compliance, as tax administration could potentially piggyback off of the State's taxation of payroll for unemployment insurance purposes.
- This alternative would slightly reduce the cyclical stability of the business tax as a revenue stream because employee levels are less cyclical than gross receipts.
- This type of tax would likely improve horizontal equity. However, the tax would not be equitable to the extent that employers with part-time and low-wage employees would be taxed at the same rate as employers with full-time and high-wage employees. The tax would not be equitable to the extent that it fails to capture compensation accruing to the business owner.

Square Footage

An alternative to the existing tax is a simple tax on square footage. Different types of businesses use their space at different levels of intensity, creating different burdens upon the City and its infrastructure and services. For example, industrial and warehouse businesses, which have fewer employees and customer on site per square foot, generally make less intense use of their space than retail or professional services businesses. Consequently, it is appropriate to charge a lower rate per square foot for an industrial or warehouse use than for a retail or professional services use.

The City of Cupertino currently levies its business tax on square footage while the Cities of El Segundo and Commerce levy a hybrid square footage-employee tax.

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- This type of tax improves economic efficiency because paying for the space used in the City constitutes a user charge (conceptually, not legally) and imposes less of a distortion than a gross receipts tax.
- This alternative would have positive effects on administrability and compliance. Square footage is a straightforward, visible, and easily observable tax base measure. Square footage is relatively simple to audit; the square footage reported can be compared to the building square footage to determine if any building occupants are under-reporting.
- This alternative would slightly improve the cyclical stability of the business tax as a revenue stream because square footage is less cyclical than gross receipts.

- This type of tax would likely improve horizontal equity based on the benefit principle, but not based on the ability to pay principle.

Real Estate Rental Receipts

An alternative to the existing tax is a simple tax on real estate rentals. Such a tax could be structured so that multi-family housing is taxed at a lower rate than commercial office space. The City of Los Angeles currently levies such a tax on landlords. The alternative would involve landlords essentially collecting the tax from their tenants and eliminating the requirement for businesses to pay the business tax directly to the City.

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- This type of tax could potentially improve economic benefits if owner-occupied commercial properties could also be taxed.

- This alternative would be extremely simple in the case of tenant-occupied properties and extremely complicated in the case of owner-occupied properties. This alternative could be structured to have positive compliance effects.

- This alternative would not improve the cyclical stability of the business tax as a revenue stream.

- This type of tax would improve horizontal equity if owner-occupied commercial properties could also be taxed.

Lump-Sum Tax

A lump-sum tax refers to a fixed tax liability for each taxpayer regardless of the size of business. Under this approach, the largest business pays the same amount in business taxes as the smallest business. Many cities levy a lump-sum tax due to its simplicity. Such a tax is also economically efficient in the sense that no matter what business decision is made, each business entity pays the same tax. Where this tax falls short is in regard to fairness. A lump-sum tax does not take into account a business' ability to pay such a tax or the differences in City services used by businesses of different sizes.[134]

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- This type of tax would be economically neutral, because the tax is the same regardless of the economic decisions made by a given business.

- This alternative would have positive effects on administrability and compliance. It would be extremely simple to administer, and simple for taxpayers to comply.

[134] The term "lump-sum" is used here for the sake of clarity rather than "flat tax", because the term flat tax is often used interchangeably to mean a lump sum tax or any tax levied at a uniform rate.

- This alternative would not improve the cyclical stability of the business tax as a revenue stream.

- This type of tax would reduce both horizontal and vertical equity.

Classification Alternatives

Classification alternatives involve a change in the tax category scheme without a change in the measure of the tax base. Under the current tax, there are as many as 59 different tax categories, although there are only six different rate categories used extensively. A classification alternative involves redefining or combining tax categories, and would likely also involve altering the tax rates paid under the different categories.

There are many types of classification alternatives. The more feasible alternatives would involve realignments of the existing gross receipts tax to implicitly tax another measure, such as value-added or net income, as well as tax simplification approaches.

Value-Added Proxy

A value-added classification alternative would involve assigning taxpayers to tax categories based on the portion of the receipts attributable to value-added in the particular industry. This approach has also been called a 'modified gross receipts tax' and a 'graduated gross receipts tax',[135] because under this approach the explicit tax base would continue to be gross receipts. Such an approach would involve using the industry or economic sector of a taxpayer to assign that taxpayer to a rate category. The tax rates would be designed to be lower for industries with low value-added and to be higher for industries with higher value-added.

An example of such an alternative is the City of Merced's approach to business taxation. In Merced, businesses are classified into one of four rate categories depending on the gross profit margin of the business or industry.[136]

There are numerous ways to structure a value-added classification alternative. The structuring alternatives involve decisions about the number of tax categories, the tax rates and the manner in which a taxpayer is assigned to a tax category. In structuring such a tax, there is a tradeoff between the simplicity afforded by a relatively low number of tax categories and the horizontal equity of the tax because more rate categories provide greater opportunities for rates to be proportional to value-added in each industry.

The 1997 Tax Equity study assessed one approach to a value-added classification alternative in which the tax rate rises in concert with the industry profit margin, as measured by the Internal Revenue Service.[137] The 1997 study assessed a "graduated gross receipts tax" alternative involving

[135] The 1997 Milken study termed this approach "graduated gross receipts", and popular reference to this approach often uses the term "modified gross receipts". The reader should be cautioned to understand that although the measure of gross receipts is the explicit tax base under this approach, the implicit tax base is value-added.

[136] The definition of gross profit margin in Merced is similar to the notion of value-added.

[137] The scenario studied in the 1997 report defined profit margin in a manner similar to value-added. In that study, profit margin included payroll, employee benefits, rent, net income and officer compensation. See Burr, Reardon and Coomes, 1997, page 28.

five tax categories with tax rates ranging from $1.30 to $4.90 per $1,000 in gross receipts. The prior study found that such an alternative would tend to increase the business taxes owed by broadcasters, phone companies, hotels and motion picture producers and would tend to decrease the business taxes owed by retailers, construction, auto services, apparel manufacturers and landscapers.

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- This type of tax would have ambiguous effects on economic benefits, as the tax base would continue to cause pyramiding of the tax.

- This alternative would have positive effects on administrability. However, the approach does not offer any additional tax enforcement tools or information.

- This alternative would not affect the cyclical stability of the business tax as a revenue stream because the tax base is not redefined under this approach.

- This type of tax would improve horizontal equity so long as the tax rates and classification scheme are structured to achieve horizontal equity.

Net Income Proxy

A net income classification alternative would involve assigning taxpayers to tax categories based on the portion of the receipts attributable to net income (profit) at the particular firm. Such an approach would likely involve using the industry or economic sector of a taxpayer to assign that taxpayer to a rate category. The tax rates would be designed to be lower for industries with low net income and to be higher for industries with higher net income.

An example of such an alternative is the City of Vallejo's approach to business taxation. In Vallejo, businesses are classified into one of three rate categories depending on the net profit margin of the particular industry. In Vallejo, net profit is defined as the amount of gross receipts diminished by total expense except (a) wages to proprietors, owners, or partners, and (b) rent to premises owned by the business or its proprietors, owners, partners.

The expert panel evaluated this alternative according to the EASE criteria and reached the following conclusions:

- This type of tax would have ambiguous effects on economic benefits.

- This alternative would improve administrability and compliance. The tax rates would require frequent re-estimation, as industry net income levels are cyclically volatile.

- This alternative would not affect the cyclical stability of the business tax as a revenue stream because the tax base is not redefined under this approach.

- This type of tax would improve horizontal equity so long as the tax rates and classification scheme are structured to achieve horizontal equity.

Tax Simplification

A tax simplification classification alternative would involve combining existing tax categories in such a manner as to reduce the number of tax categories. It might also involve realigning tax rates. A variant on this theme would involve single-category filing in which taxpayers would no longer be required to file under multiple tax categories, but rather to file under a single tax category.

Our team evaluated this approach under the EASE criteria outlined earlier in this report and concluded that the approach would likely have the following effects:

- This type of tax would have ambiguous effects on economic benefits.
- Tax simplification would improve administrability and compliance.
- This alternative would not affect the cyclical stability of the business tax as a revenue stream because the tax base is not redefined under this approach for most taxpayers.
- The horizontal equity effects of this type of tax depend on the particulars as to how the policy is structured.

INSTRUMENT ALTERNATIVES

Instrument alternatives involve a change in the legal tax instrument being used. The current tax is legally structured as a business tax. Alternative tax instruments involve a change to an entirely different legal structure, or increases in alternative tax instruments, such as the sales tax, in order to finance reductions in business tax rates.

Sales tax increase

A 0.25 percent increase in the sales tax imposed in the City would generate approximately $90 million. Such a policy would generate enough revenue to reduce business tax rates by approximately 25 percent in a revenue-neutral fashion, but does not have potential as a revenue-neutral replacement for the business tax.

A city-specific sales tax increase would need to be authorized by the legislature and approved by the City's voters. The City of Avalon implemented a 0.5 percent increase in the sales tax rate to pay for hospital costs in 2001. The City of Woodland implemented a 0.5 percent increase in 2000 for general purposes. The City of Visalia received legislative approval for a sales tax increase, but has not yet placed the measure on the ballot.

The panel deemed this approach to be outside the control of the City, unlikely, and unable to yield adequate revenue.

Utility users tax increase

An increase in the utility users' tax or an extension of the tax to cover water utility service could potentially raise revenue to finance reductions in the business tax rates. The MMC panel deemed this approach as economically negative, as it provides an unstable revenue stream and an inequitable burden on utility-intensive businesses.

User fees

While a greater reliance on user fees could potentially finance reductions in business tax rates, it is unlikely that a system of user fees could potentially replace the existing gross receipts business tax.

A greater reliance on user fees would promote horizontal equity. As discussed under the horizontal equity evaluation criterion, one principle for evaluating horizontal equity is the notion that taxpayers should pay in accordance with the benefits they receive from municipal services.

The panel indeed studied this approach in-depth, and found that there is not potential to replace the business tax by increasing user fees that are primarily paid by businesses.

Tax exporting strategies

There are various approaches to shifting a greater share of the tax burden to tourists and visitors: Airport access fees, hotel tax increases, and improved nexus enforcement under the existing business tax. While a greater reliance on tax export strategies could potentially finance reductions in business tax rates, it is unlikely that tax export strategies could potentially replace the existing gross receipts business tax in a revenue-neutral fashion.

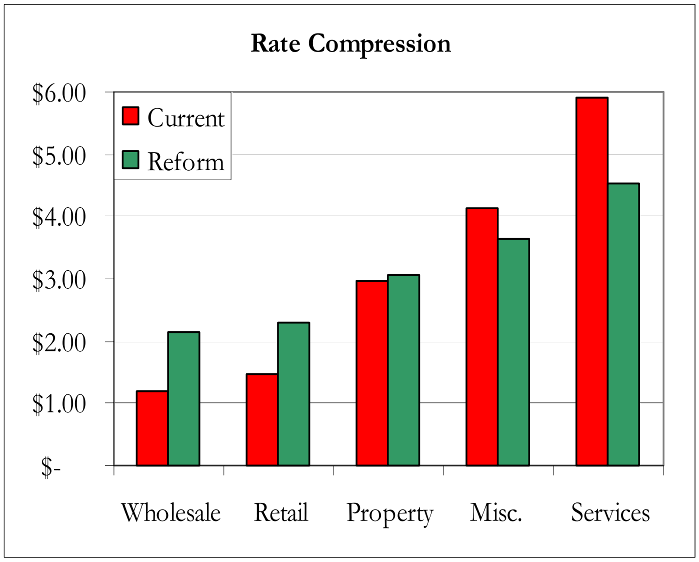
RATE RESTRUCTURING

Rate restructuring alternatives represent minor variations rather than major alternatives to the existing gross receipts tax. While rate restructuring would not form the centerpiece of an alternative to the existing tax, rate-restructuring issues should be considered in specifying the details of alternative tax policies.

Rate Compression

Tax rate compression involves a reduction in the rate differences between categories. The accompanying figure illustrates a hypothetical reform that eliminates one -half the current differences from the average business tax rate. In other words, taxpayers currently paying low rates would pay somewhat higher rates and taxpayers currently paying high rates would pay somewhat lower rates. Rate compression was recommended in the prior tax equity study, and formed a component of the 'graduated receipts scenario'. As indicated in Figure 6-1, if tax rates were compressed, the tax rates for wholesaler and retailers would increase, those for property rental would remain the same, and those for services would decrease.

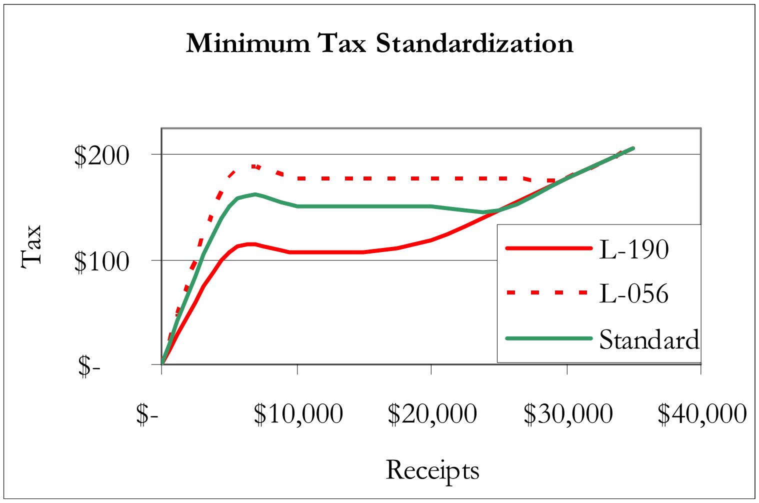
Figure 6-1: Rate Compression



Minimum Tax Standardization

Current tax minimums differ substantially among tax categories. Minimum tax standardization involves levying consistent minimum taxes. The accompanying figure illustrates how auto parks currently pay a higher minimum tax than professions, even though both are in the same rate category. The middle (green) line demonstrates a hypothetical standardization approach.

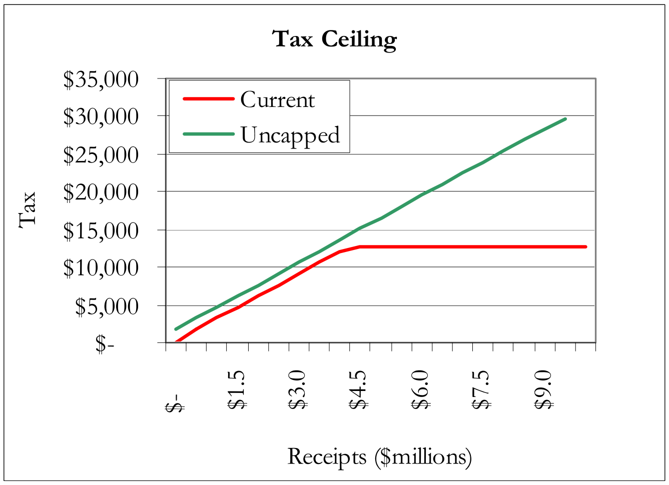
Figure 6-2: Minimum Tax Standardization



Tax Ceilings

Tax ceilings are essentially caps on the tax burden on businesses in a particular category. Generally, tax ceilings do not promote vertical equity in that smaller businesses pay a greater share of their incomes than do larger businesses. An example of a tax ceiling in the existing tax ordinance is that currently in place for large motion picture producers. The upper (green) line depicts how taxes would be levied in this industry if this cap were not in existence.

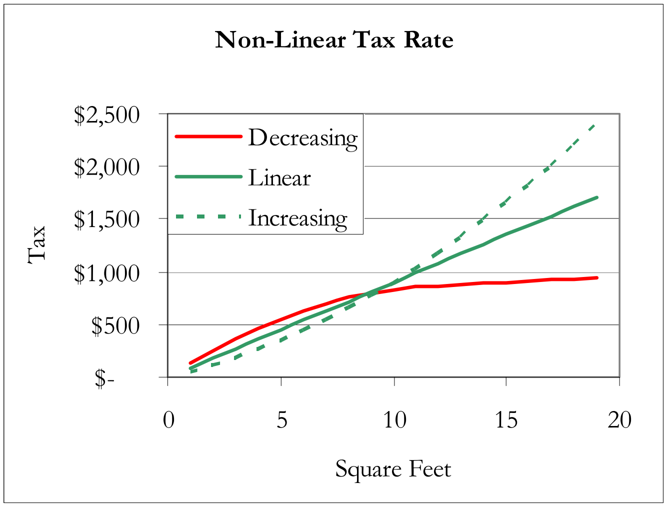
Figure 6-3: Tax Ceiling



Nonlinear Tax Rates

Nonlinear tax rates increase or decrease with business size. An example of an increasing non-linear tax rate is the existing federal income tax schedule in which higher incomes are taxed at higher marginal tax rates. An example of a decreasing non-linear tax rate is the City's taxation of dance hall square footage. In the accompanying figure, the non-linear (red) line illustrates the existing approach to taxing dance hall square footage, and the straight (green) lines illustrate alternative approaches (linear and increasing rates).

Figure 6-4: Non-Linear Tax Rate



Nonlinear tax rates tend to create unpredictable non-compliance incentives.

Decreasing tax rate structures are often deemed regressive from a vertical equity standpoint.

POLICY ADD-ONS

Policy add-ons constitute minor variations in business taxation approach that could be incorporated into a major reform alternative: Special incentives and other measures such as revenue protection measures and compliance promotion measures.

Special incentives

Special incentives are aimed at promoting specific types of businesses or counteracting the negative effects of a major tax approach on particular types of businesses.

Industry-specific tax incentives are incorporated into the existing business tax. For example, the City currently allows motion picture producers to pay on an alternative tax base of production costs and caps the tax liability of the larger motion picture producers. This example represents special tax incentives for this particular industry. Industry-specific tax incentives generally do not promote economic efficiency, unless they are designed to provide relief to geographically mobile firms.

However, industry-specific tax incentives do tend to promote other economic development priorities of policymakers, such as economic growth among growing and export-intensive industries. Industry-specific tax incentives generally do not promote horizontal equity, but they may potentially be designed to promote vertical equity.

Multi-family housing tax credits could potentially be incorporated into tax policy affecting landlords. Such a policy might be structured to offset the negative incentives for multi-family housing development that are incorporated into property tax policy due to Proposition 13 but might also account for the fact that owners of multi-family housing are among the largest beneficiaries of the tax reduction accomplished by Proposition 13.

Small business tax exemptions are incorporated into the existing business tax. Current policy exempts those businesses with less than $5,000 in receipts. This policy encourages the formation of casual businesses, but does not clearly promote economic efficiency. This policy improves administrability by reducing the City's costs of administering the tax for a large number of very small businesses. It promotes horizontal and vertical equity in that such small businesses would otherwise be required to pay a minimum tax, which would constitute a significant share of receipts to those businesses.

Start-up tax exemptions are incorporated into the existing business tax. Current policy exempts small start-up businesses from paying the business tax during the first and second year. Larger start-up businesses with over $500,000 in receipts are essentially granted a loan during the start-up phase for the business tax that would otherwise be due, and then are required to pay at a later date. This policy is designed to encourage the formation of new businesses within the City; since its adoption, the number of businesses claiming the start-up exemption has increased.

Other Measures

Revenue protection measures may be considered as part of a tax reform alternative that is placed on the ballot. Such measures protect the revenue base by instituting automatic inflation adjustments in minimum tax, tax ceilings, and flat tax levies. Current policy does not incorporate inflation adjustment and allows certain tax policy elements to be eroded by inflation over the years.

Compliance promotion measures include increased penalty rates, equity in the penalty structure, and increased audit rates. The current penalty schedule levies a higher penalty rate on taxpayers that do not report the business tax at all than on taxpayers that under-report gross receipts. Hence, non-reporting is penalized at a higher rate than is under-reporting.

ALTERNATIVES SELECTED

Commercial Occupancy

The first recommended alternative bases the business tax on its used real estate space rather than gross receipts. The panel recommended this alternative for in-depth study because it is expected to have positive economic benefits, to promote administrability, and to promote horizontal equity based on the benefit principle.[138] The approach also offers potential for promoting tax compliance.

In the initial evaluation, the team indicated that it would suggest an approach based on square footage in the event that the commercial rental tax proved overly complex for taxation of owner-occupied businesses. In the initial evaluation, the team recommended that the alternative be structured with a special incentive for apartment buildings and consideration for other rate differences to promote other desirable economic development in city.

Value-Added Tax

The second recommended alternative is an explicit tax on value-added rather than gross receipts. Under this alternative, value-added would be defined under the subtractive method.

This approach would greatly improve the efficiency of the business tax by eliminating the double-taxation of raw materials, subcontractor payments and other receipts that do not constitute income for the business. The panel recommended this alternative because it is expected to have positive economic benefits in that the tax would not interfere with market decisions about the purchase of inputs and use of subcontractors.

The approach would promote horizontal equity in that value-added better represents a business' ability to pay than gross receipts. In addition, this alternative was expected to offer modest improvements in the stability of the business tax revenue stream because payroll, which constitutes the majority of value-added, is less cyclical than gross receipts.

Value-Added Classification

The third recommended alternative is a value-added proxy classification alternative or, in other words, a modified receipts tax. This approach differs from the value-added tax in that the tax base would remain gross receipts. The tax classification scheme would implicitly tax value-added by levying tax rates based on the industry average ratio of value-added to receipts. Value-added reflects

[138] MBIA MuniServices Company (MMC), 2003.

the value added by a particular firm and excludes the value passed through the firm in the form of raw materials, subcontractor payments, and other receipts.

The panel recommended this alternative for further study due to its potential to promote horizontal equity and simplification. The approach would promote horizontal equity by restructuring the tax rates such that value-added would be the implicit measure of the tax; value-added better represents the ability to pay of a business than gross receipts. The approach would promote simplification in that there would be fewer tax rate categories, and most of the non-receipts categories would be eliminated. Further, this approach provides an alternative that would constitute a more incremental type of reform than the prior two recommendations, which are tax base alternatives.

CHAPTER 7: COMMERCIAL OCCUPANCY SCENARIOS

Two alternatives to the existing gross receipts business tax are a tax on real estate rentals or on square footage. Under a commercial rental tax, the business tax base would be changed from gross receipts to rental payments. Under a square footage tax, the business tax base would be changed from gross receipts to the square footage of improvements utilized in a business.

While both approaches tax businesses based on their occupancy of commercial space, they tend to follow rather different taxing philosophies. The commercial rental tax generally promotes horizontal equity under the ability-to-pay principle. By comparison, a square footage tax generally promotes horizontal equity under the benefit principle by attempting to levy the tax on the basis of the extent to which businesses are benefiting from municipal services.

While these two scenarios follow different philosophical approaches, they both raise complex considerations in terms of policy structuring. An important one that needs to be addressed is how owner-occupied buildings would be treated under a commercial rental tax. Hence, the report first discusses the policy structuring challenges presented by both approaches and then discusses each approach separately.

POLICY STRUCTURING CHALLENGES

There are two legal issues with respect to levying a tax on businesses as measured by commercial rentals or square footage. First, the tax must not violate the prohibition against levying property taxes. Second, the tax must not violate the Dormant Commerce Clause.

Outside-City Business Sites

In taxing use of space, one significant challenge is how to tax businesses that are located outside the City limits. About one in ten of the City's business tax dollars come from businesses with outside-City addresses.

The first approach to this problem is to step up enforcement of situs-based reporting for the business tax. Some portion of this problem would disappear if businesses accurately reported their location. Large outside-City taxpayers tend to lease or own real estate within the City limits, although their headquarters are located outside the City. For example, a major sports team leases space in Los Angeles to play its games, and a major defense contractor owns substantial real estate in the San Fernando Valley. Both of these businesses remit their taxes from locations outside the City of Los Angeles.

A second approach to this challenge is to structure the tax as a hybrid in which taxpayers are required to pay on another tax base. Under a multiple-base hybrid, the taxpayer would be taxed on the real estate measure (commercial rentals or square feet) in addition to some other tax base, such as gross receipts. This approach leads to a reduction in the business tax owed by taxpayers based outside the City limits who do not owe any tax on the rental or square footage basis.

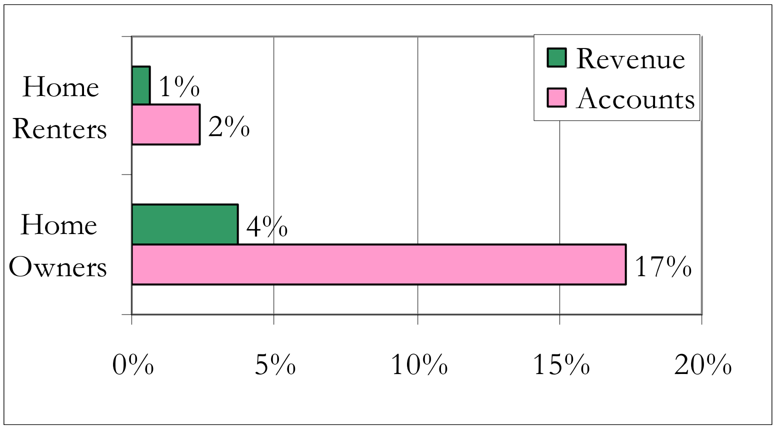
A third approach is to tax the use of space whether or not that space is located in the City. This approach would be relevant if the square footage tax were a hybrid component of the business tax, but would not be effective under a pure square footage approach to business taxation. This approach would require apportionment of the real estate based on a reasonable measure, such as payroll or sales location. Such an approach would reduce the inside-City tax base and increase the administrative costs of the tax.

A fourth approach is to implement a minimum tax designed to recoup the cost to the City of licensing the business. The fourth approach may be used in conjunction with the first and third approaches to minimize the revenue loss associated with outside-City businesses.

Home Businesses

In taxing commercial rentals or square footage, a special circumstance is the taxation of home businesses. Nine in ten home businesses are situated in a house owned by the business owner, with the remainder situated in a rented house or apartment. As indicated in Figure 7-1, about one in five businesses are based in residences.[139] Home-based businesses tend to be small and contribute only 5 percent of business tax revenue.

Figure 7-1: Home-Based Business Share of Business Tax Activity



The most equitable approach to addressing this circumstance is to require home-based businesses to report the proportion of its square footage associated with commercial use. This approach is used by the IRS for purposes of business deductions against the federal income tax for home-based businesses. While this could potentially address taxation of these entities under a square footage scenario, it would not address policy-structuring challenges for home-based businesses in owner-occupied homes under the rental scenario.[140]

To the extent that taxing home-based businesses is deemed by the City to be politically infeasible, other approaches to taxing home-business are 1) to charge such businesses a minimum tax amount, which is owed even though there is no commercial rental to be taxed; and 2) to structure the tax as a multiple-base hybrid in which taxpayers are required to pay on another tax base.

[139] Home-based businesses were established using the 2003 Los Angeles business taxpayer database cross-matched with the 2003 Los Angeles County Assessor property tax database. Business taxpayers located in multi-family dwellings were assumed to be renters, while business taxpayers located in single-family dwellings without a separate landlord business tax record were assumed to be owners.

[140] Homeowners do not pay rent.

In-depth study of the commercial rental tax resulted in the conclusion that this approach would be either inequitable or administratively cumbersome with respect to taxation of owner-occupied businesses. The tax was found to be inequitable in that 30-38 percent of business tax revenues are currently paid by owner-occupied businesses, and it would be administratively cumbersome to tax rent comparables for owner-occupied businesses.

Under a commercial rental tax, commercial building owners would pay $68.20 per $1,000 in commercial rentals, compared with the current rate of $1.48 per $1,000 in commercial rentals under the existing tax.[141] Apartment building owners and hotel owners would continue to pay at the existing tax rate of $1.48 per $1,000 in rental receipts.

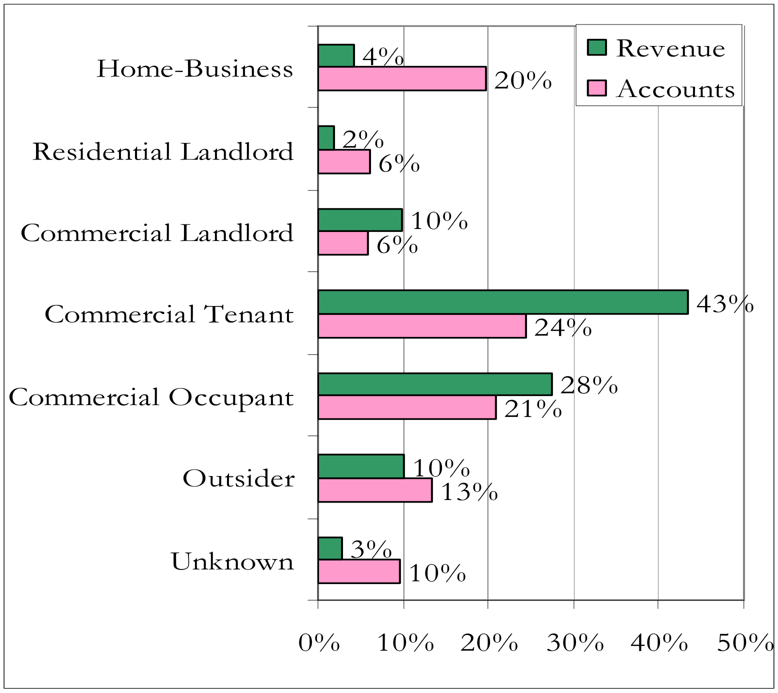
The City of Los Angeles currently levies such a tax on landlords, as do many other California cities.

OWNER-OCCUPIED BUSINESS SITES

In taxing commercial rentals, one significant challenge is how to tax businesses that own the real estate in which they do business. Such businesses do not explicitly pay rent.

In the City of Los Angeles, as much as 38 percent of business tax revenues are paid by inside-City businesses that own the property on which they are situated, as indicated in Figure 7-2.[142]

Figure 7-2: Share of Business Tax Activity by Building Occupant Type



The Los Angeles estimate is comparable to an independent estimate that 30 percent of economic activity in the service sector occurs at owner-occupied businesses in the PG&E service area.

One approach is to ignore the

[141] These tax rates assume no change in overall tax compliance compared with the status quo. The authors estimated revenue-neutral tax rates by dividing business tax revenues by the commercial landlord tax base, after removing the apartment and hotel business tax revenues from the total.

[142] Commercial occupants and commercial landlords are considered owner-occupants for this calculation. Commercial occupants are inside-City business taxpayers located in a non-residential building for which there was no landlord business tax record. Commercial landlords are inside-City business taxpayers with commercial rental receipts; many landlords often have other sources of revenue such as retail or hotel operations. Calculations are based on the 2003 Los Angeles business taxpayer database cross-matched with the 2003 Los Angeles property taxpayer database.

problem. Levying a commercial rental tax without addressing the owner-occupied businesses would require tenant-occupied businesses to pay a tax increase of 40-60 percent to pay for the business tax currently shouldered by owner-occupied businesses.

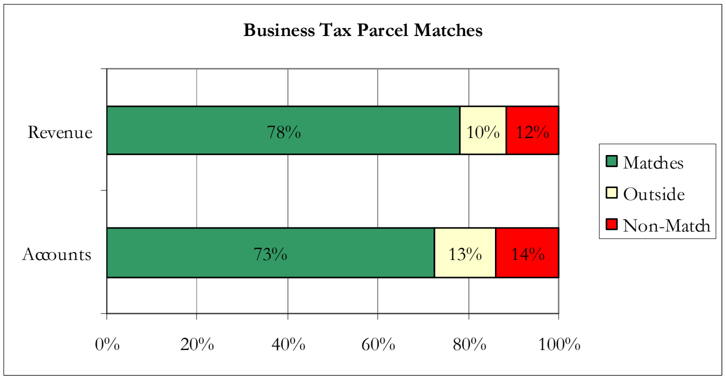
Another approach to addressing this challenge is to levy the tax on owner-occupied businesses based on the comparable rent that would be paid if the property were rented from a commercial landlord. The comparable rent would be established based on the property use, property size, geographic location, and other measures of property value.

Technical Note

There are two major challenges in assessing owner-occupied properties. To evaluate the problem of owner-occupied business sites requires knowledge of the extent of owner-occupied business taxpayers, as well as the business tax revenue currently paid by owner-occupants.

Determining how many business taxpayers are owner-occupants is complicated. Commercial landlords are allowed to report receipts from their various rental properties in combination, and are not required to report on each site. Some commercial landlords have a business license that is not the same as the building, as evidenced by the fact that 12 percent of commercial landlords have an outside-City address on the business license.[143] This means that a property without a landlord business license cannot necessarily be interpreted to be owner-occupied. Fortunately, many continue to report on the separate locations because they are organized as separate legal entities or because they need to keep separate accounting for each parcel for purposes of identifying the property-related taxes for setting lease rates.

Figure 7-3: Business Taxpayer-Parcel Match Rates



A significant share of business addresses are imperfectly reported on either the business tax or parcel databases, rendering it difficult to match all businesses to a parcel. Although 85 percent of business taxpayers with inside-City addresses were matched to a parcel, only 58 percent of non-residential parcels matched to a business taxpayer.[144] Nonetheless, as indicated in the accompanying figure, the vast majority of businesses in the 2003 Los Angeles taxpayer database have been matched to parcel records and square footage information by the authors.

[143] Although twelve percent of commercial landlords have an outside-City address, these landlords tend to be small and their activity only constitutes four percent of commercial landlord business tax revenues. Similarly, 15 percent of residential landlords have an outside-City address listed on their business license. Calculations are based on the 2003 Los Angeles business taxpayer database with geographic location geo-coded by the County of Los Angeles Urban Research Division and by the authors.

[144] Non-residential parcels include office, retail, industrial, warehouse, service, restaurant and other taxable business uses and do not include banks, governments, institutional, and other uses not likely to be taxable under the business tax.

EVALUATION

The legal experts on the team deemed the commercial rental scenario to be legally viable as an excise tax. The commercial rental scenario could be structured to provide adequate revenue yield and to be a revenue-neutral alternative to the existing tax.

Administrability

If not for the owner-occupied administrability problem, the team believes that this alternative would otherwise be simpler to administer than the existing gross receipts tax and could improve compliance. Serious administrability problems are raised by the taxation of owner-occupied buildings—rent comparables. While rent comparables can be used legally, they are onerous for the taxpayer and tax collector since they would be calculated on building use, size, and area. The Office of Finance staffing needs would shift away from cashiers and administrative jobs and toward statisticians and database coordinators. Existing staffing is poorly suited toward implementation of owner-occupied rent comparables as a business tax base.

Taxing owner-occupied businesses based on rent comparables or on depreciation would involve identifying owner-occupied facilities and estimating the tax base for them.

The first task in taxing owner-occupied businesses is to identify the businesses. Although this problem could potentially be addressed, identification of owner-occupied facilities is challenging given that landlords are not currently required to report separately on each of their buildings. Because landlords are not required to hold a business license for each building rented, it is not clear which buildings are owner-occupied and which buildings are included in a combined return of a landlord with an address at another building.

Estimating the tax base requires a significant data collection effort as well as statistical sophistication in multivariate regression modeling.[145] Further, estimation of the tax base would be based on the value of the property. Although the approach is expected to withstand legal challenge, one might expect the approach to be challenged particularly since the taxpayers who stand to gain the most from elimination of owner-occupied business taxation are relatively large businesses.

Equity

The City's gross receipts tax is horizontally inequitable because of different rates applied to different types of businesses, even though they both have the same gross receipts. The commercial rental tax cannot be structured to provide horizontal equity between owner-occupied and renter-occupied businesses without raising serious administrability concerns.

If the owner-occupied businesses were not subject to the tax, many large businesses, such as hotels, car rental companies, motion picture studios and grocery stores, would no longer pay the business tax. The tax burden of these businesses would be shifted to the owners of multi-tenant office buildings, shopping malls, and industrial parks. Most of these multi-tenant facilities currently levy gross rents under lease conditions that allow them to pass along tax increases of this nature to

[145] Multivariate regression modeling involves the statistical estimation of the contribution of various building size, location and quality indicators to observed rents in renter-occupied buildings, and the use of the resulting coefficients in estimating the rent comparable in owner-occupied buildings based on building size, location and quality indicators.

tenants. Economic conditions would limit the ability of landlords in regionally competitive real estate markets to pass the tax on to tenants, as some tenants would relocate to avoid the tax. Office tenants would be expected to put downward pressure on landlords' ability to pass on the increased tax load due to relatively high (15 percent) vacancy rates in the Los Angeles office market.

CONCLUSION

The expert team concluded that a commercial rentals tax would be difficult to administer. The team rejected the commercial rentals taxation approach on the grounds that it would be difficult for existing staff at the Office of Finance to administer such a tax. In its stead, the team favored a square footage approach to taxing commercial real estate usage.

SQUARE FOOTAGE TAX

Another alternative to the existing tax is a simple tax on square footage. Such a tax could be structured so that industrial square footage is taxed at a lower rate than commercial office space square footage. Two cities, Cupertino and El Segundo, both currently levy a business tax on square footage, or some variation thereof.

Specifically, the City of Cupertino has a straightforward square footage tax that is applied directly to businesses; the city does not work through landlords. The tax consists of a base tax plus a tax on 85% of the square footage (floor area) in order to compensate for unused areas of the office, such as stairwells, elevator shafts, and mechanical rooms. When someone applies for a business license to conduct business within the city, a copy of the lease is presented and the business is logged into the city's records, thereafter under obligation to remit an annual payment to the city. Non-profits, financial institutions, and government agencies are all exempt. When office space is shared by one or more businesses, the tax can be split in any way desirable, although both businesses are subject to the flat fee.

The City of El Segundo has had a business tax partially based on square footage since 1911; the tax is based on three parts: (1) Number of employees, (2) Square footage of floor area, and (3) Number of additional facilities within the city. Square footage is defined as all covered areas available for business use, less stairwells, elevator shafts, mechanical equipment rooms, etc. In cases where the landlord maintains an office in the building, he/she is taxed only on that office space. When there are vacant spaces in the building, the landlord is required to pay the square footage tax at a reduced rate, thereafter receiving a refund (in full or part) when the property is leased and the business registers with the city. To audit the businesses, the city cross-references the square footage reported between years and often contacts landlords directly for confirmation.

As, under this alternative, the tax burden is primarily borne by the businesses located inside the City limits, it is suggested to introduce a square footage tax as a part of a multi-base hybrid approach in order to continue taxing outside-City businesses that conduct business within the City.[146] Alternatively, outside-City businesses could be taxed on self-reported square footage of property used outside the City, although the relation of this measure to either ability to pay or consumption of City services is not obvious. Consequently, the researchers propose the introduction of a square

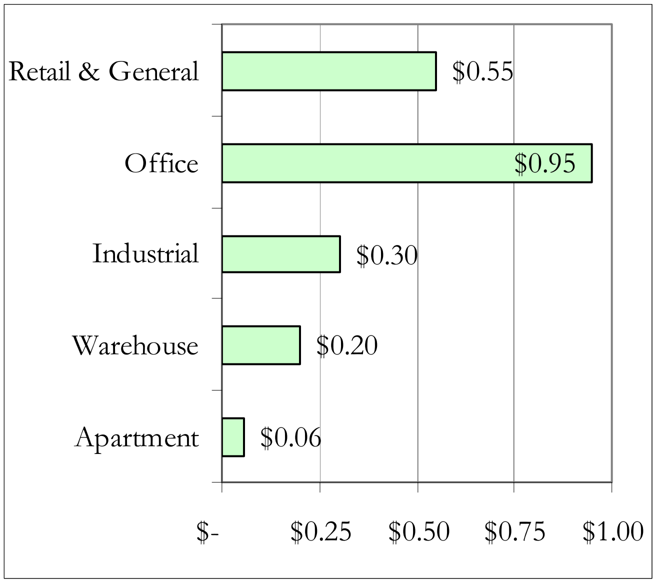
[146] The hybrid square footage-net receipts scenario is evaluated and discussed in chapter 10.

footage tax in combination with the value-added proxy tax ("modified receipts"). Under this multi-base hybrid scenario, the team envisions that approximately 30 percent of the current business tax revenue would be raised from the square footage tax aspect and the remaining revenue would come from the value-added proxy tax.

POLICY SPECIFICS

Under a pure square footage tax, each business taxpayer would pay a tax based on the square footage used for business purposes in excess of 250 square feet. Business tenants would pay on the square footage leased within the structure as well as any leased outdoor space, such as parking. Home-based businesses would pay based on the portion of the home used for business purposes, as reported to the IRS. Landlords would pay the tax on common space, areas used for property management offices, space leased for residential use, and unoccupied space offered for lease. The landlord would not pay the tax with respect to space leased by tenants holding a business registration certificate or a business exemption certificate. The landlord would report the deducted tenants, which is expected to promote compliance. Landlords in mixed-use buildings (such as retail and residential) would pay based on the primary use, with the onus on the taxpayer to prove that the primary use is at the lower tax rate.

Figure 7-4: Square Footage Tax Rates



The square footage tax rates were designed to be revenue-neutral for broad categories of property use.[147] The general tax rate would be $0.55 per square foot per year; this rate would apply to retail, service and miscellaneous businesses. The office tax rate would be $0.95 per square foot. The industrial tax rate would be lower at $0.30 per square foot, and the warehouse tax rate would be $0.20 per square foot. Finally, the tax rate for apartment landlords would be $0.06 per square foot.[148]

A modest number of taxpayers (less than 100) that are exempt from the business tax, but nonetheless own commercial property, currently pay taxes on rental receipts under the 'Commercial Occupancy Tax'. These taxpayers include government agencies, banks and non-profits owning buildings. It is recommended that these taxpayers also be shifted to taxation on the basis of the square footage that is not occupied by tax-exempt businesses.

[147] This means that the rates were calculated for each tax category (i.e. office, general/retail, industrial, warehouse and apartments) by dividing the current business tax revenue by the square footage appearing in the County Assessor's secured basic file in the buildings where the business taxpayers are located. Adjustments were made to account for the non-match rate among taxpayers, but not for the non-match rate among buildings because landlords are currently allowed to consolidate buildings in their registration certificate.

[148] The revenue-neutral tax rates were calculated by taking 2003 by building type as indicated in the 2003 Los Angeles County Assessor database and dividing by the square footage for building improvements as reflected in the Assessor database. The authors developed and estimated the rates using a 2003-taxpayer database of business tax records cross-matched with Assessor parcel records.

The proposed square footage tax would be a tax upon the privilege of operating a business in the City. The measure of the tax would be the amount of square feet of building space (and outdoor space used to provide services or display inventory) used in the course of business.

A business would owe the tax only with respect to their commercial occupancies. Businesses that operate commercial space for lease would owe the tax only with respect to space that is offered for lease, and not with respect to property that has been removed from the leasing market. A lessor would not have to pay the tax with respect to any square footage for which a tenant pays the tax. In other words, commercial landlords would only pay the tax with respect to space offered for lease (but not occupied) and with respect to space actually used by the business operations of the landlord (i.e. building management offices).

Because this tax would be owed by the business using space or offering that space for lease and would not be charged based on ownership of property but use of space in the course of business, this tax would not be a prohibited parcel tax.

Table 7-5: Square Foot Scenario Revenue Impacts by Industry

Industry	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
ALL INDUSTRIES	$ 357.3	$ 358.8	$ 1.5	0%	$ 5.48	$ 5.50
Utilities	1.0	0.8	$ (0.2)	-17%	$ 5.43	$ 4.53
Building Construction	6.7	3.8	$ (2.9)	-43%	$ 5.88	$ 3.32
Heavy Construction	1.7	0.7	$ (1.0)	-57%	$ 4.64	$ 2.02
Construction Trades	6.1	4.4	$ (1.7)	-28%	$ 5.55	$ 4.02
Food Manufacturing	1.8	1.8	$ (0.0)	-1%	$ 3.53	$ 3.49
Apparel	3.1	7.0	$ 3.9	124%	$ 5.03	$ 11.25
Printing	1.5	2.0	$ 0.4	29%	$ 3.63	$ 4.68
Petroleum Refineries	1.7	1.1	$ (0.6)	-37%	$ 5.16	$ 3.27
Chemicals	1.3	0.9	$ (0.4)	-33%	$ 2.81	$ 1.89
Fabricated Metal	1.7	1.8	$ 0.1	7%	$ 5.65	$ 6.05
Communication Equipment	1.8	2.4	$ 0.6	35%	$ 4.29	$ 5.77
Transportation Equipment	3.0	3.2	$ 0.2	7%	$ 8.02	$ 8.61
Furniture Manuf.	0.7	1.8	$ 1.1	142%	$ 3.81	$ 9.19
Misc. Manuf	1.2	2.3	$ 1.2	99%	$ 3.06	$ 6.11
Wholesale Motor Vehicle	1.2	1.6	$ 0.4	37%	$ 7.13	$ 9.74
Wholesale Furniture & Construction	1.1	1.2	$ 0.2	16%	$ 6.46	$ 7.47
Wholesale Professional Equip.	3.1	2.2	$ (0.9)	-29%	$ 8.97	$ 6.37
Wholesale Electronics	1.2	1.8	$ 0.6	52%	$ 6.80	$ 10.32
Wholesale Equipment	1.3	1.2	$ (0.0)	-3%	$ 7.80	$ 7.56
Wholesale Sports & Toys	2.4	2.8	$ 0.4	18%	$ 5.93	$ 6.98
Wholesale Apparel	2.4	2.8	$ 0.4	18%	$ 4.48	$ 5.28
Wholesale Groceries	4.5	2.3	$ (2.2)	-49%	$ 8.64	$ 4.41
Wholesale Misc.	3.9	5.7	$ 1.8	45%	$ 7.39	$ 10.74
Retail Autos	9.7	2.1	$ (7.6)	-78%	$ 14.41	$ 3.13
Retail Motor Vehicles	2.0	2.7	$ 0.7	36%	$ 7.56	$ 10.30
Retail Furniture	1.6	3.0	$ 1.3	81%	$ 4.39	$ 7.96
Retail Appliance	3.0	2.8	$ (0.2)	-6%	$ 6.17	$ 5.78
Retail Building Material	3.1	2.9	$ (0.2)	-7%	$ 5.68	$ 5.30
Retail Grocery	9.4	11.5	$ 2.1	22%	$ 6.15	$ 7.50
Retail Drugs & Health	3.9	4.4	$ 0.5	13%	$ 6.67	$ 7.51
Gas Stations	3.1	0.8	$ (2.3)	-73%	$ 11.82	$ 3.21
Retail Apparel	4.1	8.1	$ 4.0	97%	$ 4.02	$ 7.93
Retail Misc.	8.4	14.4	$ 6.0	71%	$ 5.26	$ 9.00
Retail General	4.4	7.3	$ 2.9	66%	$ 6.03	$ 10.00
Transportation	1.4	1.4	$ 0.0	2%	NA	NA
Transportation Service	2.8	2.9	$ 0.1	4%	$ 5.36	$ 5.56
Warehousing & Storage	0.9	1.2	$ 0.3	30%	$ 2.85	$ 3.71
Publishers	1.6	3.1	$ 1.5	94%	$ 3.52	$ 6.81
Motion Picture	5.2	4.3	$ (1.0)	-18%	NA	NA
Movie Theater	0.3	1.0	$ 0.7	249%	$ 2.92	$ 10.22
Telecommunications	3.7	2.1	$ (1.6)	-44%	$ 2.04	$ 1.14
Information Services	1.1	1.1	$ (0.0)	-1%	$ 4.77	$ 4.73
Finance	3.2	2.8	$ (0.4)	-13%	$ 7.27	$ 6.30
Investment Banking	13.0	5.0	$ (8.0)	-61%	$ 6.70	$ 2.58
Insurance	8.9	1.7	$ (7.2)	-81%	$ 20.74	$ 3.97
Insurance Agencies & Brokerages	3.8	3.9	$ 0.1	2%	$ 8.55	$ 8.73

Industry	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
Residential Landlords	5.9	9.7	$ 3.8	64%	$ 2.08	$ 3.42
Commercial Landlords	8.3	24.9	$ 16.6	199%	$ 2.23	$ 6.67
Real Estate	7.0	5.0	$ (2.0)	-28%	$ 6.40	$ 4.58
Car Leasing	1.8	1.6	$ (0.2)	-11%	$ 5.04	$ 4.47
Consumer Rental	1.5	1.7	$ 0.2	13%	$ 4.49	$ 5.09
Commercial Rental	2.2	0.8	$ (1.4)	-63%	$ 4.31	$ 1.59
Offices of Lawyers	33.5	18.4	$ (15.1)	-45%	$ 6.82	$ 3.74
Accounting	7.1	7.1	$ 0.1	1%	$ 7.21	$ 7.29
Architects & Engineers	5.4	3.0	$ (2.5)	-45%	$ 8.61	$ 4.73
Design Services	3.7	4.9	$ 1.2	32%	$ 4.83	$ 6.38
Management Consulting Services	6.2	5.0	$ (1.2)	-20%	$ 7.48	$ 6.00
Research Service	0.6	0.3	$ (0.3)	-46%	$ 8.61	$ 4.66
Advertising Agencies	10.5	4.0	$ (6.5)	-62%	$ 7.36	$ 2.81
Misc. Prof. Service	1.7	1.9	$ 0.2	11%	$ 6.12	$ 6.82
Admin Services	16.2	13.1	$ (3.1)	-19%	$ 3.98	$ 3.21
Employee Services	3.4	6.1	$ 2.7	79%	$ 6.61	$ 11.83
Travel Agencies	1.4	2.0	$ 0.6	41%	$ 7.35	$ 10.40
Building Services	7.9	7.2	$ (0.7)	-8%	$ 7.23	$ 6.62
Education	2.9	3.2	$ 0.3	11%	$ 7.00	$ 7.79
Physician Offices	25.8	22.3	$ (3.5)	-13%	$ 6.72	$ 5.82
Outpatient Health	3.9	2.1	$ (1.8)	-45%	$ 8.69	$ 4.74
Hospitals	8.2	3.2	$ (5.1)	-62%	$ 5.16	$ 1.97
Social Services	0.6	1.2	$ 0.5	84%	$ 4.36	$ 8.01
Performing Arts	3.8	2.3	$ (1.4)	-38%	$ 4.51	$ 2.77
Amusement & Recreation	1.8	1.7	$ (0.0)	0%	NA	NA
Hotels	2.0	2.0	$ (0.0)	-1%	$ 3.00	$ 2.97
Restaurants	7.2	24.6	$ 17.4	241%	$ 2.79	$ 9.50
Auto Repair	3.4	4.1	$ 0.7	22%	$ 6.93	$ 8.43
Repair Service	1.8	1.5	$ (0.3)	-17%	$ 7.83	$ 6.51
Personal Service	3.8	6.4	$ 2.6	66%	$ 5.34	$ 8.88
Parking Lots and Garages	4.4	8.6	$ 4.3	97%	$ 7.79	$ 15.36

Effects by Business Type

Table 7-5 above provides the revenue impacts of the net receipts alternative on the existing tax base in industry order (based on the North American Industry Classification System). In this table, the effective tax rate reflects the current baseline tax as a percentage of value-added ($1000s). Baseline revenue reflects business tax revenue currently generated, whereas scenario revenue reflects revenue that would be raised under the square footage scenario. The baseline and scenario tax rates reflect tax revenue per $1,000 in net receipts; these rates are effective tax rates and do not reflect the actual statutory tax rate. As can be seen by comparing the effective baseline and scenario tax rates, this alternative provides a much lesser degree of horizontal equity between taxpayers.

EFFECTS BY INDUSTRY

Under this scenario, construction, gas stations, auto dealers, law offices, and advertising agencies would see a significant reduction in the business tax owed. On the other hand, apparel manufacturers, furniture and apparel stores, commercial landlords, parking garages, restaurants, and movie theaters would all see a significant increase in the business tax owed. Detailed impacts by industry are listed in Table 7-5.

EFFECTS BY GEOGRAPHY

Under the square footage alternative, outside-City taxpayers would only owe the minimum tax and would not owe a tax on square footage. The outside-City taxpayers would receive an 81 percent reduction in business taxes owed, while inside-City taxpayers would receive a 9 percent increase in business taxes owed.

Table 7-6: Square Foot Scenario Revenue Impacts by Location

Area	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
Total	$ 357.3	$ 358.8	$ 1.5	0%	$5.48	$5.50
Unknown	$ 2.4	$ 3.7	$ 1.3	55%	$5.60	$8.69
Inside	$ 317.9	$ 348.0	$ 30.2	9%	$5.59	$6.12
Outside	$ 37.0	$ 7.1	$ (30.0)	-81%	$4.66	$0.89

REVENUE EFFECT

Had this alternative been actual City policy in the 2003 tax year, the City's business tax revenues for the 2003 tax year would have been $358.8 million compared to the $357.3 million that the authors estimate the City will receive for the 2003 tax year. The net revenue impact would have been a $1.5 million gain for the general fund.[149]

On a cash flow basis, the revenue yield would be slightly different. Business tax payments in a particular fiscal year consist primarily (89-90%) of business tax revenues from the current year, but 10-11 percent of revenues received are from prior tax years.[150] Had the square footage tax been City policy in 2003, the City's FY 2002-03 business tax revenues would have included about 10-11 percent of revenue from prior tax years under the old policy. Therefore, the general fund revenue impact would have been a $1.4 million gain in FY 2002-03 had the square footage alternative been City policy.

[149] Note that levying square footage tax rates in fractions of a cent can reduce the revenue impact. Alternative tax rates can be structured to increase or decrease the expected revenue yield of a square footage tax.

[150] The 90% estimate is based on comparison of business tax payments from the 2001 tax year that were received during FY 2000-01 and total business tax revenues for that fiscal year as reported by the CAO. The 89% estimate is based on comparison of business tax payments from the 2002 tax year that were received during FY 2001-02 and total business tax revenues for that fiscal year as reported by the CAO.

The square footage alternative could be considered for City policy beginning no sooner than tax year 2006. Assuming that the actual square footage tax rates on a ballot measure are adjusted for inflation between 2003 and 2006, the tax rates would be somewhat higher, as would the revenue. However, the revenue impact in percentage terms would be expected to be zero (0) percent.

Economic Effects

The effects discussed in the two prior sections do not take into account economic responses to the tax policy.

Owners of local businesses facing higher taxes under the policy will decide to what extent the money will come from profits, wages, higher prices, reduced output and employment, or reduced capital in light of the market forces facing their industries. Owners whose taxes are lower under the square footage tax face similar decisions about how to spend the dollars that once were sent to the government. After these decisions are made and if, on average, most firms have more money to invest, this will generate additional sales in the City as companies buy more from their suppliers and hire more workers. Newly hired workers stimulate the economy further by spending their new earnings on housing, food, and other consumer items. To the extent that the local economy grows, the City earns additional tax revenues from the new activity.

For each industry, the response to a tax change differs due to competitive conditions in the industry and the share of business taxes in operating costs. The model estimates the full set of interactive economic effects among local industries.

Additional complexity in the model comes from the spillover effects between the City and the rest of the County. Finally, the model estimates the extent to which the City earns additional tax revenues from the economic changes induced by this tax policy.

These results are summarized in Table 7-7. The estimates derive from our model estimates of businesses' responsiveness to changes in their operating costs due to tax policy changes.

Table 7-7: Square Foot Scenario Economic Impacts ($millions)

	Status Quo	Policy Impact	
	Amount	Amount	%
Output	$ 279,143	$ (59)	0.0%
Wages	$ 82,747	$ (12)	0.0%
Employment	1,903,055	(991)	-0.1%
Tax Revenues			
Business Taxes	$ 357.3	$ (1.6)	-0.4%
Sales Taxes	$ 363.2	$ (0.2)	-0.1%
Hotel Taxes	$ 94.2	$ 0.0	0.0%

The overall effect of the square footage policy on job creation in the City is negligible because the policy has been structured to be revenue-neutral. Under this policy, the business community as a whole is transferring $1.5 million to the City in increased tax payments, which constitutes a negligible share of business operating expenses in the City. Hence, the economic stimulus is also negligible. As indicated in Table 7-7, fewer than 1,000 jobs are expected to be lost as a result of this policy.

EVALUATION

Economic Benefit

This type of tax would improve economic benefits. Businesses would be required to pay the current business tax burden under a square footage tax approach, which serves as a proxy for the business demand for municipal services. In this sense, the tax would distort economic decisions less than a tax on gross receipts.

Administrability

The square footage tax is expected to promote simplicity for the taxpayer because square footage is easily measured and changes only when businesses move. A square footage tax would be imposed on the business that occupies space in the City in order to boost compliance. The imposition, compliance responsibility, and cost fall on the individual business rather than shifting tax collection responsibility to the landlord. From an audit standpoint, the City would not be required to determine the ownership of the building in order to administer the tax.[151] Instead, the audit focus would be on the business occupant, who would be required to display a permit, as is currently the case. In order to aid enforcement of the tax, additional responsibility would be shifted to the landlord to ensure that tax is paid for common areas of the building and for areas occupied by businesses that do not have either a business tax registration or exemption certificate.

It is expected that the City will experience greater compliance under this scenario, as it is easier to audit the accuracy of reporting square footage than gross receipts because the City has building permit records and assessor's records against which building areas can be checked.

Stability

A square footage tax is by far the most stable tax revenue source, as square footage assessments do not depend on business cycle fluctuations. Furthermore, in the absence of vacant building exemptions, this tax revenue source is not affected by different phases of the business cycle. Moreover, the use of space by a business can be expected to trail other indicia of an economic downturn due to long-term leases and other factors attendant to the commercial use of real property.

Equity

Horizontal equity refers to business in the same situation paying the same taxes. The City's gross receipts tax is horizontally inequitable for several reasons, as discussed in Chapter 4. The square footage tax promotes horizontal equity under the benefit principle: All businesses that use comparable amounts of City services would pay similar taxes.

However, a square-footage tax has significant drawbacks in terms of vertical equity. The square footage component increases the tax burden of businesses located in low-income communities, and

[151] Determination of building owner for each business tax record is currently complicated due to the fact that landlords are not required to report the tax for each building owned. The City would need to require situs-based reporting for all business taxpayers in order to effectively administer a square footage tax. Please refer to the technical note in the Commercial Rental Tax section earlier in this chapter for elaboration.

decreases the tax burden of businesses in expensive neighborhoods. It cannot easily be structured within the confines of the Dormant Commerce Clause tests to maintain the current tax burden on outside-City businesses. Hence, under this alternative the square footage tax would be designed to raise only one-third of the existing business tax revenue and the remainder would be raised under a taxing principle that considers ability-to-pay.

CHAPTER 8: VALUE-ADDED SCENARIO

A value-added tax is a tax on the value-added directly by the taxpayer during the process of production through labor inputs and the use of buildings, equipment and capital. This approach avoids multiple taxation by only taxing final goods rather than all the inputs and intermediate transactions. Value-added is calculated as a difference between the total revenues and the costs of goods and services purchased from other firms and used as inputs in the production process. An alternative calculation is to add payroll, interest paid, depreciation, and profit. These two approaches are equivalent.

European Experience

In Europe, the value-added tax (VAT) is remitted by businesses to the taxing authority, although consumers pay the tax when they buy final goods, much like a sales tax. The businesses receive a refund for overpayment related to tax payments made by the business for intermediate inputs. This tax allows the seller to avoid the double-taxation that would otherwise result given that a portion of sales value is attributable to activity at other firms. Both the buyer and the seller keep records of the amount of the tax collected and paid. At the end of each tax period, all accounts are reconciled and only the difference is paid to the tax authority. This tax collection system requires significant implementation efforts (all receipts include a special calculation for VAT reconciliation purposes), but it is relatively easy to administer. Tax evasion is reduced when this tax collection scheme is applied, as the seller collects the tax. However, this approach is implemented at a national level in Europe and would present an excessive compliance burden if implemented in this fashion at the municipal level.

Michigan Experience

Another approach to value-added taxation has been used in Michigan, where the value-added tax is essentially a tax on payroll and profit and hence is subject to the same administrative costs as payroll and profit taxes. Value-added is calculated as the sum of payroll and profit. Under Michigan's system, all firms are allowed to deduct capital purchases in the year that these purchases are made. Such an incentive is an additional encouragement to get firms to accept this form of taxation and to benefit labor through the encouragement of greater capital purchases, thereby enhancing labor productivity and enabling labor to command higher compensation as a result.

In Michigan, only 35% of the State's businesses pay the value-added tax. Firms with adjusted gross receipts below $250,000 and farms do not. Insurance companies use a tax base of 25% of adjusted receipts rather than value-added.

Michigan uses an "adding-up" method to calculate the value-added tax base. The method involves adding business income to compensation, depreciation, and interest paid (hence rent is not taxed). The following components are added to define the tax base:

- Business income (even if zero or negative)
- Gross interest income and dividends from obligations or securities of states other than Michigan
- All taxes on, or measured by, net income (including this tax)
- Depreciation and amortization

- Dividend paid minus dividends received
- Interest
- Royalties
- Compensation
- Net capital gain

A deduction from the tax base (capital acquisition deduction or CAD) was allowed for 100 percent of the capital investments made in Michigan, until this deduction was successfully challenged for violation of the Dormant Commerce Clause.

For multi-state firms, the tax base is apportioned using a three-factor formula involving proportion of payroll in the State to total payroll (5%), property in the State to total property (5%), and sales in the State to total sales (90%).

The value-added tax, as structured in Michigan, became unpopular after a Dormant Commerce Clause legal challenge unraveled the capital investment credit. The legislature in 1999 passed a policy phasing out the VAT gradually through the year 2022; however, the phase-out was halted due to excessive State revenue losses.

Advantages at the time of the introduction

(1) Revenue stability compared with the erratic corporate income tax
(2) Promotion of capital investment and creation of new jobs
(3) Simplification of administration
(4) Fairer, more equal treatment of businesses
(5) Improved image of the State with multinational corporations

Problems

(1) Equity: The business community does not view the tax as fairly structured based on ability-to-pay. In comparing the value-added tax with a corporate income tax, businesses complain that their tax burden remains the same regardless of how profitable the business has been in a particular year. On the basis of horizontal equity associated with the benefit principle—use of governmental services—the tax is considered to provide equity.
(2) Equity: The value-added tax has been amended several times to accommodate businesses seeking special treatments, and has evolved into a tax that does not provide the horizontal equity embodied in the original tax policy.
(3) Administrability: The VAT is unique in the sense that no other state or city has implemented it. Comments from businesses indicate that this tax is complicated, confusing, onerous, anticompetitive, and burdensome overall. In addition, compliance costs (including accounting fees) for small businesses can exceed the tax liability. Thus, Michigan found the uniqueness and unfamiliarity of the tax to be an impediment in selling the State to new investors, hence in attracting business.
(4) Legality: The capital acquisition deduction failed the Dormant Commerce Clause test due to the different treatment of investments inside and outside the State by multi-state companies.

Adapting the Tax to Los Angeles

There are several considerations in adapting a value-added tax to Los Angeles. To best promote equity, the tax would be structured at a uniform rate. The tax must be legally structured using a deduction approach. Hence it must be defined as receipts less various deductions representing payments made to other businesses. This approach eliminates most forms of double taxation.

Specific deductions would include materials costs, subcontractor payments, and outside services. Subcontractor payments constitute payments made to other businesses and would be excluded from the value-added tax base. In learning from Michigan's experience, there should be no deduction for capital acquisitions within the City limits due to apparent violation of the Dormant Commerce Clause test. Deduction items should be defined similarly as items that businesses report on their corporate income tax forms in order to simplify the audit process. However, this would likely require the City to change the existing timetable for payment of gross receipts taxes from February to April so that the corporate income tax returns are prepared in advance of a business computing its business tax. The definition of deductions will require clarification of the specific elements of the deduction as part of the implementation. Deductions must be defined by regulatory action after the policymakers define an approach to changing the tax system. These regulatory definitions may create some level of complexity, but are necessary to facilitate compliance and ensure fair and equitable administration of the tax system.

Outside-City taxpayers would continue to pay the business tax under this alternative, just as they do under the current business tax policy. The City should use industry indicators of value-added as a share of receipts in order to flag businesses that are reporting a below-average share of receipts as taxable value-added. To accomplish this, the City should require businesses to continue to report gross receipts as well as total deductions from receipts. Further, the City could require taxpayers to report the names, addresses and taxpayer identification numbers of businesses to which they have made significant payments constituting a significant portion of deductions from receipts.

There is currently a perceived lack of transparency in the application of the existing apportionment formulae for certain classes of taxpayers. Moreover, existing apportionment formulae may need to be addressed if there is a transition to a 'net receipts' approach. For example, the exemption for the out-of-state sale of goods, contained in Section 21.168.1, may or may not be retained in the net receipts apportionment approach is a policy consideration that should be addressed. Further clarification of apportionment formulae is an important implementation issue that must be addressed after tax policy is made.

Policy Specifics

The taxable base would be defined as gross receipts less deductions for cost of materials[152] and subcontractor payments[153], with a uniform rate of $4.90 per $1,000 in net receipts being applied

[152] Materials deductions would include the cost of merchandise purchased from a separate company and resold to customers as well as the cost of raw materials that become an "identifiable element" of the goods or services sold directly by the taxpayer. Hence, the purchase of goods for resale by wholesalers and retailers would be deductible, the purchase of raw materials used as part of the manufacturers' final product would be deductible, and the purchase of raw materials resold by service sector companies would be deductible (e.g. hotel toiletries, Kinko's paper supplies).

across industries. In order to receive the subcontractor deduction, the taxpayer must report the subcontractor's name, address, and receipts. The prime contractor would not receive the tax deduction for subcontractors without a registration or exemption certificate. This requirement is expected to promote compliance and help the City identify businesses that are not currently complying with the business tax.

The revenue-neutral net receipts tax rate would be $4.90 per $1,000 in net receipts.[154] The actual rate would most likely be significantly lower so long as taxpayers currently taxed on odd and presumptive tax rates are successfully converted to the net receipts tax base. A lack of meaningful receipts data on motion picture companies and amusements limits our ability to forecast scenario revenue for these industries; hence, this report erred on the side of caution and certainty.

The tax base would be defined as net receipts in excess of $30,000. Approximately half of the businesses have net receipts less than $30,000 and would simply pay the $145 minimum tax. The remaining businesses would pay a tax on their net receipts in excess of $30,000.[155]

Under this policy, each taxpayer would owe a minimum tax designed to recoup the cost of administering the business tax. The minimum tax for this analysis is established at $145 per taxpayer, with a special filing fee of $25 for start-ups and small businesses with less than $5,000 in receipts. The fee was established based on the assumption that approximately three-quarters of the Office of Finance revenue collection costs are associated with enforcement of the business tax.[156]

[153] A subcontractor is a partnership, limited partnership, corporation, business trust, joint stock company, trust, unincorporated association, joint venture, governmental entity or other entity of whatever nature hired by a vendor (other than employees) under separate contractual arrangements to perform portions of the work under an agreement. Subcontractor payments are deductible in Bakersfield, Davis, Santa Ana, Stockton and Berkeley; but the term is not explicitly defined in their respective Municipal Codes.

[154] The revenue-neutral tax rate is calculated by taking business tax revenue net of revenue from the minimum tax, then dividing by net receipts. Net receipts were calculated on a detailed industry basis using Internal Revenue Service data to establish the ratio of gross receipts that are net receipts and multiplying that ratio by the taxpayer's reported taxable receipts in tax year 2003. Net receipts for purposes of the calculation was defined as business receipts less cost of goods sold, except that the cost of goods sold were adjusted for any direct payroll expense classified by the corporate income taxpayer under cost of goods sold.

[155] The source for these and all other estimates relating to the Los Angeles business tax is the MMC tax policy model, which is based on 2003 Los Angeles business tax data cross-matched by address with geographic identifiers and parcel data and cross-matched by business name and address with sales tax data, phone numbers and employment data.

[156] Revenue collection costs include related and indirect costs such as pension, building services and employee benefits.

EFFECTS BY BUSINESS TYPE

Table 8-1: Value-Added Scenario Impacts by Tax Category ($millions)

Primary Tax Category	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
ALL TAXPAYERS	**$ 357.3**	**$ 358.4**	**$ 1.0**	**0%**	**$ 5.48**	**$ 5.49**
Telephone Service	2.8	8.8	6.0	217%	$ 1.71	$ 5.43
Commercial Rental	9.6	23.3	13.6	141%	$ 2.26	$ 5.44
Theater	0.5	1.0	0.5	109%	$ 2.60	$ 5.43
Hotel, Apartment	9.3	22.1	12.8	138%	$ 2.27	$ 5.40
Laundry/Cleaner/Shoe Repair	0.8	1.8	1.0	126%	$ 2.41	$ 5.45
Radio/TV Broadcaster	2.9	5.8	2.8	98%	$ 2.75	$ 5.45
Sporting Events	1.2	1.7	0.4	36%	$ 3.99	$ 5.43
Wholesale Sales	37.5	49.3	11.8	32%	$ 4.14	$ 5.45
Contractor Outside LA	7.8	10.4	2.6	33%	$ 4.32	$ 5.74
Telemarketing	0.2	0.3	0.0	15%	$ 4.74	$ 5.43
Personal Property Rental	5.9	6.6	0.8	14%	$ 4.79	$ 5.44
Storage, Freight Forward	2.8	3.1	0.3	11%	$ 4.87	$ 5.41
Collection Agency	0.3	0.3	0.0	12%	$ 4.78	$ 5.35
Retail Sales	69.2	76.1	6.9	10%	$ 4.99	$ 5.49
Contractor-LA Business	6.7	6.9	0.2	3%	$ 5.69	$ 5.84
Miscellaneous Services	14.1	11.0	(3.1)	-22%	$ 6.96	$ 5.44
Vending Machines	0.2	0.1	(0.0)	-20%	$ 8.58	$ 6.84
Professions	165.8	119.9	(46.0)	-28%	$ 7.61	$ 5.50
Sale Real Property	0.8	0.5	(0.3)	-35%	$ 8.42	$ 5.46
Auto Park	2.5	1.6	(0.9)	-37%	$ 8.70	$ 5.46

Table 8-1 provides the revenue impacts of the net receipts alternative on the existing tax base. In this table, the effective tax rate reflects the current baseline tax as a percentage of value-added ($1000s). Baseline revenue reflects business tax revenue currently generated whereas net receipts revenue reflects revenue that would be raised under this scenario. All industries would be taxed at a uniform rate of $4.90, and there would no longer be separate tax categories. However, the report illustrates the impacts of this policy on the existing tax categories in this table. The baseline and scenario tax rates reflect tax revenue per $1,000 in net receipts; these rates are effective tax rates and do not reflect the actual statutory tax rate. As can be seen by comparing the effective baseline and scenario tax rates, this alternative provides a much greater degree of horizontal equity between taxpayers.

EFFECTS BY INDUSTRY

The beneficiaries of this policy alternative are the industries that are currently taxed heavily under the gross receipts tax, as indicated in Table 8-4 with the industries in the order established by the North American Industry Classification System. These industries—law offices, management consultants, accountants and doctors' office, health maintenance organizations, auto parks, and businesses not otherwise taxed—currently pay taxes in the professions and occupations tax category ($5.91 per $1,000 in gross receipts).

The industries affected most adversely are landlords, phone companies, theaters, broadcasters and multi-media companies currently benefiting from the City's multi-media tax relief in Hollywood. These are the industries, which under the current gross receipts tax system, pay relatively low taxes compared with other industries.

The impact of the net receipts alternative on the two percent of taxpayers with significant non-receipts activity is uncertain. These taxpayers include motion picture producers, transportation providers, and amusements such as bowling alleys. The alternative would be beneficial to the motion picture industry in terms of enhancing apportionment opportunities compared with the current tax base of production costs, because most box office receipts come from outside the City whereas production costs are more likely to be incurred within the City limits. On the other hand, elimination of the motion picture tax cap could potentially increase the tax burden among large motion picture studios.

EFFECTS BY GEOGRAPHY

This policy alternative tends to benefit companies located inside the City with modest tax relief and increases the business tax liability of companies with addresses outside the City limits by about 20 percent. The reason for this impact on outside-City businesses is that such businesses tend to benefit currently from favorable tax rates. Outside-City businesses tend to become registered because they are in more heavily regulated businesses, such as construction-related work. Construction businesses located outside the City limits would face a 33 percent increase in business taxes under this alternative.

Table 8-2: Value-Added Scenario Impacts by Location ($millions)

	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
Total	$ 357.3	$ 358.4	$ 1.0	0%	$ 5.48	$ 5.49
Unknown	$ 2.4	$ 2.4	$ 0.0	2%	$ 5.60	$ 5.71
Inside	$ 317.9	$ 311.4	$ (6.5)	-2%	$ 5.59	$ 5.48
Outside	$ 37.0	$ 44.5	$ 7.5	20%	$ 4.66	$ 5.61

REVENUE EFFECT

Had this alternative been actual City policy in the 2003 tax year, the City's business tax revenues for the 2003 tax year would have been $358.4 million compared with the $357.3 million that the authors estimate the City will receive for the 2003 tax year. The net revenue impact would have been a $1.0 million gain for the general fund.[157]

On a cash flow basis, the revenue yield would be slightly different. Business tax payments in a particular fiscal year primarily consist primarily (89-90%) of business tax revenues from the current

[157] Alternative tax rates can be structured to increase the expected revenue yield of a value-added tax.

year, but 10-11 percent of revenues received are from prior tax years.[158] Had the value-added tax been City policy in 2003, the City's FY 2002-03 business tax revenues would have included about 10-11 percent of revenue from prior tax years under the old policy. Therefore, the general fund revenue impact would have been a $0.9 million gain in FY 2002-03 had the value-added alternative been City policy.

The value-added alternative is under consideration for City policy beginning in tax year 2006. The revenue impact in percentage terms would be expected to be zero (0) percent.

ECONOMIC EFFECTS

The effects discussed in the two prior sections do not take into account economic responses to the tax policy.

Owners of local businesses facing higher taxes under the policy will decide to what extent the money will come from profits, ages, higher prices, reduced output and employment, or reduced capital in light of the market forces facing their industries. Owners whose taxes are lower under the value-added tax face similar decisions about how to spend the dollars that once were sent to the government. After these decisions are made and if, on average, most firms have more money to invest, this will generate additional sales in the City as companies buy more from their suppliers and hire more workers. Newly hired workers stimulate the economy further by spending their new earnings on housing, food, and other consumer items. To the extent that the local economy grows, the City earns additional tax revenues from the new activity.

For each industry, the response to a tax change differs due to competitive conditions in the industry and the share of business taxes in operating costs. The model estimates the full set of interactive economic effects among local industries.

Additional complexity in the model comes from the spillover effects between the City and the rest of the County. Finally, the model estimates the extent to which the City earns additional tax revenues from the economic changes induced by this tax policy.

Table 8-3: Value-Added Scenario Economic Impacts ($millions)

	Status Quo	Policy Impact	
	Amount	Amount	%
Output	$ 279,143	$ 28	0.0%
Wages	$ 82,747	$ 16	0.0%
Employment	1,903,055	139	0.0%
Tax Revenues			
Business Taxes	$ 357.3	$ (1.9)	-0.5%
Sales Taxes	$ 363.2	$ 0.5	0.1%
Hotel Taxes	$ 94.2	$ (0.2)	-0.2%

These results are summarized in Table 8-3. The range of estimates derives from our model estimates of businesses' responsiveness to changes in their operating costs due to tax policy changes.

The overall effect of the value-added policy on job creation in the City is negligible because the policy has been structured to be revenue-neutral. Under this policy, the City is imposing an additional $1 million in

[158] The 90% estimate is based on comparison of business tax payments from the 2001 tax year that were received during FY 2000-01 and total business tax revenues for that fiscal year as reported by the CAO. The 89% estimate is based on comparison of business tax payments from the 2002 tax year that were received during FY 2001-02 and total business tax revenues for that fiscal year as reported by the CAO.

taxes on the business community, which constitutes a negligible share of business operating expenses in the City. Hence, the economic stimulus is also negligible. As indicated in Table 8-3, an inconsequential number of jobs is expected to be created as a result of this policy.

EVALUATION

Economic Benefit

This type of tax would improve economic benefits. By eliminating multiple taxation, businesses with low profit margins but high gross receipts will no longer be discouraged from doing business by inequitably large tax burdens.

Eliminating multiple taxation eliminates the 'cascading' of the tax through stages of production. If this occurs, the price of a taxed item can actually rise by more than the posted tax rate. For instance, a ½-percent gross receipts tax on all goods and services produced in the City of LA could cause the price of these goods and services to rise by much more than ½-percent. This form of hidden taxation raises more revenue than consumers and businesses think they are paying, but from an efficiency standpoint there are reasons to dislike it: (1) The effective tax rate by industry and even firm will vary arbitrarily based upon number of stages of production; and, (2) The taxation approach creates an undesirable incentive for a firm to vertically integrate simply to reduce taxes rather than to improve overall efficiency.

Administrability

This alternative would reduce compliance costs for many small businesses that would be paying a simple minimum tax to recoup business license costs. For half of the business taxpayers, compliance would be straightforward. For businesses with over $30,000 in gross receipts, the taxpayer would be required to complete certain tax calculations to determine whether or not the taxpayer's net receipts exceed $30,000. For the 110,000 businesses with net receipts in excess of this threshold, the business tax calculation would be less complicated in the sense that there are no separate tax categories and more complicated in the sense that the deductions from net receipts must be accounted for and reported.

This tax alternative would most likely increase the costs of compliance for a minority of business taxpayers compared with the existing gross receipts tax. Businesses would be required to track their deductions in addition to their gross receipts. To the extent that taxpayers must report the activity of their subcontractors for deduction purposes, this policy improves the enforcement mechanism for the tax and is expected to promote compliance.

Stability

This alternative would be unlikely to affect the stability of the tax base. If an effect were noticed, it would be expected to have positive effects on revenue stability, because employee compensation (the major component of value-added) is less cyclical than gross receipts.[159]

[159] In the Michigan experiment, value-added proved to be less cyclical than the prior tax on corporate incomes. The absence of cyclicality also generated criticisms from the business community, which had come to expect tax abatement during downturns in the economic cycle.

Equity

Horizontal Equity

This type of tax would improve horizontal equity, as businesses that have higher costs are not penalized. The tax eliminates double taxation and is an improvement over the current system if implemented within a very simple structure and with minimal exemptions.

Vertical Equity

Firms that are producing greater 'value' are paying more taxes as opposed to firms generating greater revenue. Most people would consider this an improvement in fairness. A special tax rate for apartment owners may be considered to eliminate the negative impact of a tax increase on this sector on apartment renters in Los Angeles.

Table 8-4: Value-Added Scenario Impacts by Detailed Industry ($millions)

Industry	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
ALL INDUSTRIES	$ 357.3	$ 358.4	$ 1.0	0%	$ 5.48	$ 5.49
Utilities	1.0	1.0	0.0	0%	$ 5.43	$ 5.45
Building Construction	6.7	6.6	(0.1)	-2%	$ 5.88	$ 5.78
Heavy Construction	1.7	2.1	0.4	22%	$ 4.64	$ 5.66
Construction Trades	6.1	6.5	0.4	6%	$ 5.55	$ 5.90
Food Manufacturing	1.8	2.7	1.0	54%	$ 3.53	$ 5.43
Apparel	3.1	3.3	0.2	7%	$ 5.03	$ 5.36
Printing	1.5	2.3	0.8	50%	$ 3.63	$ 5.46
Petroleum Refineries	1.7	1.7	0.1	5%	$ 5.16	$ 5.43
Chemicals	1.3	2.6	1.2	93%	$ 2.81	$ 5.43
Fabricated Metal	1.7	1.6	(0.1)	-4%	$ 5.65	$ 5.44
Communication Equipment	1.8	2.2	0.5	27%	$ 4.29	$ 5.44
Transportation Equipment	3.0	2.0	(1.0)	-32%	$ 8.02	$ 5.46
Furniture Manuf.	0.7	1.1	0.3	44%	$ 3.81	$ 5.49
Misc. Manuf	1.2	2.1	0.9	77%	$ 3.06	$ 5.42
Wholesale Motor Vehicle	1.2	0.9	(0.3)	-23%	$ 7.13	$ 5.47
Wholesale Furniture & Construction	1.1	0.9	(0.2)	-15%	$ 6.46	$ 5.50
Wholesale Professional Equip.	3.1	1.9	(1.2)	-39%	$ 8.97	$ 5.47
Wholesale Electronics	1.2	1.0	(0.2)	-19%	$ 6.80	$ 5.52
Wholesale Equipment	1.3	0.9	(0.4)	-29%	$ 7.80	$ 5.52
Wholesale Sports & Toys	2.4	2.3	(0.1)	-6%	$ 5.93	$ 5.57
Wholesale Apparel	2.4	2.9	0.5	21%	$ 4.48	$ 5.42
Wholesale Groceries	4.5	2.9	(1.6)	-37%	$ 8.64	$ 5.48
Wholesale Misc.	3.9	3.0	(0.9)	-24%	$ 7.39	$ 5.65
Retail Autos	9.7	3.7	(6.0)	-62%	$ 14.41	$ 5.46
Retail Motor Vehicles	2.0	1.4	(0.5)	-26%	$ 7.56	$ 5.59
Retail Furniture	1.6	2.1	0.4	26%	$ 4.39	$ 5.53
Retail Appliance	3.0	2.7	(0.3)	-10%	$ 6.17	$ 5.53
Retail Building Material	3.1	3.0	(0.1)	-4%	$ 5.68	$ 5.47
Retail Grocery	9.4	8.4	(1.1)	-11%	$ 6.15	$ 5.46
Retail Drugs & Health	3.9	3.2	(0.7)	-18%	$ 6.67	$ 5.46
Gas Stations	3.1	1.4	(1.7)	-54%	$ 11.82	$ 5.43
Retail Apparel	4.1	5.7	1.6	38%	$ 4.02	$ 5.54
Retail Misc.	8.4	9.2	0.8	9%	$ 5.26	$ 5.73
Retail General	4.4	4.0	(0.4)	-8%	$ 6.03	$ 5.52
Transportation	1.4	NA	NA	NA	NA	NA
Transportation Service	2.8	2.8	0.0	1%	$ 5.36	$ 5.43
Warehousing & Storage	0.9	1.8	0.9	90%	$ 2.85	$ 5.42
Publishers	1.6	2.5	0.9	54%	$ 3.52	$ 5.43
Motion Picture	5.2	NA	NA	NA	NA	NA
Movie Theater	0.3	0.5	0.2	85%	$ 2.92	$ 5.41
Telecommunications	3.7	9.9	6.2	166%	$ 2.04	$ 5.43
Information Services	1.1	1.3	0.2	14%	$ 4.77	$ 5.43
Finance	3.2	2.4	(0.8)	-26%	$ 7.27	$ 5.41
Investment Banking	13.0	10.5	(2.5)	-19%	$ 6.70	$ 5.43
Insurance	8.9	2.3	(6.6)	-74%	$ 20.74	$ 5.43
Insurance Agencies & Brokerages	3.8	2.4	(1.4)	-36%	$ 8.55	$ 5.45

Industry	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
Residential Landlords	5.9	15.4	9.4	159%	$ 2.08	$ 5.39
Commercial Landlords	8.3	20.3	12.0	144%	$ 2.23	$ 5.44
Real Estate	7.0	6.0	(1.0)	-15%	$ 6.40	$ 5.44
Car Leasing	1.8	2.0	0.1	8%	$ 5.04	$ 5.42
Consumer Rental	1.5	1.8	0.3	22%	$ 4.49	$ 5.48
Commercial Rental	2.2	2.7	0.6	26%	$ 4.31	$ 5.43
Offices of Lawyers	33.5	26.6	(6.9)	-21%	$ 6.82	$ 5.41
Accounting	7.1	5.4	(1.7)	-24%	$ 7.21	$ 5.48
Architects & Engineers	5.4	3.5	(1.9)	-36%	$ 8.61	$ 5.55
Design Services	3.7	4.2	0.5	13%	$ 4.83	$ 5.49
Management Consulting Services	6.2	4.6	(1.6)	-26%	$ 7.48	$ 5.56
Research Service	0.6	0.4	(0.2)	-37%	$ 8.61	$ 5.45
Advertising Agencies	10.5	7.7	(2.7)	-26%	$ 7.36	$ 5.43
Misc. Prof. Service	1.7	1.5	(0.2)	-9%	$ 6.12	$ 5.54
Admin Services	16.2	22.2	6.1	37%	$ 3.98	$ 5.47
Employee Services	3.4	2.8	(0.6)	-18%	$ 6.61	$ 5.43
Travel Agencies	1.4	1.1	(0.3)	-23%	$ 7.35	$ 5.65
Building Services	7.9	6.3	(1.6)	-20%	$ 7.23	$ 5.76
Education	2.9	2.3	(0.6)	-21%	$ 7.00	$ 5.52
Physician Offices	25.8	20.8	(5.0)	-20%	$ 6.72	$ 5.41
Outpatient Health	3.9	2.5	(1.4)	-36%	$ 8.69	$ 5.54
Hospitals	8.2	8.7	0.4	5%	$ 5.16	$ 5.42
Social Services	0.6	0.8	0.2	29%	$ 4.36	$ 5.62
Performing Arts	3.8	4.6	0.8	22%	$ 4.51	$ 5.50
Amusement & Recreation	1.8	NA	NA	NA	NA	NA
Hotels	2.0	3.6	1.6	80%	$ 3.00	$ 5.41
Restaurants	7.2	14.0	6.7	93%	$ 2.79	$ 5.39
Auto Repair	3.4	2.6	(0.7)	-22%	$ 6.93	$ 5.43
Repair Service	1.8	1.4	(0.5)	-25%	$ 7.83	$ 5.88
Personal Service	3.8	4.2	0.4	10%	$ 5.34	$ 5.89
Parking Lots and Garages	4.4	3.3	(1.1)	-24%	$ 7.79	$ 5.88

CHAPTER 9: VALUE-ADDED PROXY ('MODIFIED RECEIPTS')

A value-added classification alternative would involve assigning taxpayers to tax categories based on the portion of the receipts attributable to value-added in the particular industry. This approach has also been called a 'modified gross receipts tax' and a 'graduated gross receipts tax'. There are numerous ways to structure a value-added classification alternative. The structuring alternatives involve decisions about the number of tax categories, the tax rates and the manner in which a taxpayer is assigned to a tax category. In structuring such a tax, there is a tradeoff between the simplicity afforded by a relatively low number of tax categories and horizontal equity.

The taxpayer's industry or economic sector (NAICS) would be the basis for assigning that taxpayer to a rate category. The tax rates would be designed to be lower for industries with low value- added (as a share of receipts) and to be higher for industries with higher value- added. An example of such an alternative is the City of Merced's approach to business taxation. In Merced, businesses are classified into one of four rate categories depending on the gross profit margin of the business or industry (where gross profit margin is defined very similar to value-added).

POLICY DETAILS

This particular tax alternative is structured to promote equity despite use of gross receipts as the explicit tax base. Although the gross receipts tax base leads to double taxation of business-to-business transactions and horizontal inequity, levying a business tax rate on gross receipts that is designed to implicitly tax value-added can mitigate this effect.

Each industry was assigned to a tax category based on the percent of that industry's gross receipts that reflect value-added. The industries were then grouped and placed into one of seven tax categories. Table 9-1 illustrates the tax classification scheme that has been used for purposes of structuring this policy alternative. For example, a taxpayer that wholesales groceries would be assigned to the first tax category in which the gross receipts tax rate is $0.69 per $1,000 in gross receipts, and a law office would be assigned to the seventh tax category at the $4.70 tax rate.

For the sake of caution, this alternative is based on the relatively high rates that would be required as long as the entertainment and amusement industries are taxed in uniquely favorable ways. A lack of meaningful receipts data on motion picture companies and amusements limits our ability to forecast scenario revenue for these industries. Part of the tax reform would involve shifting these businesses to a gross receipts basis for taxation. Once the film studios and others are successfully transitioned to the gross receipts tax, actual tax rates would be reduced. Currently, motion picture producers pay a capped tax on their production costs, the large studios do not currently report receipts, amusement centers and dance halls pay presumptive taxes, and pawn shops pay a flat rate.

Table 9-1: Modified Receipts Tax Categories and Gross Receipts Tax Rates

Category	Industries	Gross Receipts Tax Rate	Minimum Tax Threshold	Value-Added as % of Receipts
1	Wholesale groceries, auto dealers	$ 0.69	$ 210	9% — 17%
2	Grocery stores, drug stores, wholesale equipment	$ 1.24	$ 116	21% — 27%
3	Construction, department stores, lumber yards	$ 1.61	$ 90	28% — 37%
4	Apparel manufacturing, food manufacturing, sporting good manufacturing, apparel stores	$ 2.16	$ 67	37% — 53%
5	Hotels, car rental, restaurants, auto repair, architects and engineers, temporary help	$ 3.28	$ 44	55% — 72%
6	Real estate leasing, performing arts, parking, broadcasting	$ 4.07	$ 35	73% — 90%
7	Law offices, physicians, investment banking	$ 4.70	$ 30	92% — 96%

Under this policy, each taxpayer would owe a minimum tax designed to recoup the cost of administering the business registration and tax. The minimum tax for this analysis is established at $145 per taxpayer, with a special filing fee of $25 for start-ups and businesses with less than $5,000 in gross receipts. The minimum tax was established based on the assumption that approximately three-quarters of Office of Finance revenue collection costs are associated with enforcement of the business tax.[160]

Small businesses would indicate on the tax form their gross receipts, and would determine that they simply owe the minimum tax. For the 102,000 businesses with receipts less than the minimum tax threshold, the business tax owed would be the $145 minimum tax. The minimum tax threshold would vary based on the ratio of the $145 minimum tax to the gross receipts tax rate: from $30,000 for law offices to $210,000 for grocery wholesalers.

EFFECTS BY BUSINESS TYPE

Under this tax alternative, most businesses would simply pay the minimum tax and not be required to pay a gross receipts tax. Most businesses are small businesses, and small businesses would benefit from this tax policy approach.

[160] Revenue collection costs include related and indirect costs such as pension, building services and employee benefits.

Table 9-2: Modified Receipts Scenario Impacts by Detailed Industry ($millions)

Industry	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate	Statutory Tax Rate
ALL INDUSTRIES	$ 357.3	$ 364.7	$ 7.4	2%	$ 5.48	$ 5.59	NA
Utilities	1.0	1.1	0.1	10%	$ 5.43	$ 5.95	$ 4.07
Building Construction	6.7	6.9	0.2	3%	$ 5.88	$ 6.05	$ 1.61
Heavy Construction	1.7	1.9	0.2	10%	$ 4.64	$ 5.13	$ 1.61
Construction Trades	6.1	6.1	(0.0)	-1%	$ 5.55	$ 5.51	$ 1.61
Food Manufacturing	1.8	3.1	1.3	73%	$ 3.53	$ 6.12	$ 2.15
Apparel	3.1	3.6	0.5	15%	$ 5.03	$ 5.76	$ 2.15
Printing	1.5	2.2	0.6	42%	$ 3.63	$ 5.15	$ 2.15
Petroleum Refineries	1.7	1.8	0.2	10%	$ 5.16	$ 5.67	$ 1.61
Chemicals	1.3	2.2	0.8	64%	$ 2.81	$ 4.60	$ 2.15
Fabricated Metal	1.7	1.7	(0.0)	-1%	$ 5.65	$ 5.58	$ 2.15
Communication Equipment	1.8	2.1	0.4	22%	$ 4.29	$ 5.22	$ 2.15
Transportation Equipment	3.0	2.1	(0.9)	-31%	$ 8.02	$ 5.51	$ 1.61
Furniture Manuf.	0.7	1.1	0.4	53%	$ 3.81	$ 5.81	$ 2.15
Misc. Manuf	1.2	1.8	0.7	56%	$ 3.06	$ 4.79	$ 2.15
Wholesale Motor Vehicle	1.2	1.0	(0.1)	-12%	$ 7.13	$ 6.30	$ 1.24
Wholesale Furniture & Construction	1.1	1.0	(0.1)	-6%	$ 6.46	$ 6.07	$ 1.24
Wholesale Professional Equip.	3.1	1.9	(1.2)	-39%	$ 8.97	$ 5.52	$ 1.24
Wholesale Electronics	1.2	1.1	(0.0)	-4%	$ 6.80	$ 6.53	$ 1.24
Wholesale Equipment	1.3	0.9	(0.3)	-27%	$ 7.80	$ 5.71	$ 1.24
Wholesale Sports & Toys	2.4	2.3	(0.1)	-5%	$ 5.93	$ 5.65	$ 1.24
Wholesale Apparel	2.4	3.1	0.7	30%	$ 4.48	$ 5.81	$ 1.61
Wholesale Groceries	4.5	2.5	(2.0)	-44%	$ 8.64	$ 4.82	$ 0.69
Wholesale Misc.	3.9	3.5	(0.4)	-11%	$ 7.39	$ 6.61	$ 1.24
Retail Autos	9.7	4.2	(5.5)	-57%	$ 14.41	$ 6.21	$ 0.69
Retail Motor Vehicles	2.0	1.4	(0.6)	-29%	$ 7.56	$ 5.35	$ 1.24
Retail Furniture	1.6	2.3	0.7	41%	$ 4.39	$ 6.17	$ 2.15
Retail Appliance	3.0	2.8	(0.2)	-7%	$ 6.17	$ 5.75	$ 1.61
Retail Building Material	3.1	3.2	0.1	4%	$ 5.68	$ 5.92	$ 1.61
Retail Grocery	9.4	7.8	(1.7)	-17%	$ 6.15	$ 5.07	$ 1.24
Retail Drugs & Health	3.9	3.2	(0.7)	-19%	$ 6.67	$ 5.43	$ 1.24
Gas Stations	3.1	1.4	(1.7)	-56%	$ 11.82	$ 5.21	$ 0.69
Retail Apparel	4.1	5.6	1.5	36%	$ 4.02	$ 5.48	$ 2.15
Retail Misc.	8.4	8.5	0.0	0%	$ 5.26	$ 5.29	$ 1.61
Retail General	4.4	4.6	0.2	5%	$ 6.03	$ 6.36	$ 1.61
Transportation	1.4	NA	NA	NA	NA	NA	$ 3.28
Transportation Service	2.8	2.7	(0.1)	-2%	$ 5.36	$ 5.26	$ 3.28
Warehousing & Storage	0.9	2.0	1.1	115%	$ 2.85	$ 6.11	$ 4.07
Publishers	1.6	2.3	0.7	43%	$ 3.52	$ 5.03	$ 3.28
Motion Picture	5.2	NA	NA	NA	NA	NA	$ 3.28
Movie Theater	0.3	0.6	0.3	95%	$ 2.92	$ 5.71	$ 3.28
Telecommunications	3.7	10.7	7.0	189%	$ 2.04	$ 5.88	$ 4.07
Information Services	1.1	1.4	0.3	24%	$ 4.77	$ 5.90	$ 4.07
Finance	3.2	2.2	(1.0)	-31%	$ 7.27	$ 5.04	$ 4.07
Investment Banking	13.0	10.5	(2.5)	-19%	$ 6.70	$ 5.40	$ 4.70
Insurance	8.9	2.4	(6.5)	-73%	$ 20.74	$ 5.67	$ 1.61
Insurance Agencies & Brokerages	3.8	2.7	(1.1)	-29%	$ 8.55	$ 6.07	$ 4.07

Industry	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate	Statutory Tax Rate
Residential Landlords	5.9	15.1	9.1	154%	$ 2.08	$ 5.29	$ 4.07
Commercial Landlords	8.3	19.9	11.6	140%	$ 2.23	$ 5.34	$ 4.07
Real Estate	7.0	6.1	(0.9)	-13%	$ 6.40	$ 5.55	$ 4.07
Car Leasing	1.8	2.0	0.2	9%	$ 5.04	$ 5.50	$ 3.28
Consumer Rental	1.5	2.0	0.5	36%	$ 4.49	$ 6.13	$ 4.07
Commercial Rental	2.2	3.1	0.9	43%	$ 4.31	$ 6.16	$ 4.07
Offices of Lawyers	33.5	26.6	(6.8)	-20%	$ 6.82	$ 5.43	$ 4.70
Accounting	7.1	5.1	(2.0)	-28%	$ 7.21	$ 5.18	$ 4.07
Architects & Engineers	5.4	3.4	(2.0)	-38%	$ 8.61	$ 5.38	$ 3.28
Design Services	3.7	4.0	0.2	7%	$ 4.83	$ 5.16	$ 3.28
Management Consulting Services	6.2	4.8	(1.3)	-22%	$ 7.48	$ 5.86	$ 4.07
Research Service	0.6	0.4	(0.2)	-28%	$ 8.61	$ 6.18	$ 4.07
Advertising Agencies	10.5	7.4	(3.1)	-30%	$ 7.36	$ 5.18	$ 3.28
Misc. Prof. Service	1.7	1.4	(0.3)	-15%	$ 6.12	$ 5.17	$ 3.28
Admin Services	16.2	20.5	4.4	27%	$ 3.98	$ 5.05	$ 4.07
Employee Services	3.4	2.6	(0.8)	-24%	$ 6.61	$ 5.03	$ 3.28
Travel Agencies	1.4	1.1	(0.3)	-19%	$ 7.35	$ 5.96	$ 3.28
Building Services	7.9	6.6	(1.3)	-17%	$ 7.23	$ 6.02	$ 4.07
Education	2.9	2.2	(0.6)	-23%	$ 7.00	$ 5.41	$ 4.07
Physician Offices	25.8	21.0	(4.8)	-19%	$ 6.72	$ 5.47	$ 4.70
Outpatient Health	3.9	2.8	(1.1)	-28%	$ 8.69	$ 6.29	$ 4.07
Hospitals	8.2	9.1	0.8	10%	$ 5.16	$ 5.68	$ 4.70
Social Services	0.6	0.8	0.2	31%	$ 4.36	$ 5.73	$ 4.07
Performing Arts	3.8	4.7	0.9	25%	$ 4.51	$ 5.63	$ 4.07
Amusement & Recreation	1.8	NA	NA	NA	NA	NA	$ 4.07
Hotels	2.0	3.8	1.8	87%	$ 3.00	$ 5.61	$ 3.28
Restaurants	7.2	14.8	7.6	104%	$ 2.79	$ 5.70	$ 3.28
Auto Repair	3.4	3.0	(0.4)	-12%	$ 6.93	$ 6.09	$ 3.28
Repair Service	1.8	1.6	(0.3)	-15%	$ 7.83	$ 6.66	$ 3.28
Personal Service	3.8	4.5	0.7	18%	$ 5.34	$ 6.32	$ 4.07
Parking Lots and Garages	4.4	3.6	(0.8)	-19%	$ 7.79	$ 6.32	$ 4.07

EFFECTS BY INDUSTRY

Among larger businesses, realignment of the business tax rates would benefit the low-margin retailers and wholesalers whose receipts are not at all reflective of their actual economic activity. Grocery wholesalers and stores, drug stores, architects and auto dealers would benefit from this tax approach.

The services sector would benefit from a reduction in the tax rate. Service industries, such as repair shops, architects, engineers, and designers would benefit from the business tax being based on their value-added rather than assuming that their business-to-business transactions really constitute a portion of their incomes.

Certain industries that have been paying less than an equitable share of the business tax would see their tax rates and tax liabilities increase. The real estate leasing sector is one such segment of the economy. Similarly, hotels, restaurants, apparel stores, and telephone companies would face increases in their tax liability once the business tax rates are realigned to an equitable basis.

The impact of the modified receipts alternative on the two percent of taxpayers with significant non-receipts activity is uncertain. These taxpayers include motion picture producers, transportation providers, and amusements such as bowling alleys. The alternative would most likely be beneficial to the motion picture industry in terms of enhancing apportionment opportunities compared with the current tax base of production costs, because most box office receipts come from outside the City whereas production costs are more likely to be incurred within the City limits. On the other hand, elimination of the motion picture tax cap could potentially increase the tax burden among large motion picture studios.

EFFECTS BY GEOGRAPHY

This policy alternative tends to benefit companies located inside the City with modest tax relief and increases the business tax liability of companies with addresses outside the City limits by about 21 percent. The reason for this impact on outside-City businesses is that such businesses tend to benefit currently from favorable tax rates. As indicated in Table 9-3, the effective tax rate for outside-City businesses is currently $4.66, but would increase under this alternative to $5.64 and would be more consistent with the effective tax rate imposed on inside-City businesses.

Table 9-3: Modified Receipts Scenario Impacts by Location ($millions)

	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
Total	$ 357.3	$ 364.7	$ 7.4	2%	$ 5.48	$ 5.59
Unknown	$ 2.4	$ 2.6	$ 0.2	8%	$ 5.60	$ 6.04
Inside	$ 317.9	$ 317.3	$ (0.6)	0%	$ 5.59	$ 5.58
Outside	$ 37.0	$ 44.8	$ 7.8	21%	$ 4.66	$ 5.64

REVENUE EFFECT

Had this alternative been actual City policy in the 2003 tax year, the City's business tax revenues for the 2003 tax year would have been $364.7 million compared with the $357.3 million that the authors estimate the City will receive for the 2003 tax year. The net revenue impact would have been a $7.4 million gain for the general fund.[161]

On a cash flow basis, the revenue yield would be slightly different. Business tax payments in a particular fiscal year primarily consist (89-90%) of business tax revenues from the current year, but 10-11 percent of revenues received are from prior tax years.[162] Had the modified receipts tax been City policy in 2003, the City's FY 2002-03 business tax revenues would have included about 10-11 percent of revenue from prior tax years under the old policy. Therefore, the general fund revenue impact would have been a $6.7 million gain in FY 2002-03 had the modified receipts alternative been City policy.

[161] Alternative tax rates can be structured to increase or decrease the expected revenue yield of a modified receipts tax.

[162] The 90% estimate is based on comparison of business tax payments from the 2001 tax year that were received during FY 2000-01 and total business tax revenues for that fiscal year as reported by the CAO. The 89% estimate is based on comparison of business tax payments from the 2002 tax year that were received during FY 2001-02 and total business tax revenues for that fiscal year as reported by the CAO.

The modified receipts alternative may potentially be considered for City policy beginning no sooner than tax year 2006. The revenue impact in percentage terms would be expected to be a two (2) percent increase.

ECONOMIC EFFECTS

The effects discussed in the two prior sections do not take into account economic responses to the tax policy.

Owners of local businesses facing higher taxes under the policy will decide to what extent the money will come from profits, wages, higher prices, reduced output and employment, or reduced capital in light of the market forces facing their industries. Owners whose taxes are lower under the modified receipts tax face similar decisions about how to spend the dollars that once were sent to the government. After these decisions are made and if, on average, most firms have more money to invest, this will generate additional sales in the city as companies buy more from their suppliers and hire more workers. Newly hired workers stimulate the economy further by spending their new earnings on housing, food, and other consumer items. To the extent that the local economy grows, the City earns additional tax revenues from the new activity.

For each industry, the response to a tax change differs due to competitive conditions in the industry and the share of business taxes in operating costs. The model estimates the full set of interactive economic effects among local industries.

Additional complexity in the model comes from the spillover effects between the City and the rest of the County. Finally, the model estimates the extent to which the City earns additional tax revenues from the economic changes induced by this tax policy.

Table 9-4: Modified Receipts Scenario Economic Impacts ($millions)

	Status Quo	Policy Impact	
	Amount	Amount	%
Output	$ 279,143	$ 17	0.0%
Wages	$ 82,747	$ 12	0.0%
Employment	1,903,055	17	0.0%
Tax Revenues			
Business Taxes	$ 357.3	$ 4.1	1.2%
Sales Taxes	$ 363.2	$ 0.4	0.1%
Hotel Taxes	$ 94.2	$ (0.2)	-0.2%

These results are summarized in Table 9-4. The range of estimates derives from our model estimates of businesses' responsiveness to changes in their operating costs due to tax policy changes.

The overall effect of the modified receipts policy on job creation in the City is negligible because the policy has been structured to be revenue-neutral. Under this policy, the City is imposing an additional $7 million in taxes on the business community, which constitutes a negligible share of business operating expenses in the City. Hence, the economic stimulus is also negligible. As indicated in Table 9-4, an inconsequential number of jobs is expected to be created as a result of this policy.

EVALUATION

Economic Benefit

This type of tax would have positive effects on economic benefits to the extent that the alternative better approximates taxing value-added than does the current policy. Compared with existing policy, this approach would have a less severe effect on low-profit margin taxpayers.

Administrability

This alternative would have positive effects on administrability in that taxpayers would only be required to report activity under one tax category and in that the tax base would be consistently defined across tax categories.

This approach does not provide any additional enforcement tools and is not expected to promote compliance. From a taxpayer's perspective, this alternative would present the same issues related to apportionment and allocation as are presented under the current business tax. The study was unable to assess apportionment reform due to lack of data; for the City to address existing apportionment problems would require the City to compel businesses to report their current apportionment calculations. Hence, the revenue implications of apportionment reform under this alternative could not be estimated until the City compels businesses to report these calculations.

Stability

This alternative would not affect the cyclical stability of the business tax as a revenue stream.

Equity

Horizontal Equity

This type of tax would improve horizontal equity as tax rates would vary by industry type, taxing those with higher value-added at a higher rate. The exemption for inter-company receipts should be retained in order to promote horizontal equity.

Vertical Equity

Reducing the gross receipts tax burden on grocery stores and drug stores benefits low-income residents who spend a disproportionately high share of their incomes on basic necessities and on gross receipts taxes. On the other hand, increasing the gross receipts tax rate of residential landlords would tend to have negative consequences for vertical equity among apartment building tenants who are not covered by the grandfather rent control.

CHAPTER 10: HYBRID SCENARIO

The panel determined that the value-added alternative (hereafter, 'net receipts') promised the greatest opportunity for horizontal equity among the alternatives considered.[163] This approach also provides the greatest degree of economic benefit among the alternatives considered, because it interferes the least with economic decisions.[164] In terms of revenue stability, the net receipts approach would be no more volatile than the status quo tax policy. In terms of simplification, the net receipts approach provides simplification in the sense of consistency and transparency, as well as providing a uniform tax rate and only one tax category. However, the approach would require taxpayers to track deductions and report subcontractors.[165] The policy is expected to promote tax compliance, particularly in the construction and professional services industries due to the requirement to report subcontractors when related payments are deducted from receipts.

The panel determined that the net receipts approach provides greater benefits than the modified receipts approach. The modified receipts alternative does not provide as great a degree of horizontal equity as the net receipts approach, because taxpayers are implicitly taxed on the industry average value-added in an approximate fashion through the tax classification scheme. Further, the modified receipts approach does not eliminate multiple taxation of business-to-business transactions at the taxpayer level as effectively as the net receipts approach. The modified receipts approach presents greater consistency and transparency than the status quo, but presents an administrative burden in the decision as to which tax category a taxpayer is assigned. In addition, the modified receipts approach does not contain any provisions that would be expected to promote compliance.

Under the square footage approach, a business is taxed for space used in the City including both owned and leased space. The square footage alternative was evaluated as offering the greatest benefits in terms of promoting simplicity, compliance, and equity related to municipal benefits received. The alternative provides horizontal equity based on the benefit principle in the sense that square footage use relates to the level of municipal services needed by a business and to the cost imposed by the business on the City. A business' use of space brings with it a need for police and fire protection of that space. Further, the use of space draws employee and customer traffic to an area, imposing street maintenance, policing and public works costs on the City. The square footage alternative has desirable compliance effects in that landlords are encouraged to ensure that their tenants hold business tax registration certificates. The primary drawbacks of a pure square footage approach relate to the tax burden falling only on those with fixed addresses in the City and to horizontal inequity based on the taxpayer's ability to pay.[166]

The panel determined that the square footage approach offers such positive benefits in terms of compliance and equity related to municipal benefits received that it merits inclusion as a component

[163] Horizontal equity is defined as treating businesses in the same economic situation the same in regard to business tax payments.

[164] Although a lump sum tax would interfere the least with economic decisions, its equity drawbacks were severe with respect to penalizing small businesses. Hence, the net receipts approach was more accurately deemed the second best alternative with respect to economic efficiency.

[165] Taxpayers may opt not to report deductions, in which case they would pay higher taxes. The incentive, however, is for businesses to track and report deductions in order to reduce their tax burden.

[166] Under the pure square footage scenario, effective tax rates as a percent of value-added varied between industries.

of a hybrid taxation approach. The square footage approach as a hybrid component promises greater opportunity for equity and rate relief due to its compliance-boosting effects. Because the square footage is exceedingly simple to report and relatively consistent over time, the square footage alternative would not impose a significant burden on the taxpayer.

The panel determined that a hybrid net receipts and square footage approach would offer horizontal equity based on ability to pay, municipal service benefits received, and compliance. So long as net receipts constitute the primary component of the tax, the hybrid approach offers a high degree of neutrality with respect to economic decision-making. So long as the square footage component constitutes a significant tax, this component is expected to deliver tax compliance results. Hence, the panel determined that the square footage component should raise one-quarter to one-third of business tax revenue with the net receipts approach raising the remainder of revenue.

This approach is transparent and consistent. For the small business, the approach would be simple because the small business is not required to pay on net receipts under $42,000 or on square footage use below 250 square feet. For the mid-sized and larger businesses, the approach would be consistent and transparent. However, the equity and compliance benefits to the taxpayer will undoubtedly carry with them an additional reporting burden on the business. The challenge in structuring this alternative is to set policy parameters that ensure simplicity to the greatest extent possible.

POLICY DETAILS

Under the hybrid alternative, businesses would pay the business tax based on both net receipts and square footage.

The primary component of the hybrid tax is net receipts taxation. The taxable base would be defined as gross receipts less deductions for cost of materials[167] and subcontractor payments[168], with a uniform rate of $3.50 per $1,000 in net receipts being applied across industries. In order to receive the subcontractor deduction, the taxpayer must report the subcontractor's name, address, and receipts. The prime contractor would not receive the tax deduction for subcontractors without a registration or exemption certificate. This requirement is expected to promote compliance and help the City identify businesses that are not currently complying with the business tax.

[167] Materials deductions would include the cost of merchandise purchased from a separate company and resold to customers as well as the cost of raw materials that become an "identifiable element" of the goods or services sold directly by the taxpayer. Hence, the purchase of goods for resale by wholesalers and retailers would be deductible, the purchase of raw materials used as part of the manufacturers' final product would be deductible, and the purchase of raw materials resold by service sector companies would be deductible (e.g. hotel toiletries, Kinko's paper supplies).

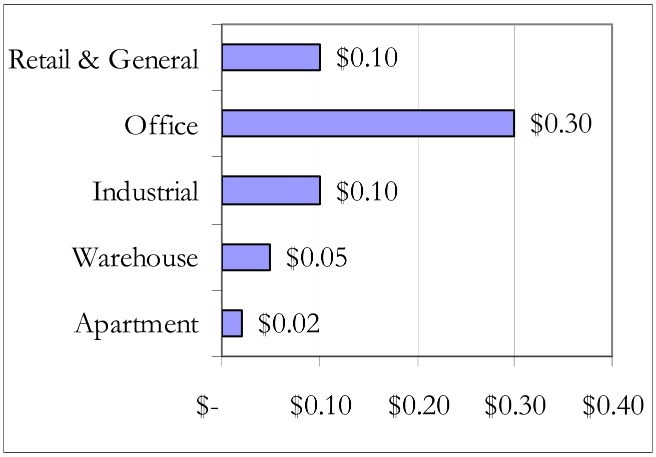
[168] A subcontractor is a partnership, limited partnership, corporation, business trust, joint stock company, trust, unincorporated association, joint venture, governmental entity or other entity of whatever nature hired by a vendor (other than employees) under separate contractual arrangements to perform portions of the work under an agreement. Subcontractor payments are deductible in Bakersfield, Davis, Santa Ana, Stockton and Berkeley; but the term is not explicitly defined in their respective Municipal Codes.

The revenue-neutral net receipts tax rate would be $3.50 per $1,000 in net receipts.[169] The actual rate would most likely be significantly lower so long as taxpayers currently taxed on odd and presumptive tax rates are successfully converted to the net receipts tax base. A lack of meaningful receipts data on motion picture companies and amusements limits our ability to forecast scenario revenue for these industries; hence, this report erred on the side of caution and certainty.

Over half of the businesses would simply pay the filing fee or minimum tax because their net receipts are less than the $42,000 minimum tax threshold. These small businesses would simply pay the $145 minimum tax, while start-ups and businesses with less than $5,000 in receipts would pay only the $25 filing fee.

In addition to the net receipts tax, those businesses using or holding more than 250 square feet would pay based on the square footage in excess of 250. Business tenants would pay on the square footage leased within the structure as well as any leased outdoor space such as parking. Home-based businesses would pay based on the portion of the home used for business purposes as reported to the Internal Revenue Service. Landlords would pay the tax on common space, areas used for property management offices, and leasable space that is not occupied. The landlord could deduct the square footage of all space leased by tenants holding a business tax registration certificate or a business exemption certificate. The landlord would report the deducted tenants, which is expected to promote compliance. Landlords in mixed-use buildings (such as retail and residential) would pay based on the primary use, with the onus on the taxpayer to prove that the primary use is at the lower tax rate.

Table 10-1: Hybrid Square Footage Tax Rates



In addition to the net receipts tax, those businesses using or holding more than 250 square feet would pay based on the square footage in excess of 250. The tax rates would be as depicted in Figure 10-1. The general tax rate would be 10 cents per square foot annually. For office space, the rate would be 30 cents per square foot annually. Whereas, warehouses would pay 5 cents per square foot, and apartment owners would pay 2 cents per square foot annually. Most home-based businesses use less than 250 square feet, so most of them would not be required to pay on square footage, although they would be required to report the square footage amount on the tax form.

The square footage component of the tax would be a tax upon the privilege of operating a business in the City. The measure of the tax would be the amount of square feet of building space (and outdoor space used to provide services or display inventory) used in the course of business.

[169] The revenue-neutral tax rate is calculated by taking business tax revenue net of revenue from the minimum tax and revenue from the square footage component of the tax, then dividing by net receipts. Net receipts were calculated on a detailed industry basis using Internal Revenue Service data to establish the ratio of gross receipts that are net receipts and multiplying that ratio by the taxpayer's reported taxable receipts in tax year 2003. Net receipts for purposes of the calculation was defined as business receipts less cost of goods sold, except that the cost of goods sold were adjusted for any direct payroll expense classified by the corporate income taxpayer under cost of goods sold.

A business would owe the tax only with respect to their commercial occupancies. Businesses that operate commercial space for lease would owe the tax only with respect to space that is offered for lease, and not with respect to property that has been removed from the leasing market. A lessor would not have to pay the tax with respect to any square footage for which a tenant pays the tax. In other words, commercial landlords would only pay the tax with respect to space offered for lease (but not occupied) and with respect to space actually used by the business operations of the landlord (i.e. building management offices).

Because this tax would be owed by the business using space or offering that space for lease and would not be charged based on ownership of property but use of space in the course of business, this tax would not be a prohibited parcel tax.

The square footage tax would only be charged with respect to use of space in the City. Apportionment of net receipts would be similar to the current approach to apportionment. The 21.168.1 interstate exemption could have a material impact on certain wholesale and retail taxpayers, if not adopted as part of the net receipts approach. Given that one of the goals of the net receipts option is increased fairness and equity, strong consideration should be given to eliminating the exemption that perhaps provides an inequitably low business tax for interstate versus intrastate sellers. If the accepted tax policy becomes a 'net receipts' scenario, and the interstate exemption is eliminated, it will become all the more important that apportionment formulae be addressed in implementing that method.

EFFECTS BY BUSINESS TYPE

EFFECTS BY INDUSTRY

The hybrid alternative would most benefit those who are currently over-taxed, i.e. grocery wholesalers, professionals, and auto dealers.

In comparing the business tax liability of various industries under the hybrid alternative to the status quo tax policy, certain currently under-taxed industries would tend to owe more under the hybrid scenario. For example, storage facilities, landlords, hotels, restaurants and movie theaters would face the most dramatic increases in their business tax. We note that the most heavily impacted businesses are among the least geographically mobile and are not expected to have significant opportunities to relocate due to the realignment of their business taxes. The manufacturing industries would see modest increases in the business tax owed.

The impact of the hybrid alternative on the two percent of taxpayers with significant non-receipts activity is uncertain. These taxpayers include motion picture producers, transportation providers, and amusements such as bowling alleys. The alternative would most likely be beneficial to the motion picture industry in terms of enhancing apportionment opportunities compared with the current tax base of production costs, because most box office receipts come from outside the City whereas production costs are more likely to be incurred within the City limits. On the other hand, elimination of the motion picture tax cap could potentially increase the tax burden among large motion picture studios.

Table 10-2: Hybrid Scenario Impacts by Detailed Industry ($millions)

Industry	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
ALL INDUSTRIES	$ 357.3	$ 356.4	$ (0.9)	0%	$ 5.48	$ 5.46
Utilities	1.0	1.0	$ (0.0)	-4%	$ 5.43	$ 5.20
Building Construction	6.7	5.8	$ (0.9)	-14%	$ 5.85	$ 5.04
Heavy Construction	1.7	1.7	$ (0.0)	-1%	$ 4.63	$ 4.59
Construction Trades	6.1	5.8	$ (0.3)	-5%	$ 5.52	$ 5.27
Food Manufacturing	1.7	2.4	$ 0.7	44%	$ 3.32	$ 4.78
Apparel	3.1	4.6	$ 1.5	49%	$ 4.99	$ 7.43
Printing	1.5	2.2	$ 0.7	44%	$ 3.61	$ 5.21
Petroleum Refineries	1.7	1.6	$ (0.1)	-5%	$ 5.16	$ 4.93
Chemicals	1.3	2.1	$ 0.8	59%	$ 2.80	$ 4.46
Fabricated Metal	1.7	1.7	$ 0.1	3%	$ 5.58	$ 5.75
Communication Equipment	1.7	2.4	$ 0.6	37%	$ 4.24	$ 5.79
Transportation Equipment	3.0	2.3	$ (0.7)	-23%	$ 8.01	$ 6.14
Furniture Manuf.	0.7	1.3	$ 0.6	77%	$ 3.76	$ 6.67
Misc. Manuf	1.2	2.1	$ 1.0	85%	$ 3.06	$ 5.66
Wholesale Motor Vehicle	1.1	1.1	$ (0.0)	-4%	$ 7.03	$ 6.78
Wholesale Furniture & Construction	1.0	1.0	$ (0.0)	-3%	$ 6.34	$ 6.15
Wholesale Professional Equip.	3.1	2.1	$ (1.0)	-33%	$ 8.97	$ 5.97
Wholesale Electronics	1.1	1.2	$ 0.1	8%	$ 6.55	$ 7.05
Wholesale Equipment	1.2	1.0	$ (0.2)	-18%	$ 7.49	$ 6.14
Wholesale Sports & Toys	2.4	2.4	$ 0.0	2%	$ 5.91	$ 6.02
Wholesale Apparel	2.4	2.9	$ 0.5	22%	$ 4.46	$ 5.43
Wholesale Groceries	4.5	2.7	$ (1.8)	-39%	$ 8.59	$ 5.21
Wholesale Misc.	3.9	3.9	$ (0.0)	0%	$ 7.33	$ 7.30
Retail Autos	9.6	3.0	$ (6.6)	-69%	$ 14.39	$ 4.52
Retail Motor Vehicles	1.9	1.7	$ (0.2)	-12%	$ 7.55	$ 6.61
Retail Furniture	1.6	2.2	$ 0.5	32%	$ 4.38	$ 5.78
Retail Appliance	2.9	2.6	$ (0.3)	-10%	$ 6.08	$ 5.45
Retail Building Material	3.1	2.8	$ (0.3)	-9%	$ 5.59	$ 5.10
Retail Grocery	9.4	8.4	$ (1.0)	-11%	$ 6.12	$ 5.47
Retail Drugs & Health	3.9	3.2	$ (0.6)	-16%	$ 6.62	$ 5.53
Gas Stations	3.1	1.2	$ (1.9)	-62%	$ 11.64	$ 4.44
Retail Apparel	4.1	5.9	$ 1.8	43%	$ 4.00	$ 5.73
Retail Misc.	8.2	10.3	$ 2.1	25%	$ 5.14	$ 6.45
Retail General	4.4	4.4	$ 0.0	0%	$ 6.03	$ 6.03
Transportation	1.3	NA	NA	NA	NA	NA
Transportation Service	2.8	2.9	$ 0.1	4%	$ 5.30	$ 5.52
Warehousing & Storage	0.9	1.6	$ 0.7	72%	$ 2.84	$ 4.89
Publishers	1.6	2.7	$ 1.1	66%	$ 3.52	$ 5.85
Motion Picture	5.1	NA	NA	NA	NA	NA
Movie Theater	0.3	0.6	$ 0.3	106%	$ 2.92	$ 6.04
Telecommunications	3.7	7.7	$ 4.0	108%	$ 2.04	$ 4.24
Information Services	1.1	1.3	$ 0.1	13%	$ 4.73	$ 5.37
Finance	3.2	2.5	$ (0.7)	-22%	$ 7.26	$ 5.68
Investment Banking	13.0	9.1	$ (3.9)	-30%	$ 6.69	$ 4.68
Insurance	8.9	2.2	$ (6.7)	-75%	$ 20.74	$ 5.13
Insurance Agencies & Brokerages	3.8	2.9	$ (0.8)	-22%	$ 8.53	$ 6.62

Industry	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
Residential Landlords	5.9	13.3	$ 7.4	126%	$ 2.07	$ 4.67
Commercial Landlords	8.3	20.7	$ 12.5	151%	$ 2.21	$ 5.55
Real Estate	7.0	5.8	$ (1.2)	-17%	$ 6.37	$ 5.30
Car Leasing	1.8	1.8	$ (0.0)	-2%	$ 5.03	$ 4.93
Consumer Rental	1.4	1.7	$ 0.2	17%	$ 4.43	$ 5.17
Commercial Rental	2.2	2.2	$ 0.0	1%	$ 4.30	$ 4.37
Offices of Lawyers	33.4	24.6	$ (8.8)	-26%	$ 6.81	$ 5.02
Accounting	7.1	6.0	$ (1.0)	-15%	$ 7.20	$ 6.13
Architects & Engineers	5.3	3.4	$ (1.9)	-36%	$ 8.46	$ 5.39
Design Services	3.7	4.5	$ 0.8	22%	$ 4.81	$ 5.88
Management Consulting Services	6.2	4.9	$ (1.3)	-21%	$ 7.45	$ 5.88
Research Service	0.6	0.4	$ (0.2)	-30%	$ 8.61	$ 5.99
Advertising Agencies	10.5	6.7	$ (3.7)	-36%	$ 7.35	$ 4.72
Misc. Prof. Service	1.7	1.8	$ 0.1	4%	$ 6.08	$ 6.33
Admin Services	16.1	19.8	$ 3.6	23%	$ 3.97	$ 4.86
Employee Services	3.4	3.9	$ 0.5	15%	$ 6.58	$ 7.55
Travel Agencies	1.4	1.3	$ (0.1)	-4%	$ 7.32	$ 7.01
Building Services	7.7	6.7	$ (1.0)	-13%	$ 7.06	$ 6.16
Education	2.9	2.8	$ (0.1)	-4%	$ 6.99	$ 6.72
Physician Offices	25.6	21.7	$ (3.9)	-15%	$ 6.66	$ 5.64
Outpatient Health	3.9	2.4	$ (1.5)	-37%	$ 8.67	$ 5.43
Hospitals	8.2	7.5	$ (0.8)	-9%	$ 5.16	$ 4.67
Social Services	0.6	0.9	$ 0.3	46%	$ 4.33	$ 6.31
Performing Arts	3.7	3.9	$ 0.2	6%	$ 4.38	$ 4.65
Amusement & Recreation	1.8	NA	NA	NA	NA	NA
Hotels	2.0	3.1	$ 1.1	57%	$ 2.96	$ 4.66
Restaurants	7.2	15.6	$ 8.4	118%	$ 2.76	$ 6.01
Auto Repair	3.4	3.4	$ 0.1	2%	$ 6.90	$ 7.05
Repair Service	1.8	1.5	$ (0.3)	-19%	$ 7.81	$ 6.32
Personal Service	3.8	5.0	$ 1.1	30%	$ 5.31	$ 6.89
Parking Lots and Garages	4.3	4.9	$ 0.6	13%	$ 7.72	$ 8.73

Effects by Geography

This policy alternative does not significantly affect the proportion of business taxes borne by inside-City taxpayers, but does reduce the proportion borne by outside-City taxpayers. The net receipts component of the policy tends to benefit companies located inside the City with modest tax relief and increases the business tax liability of companies with addresses outside the City limits. However, the square footage component tends to benefit companies located outside the City. When taken together, the hybrid policy would cause a one percent increase in the business taxes owed by inside-City taxpayers and would cause an eleven percent decrease in the business taxes owed by outside-City taxpayers.

Table 10-3: Hybrid Scenario Impacts by Location ($millions)

Area	Baseline Revenue	Scenario Revenue	Dollar Change	% Change	Effective Baseline Tax Rate	Effective Scenario Tax Rate
Total	$ 357.3	$ 356.4	$ (0.9)	0%	$ 5.48	$ 5.46
Unknown	2.4	2.8	0.4	15%	$ 5.60	$ 6.47
Inside	317.9	320.7	2.8	1%	$ 5.59	$ 5.64
Outside	37.0	33.0	(4.1)	-11%	$ 4.66	$ 4.15

Revenue Effect

Had this alternative been actual City policy in the 2003 tax year, the City's business tax revenues for the 2003 tax year would have been $356.4 million compared with the $357.3 million that the authors estimate the City will receive for the 2003 tax year. The net revenue impact would have been a $0.9 million loss for the general fund.[170]

On a cash flow basis, the revenue yield would be slightly different. Business tax payments in a particular fiscal year consist primarily (89-90%) of business tax revenues from the current year, but 10-11 percent of revenues received are from prior tax years.[171] Had the hybrid tax been City policy in 2003, the City's FY 2002-03 business tax revenues would have included about 10-11 percent of revenue from prior tax years under the old policy. Therefore, the general fund revenue impact would have been a $0.8 million loss in FY 2002-03, had the hybrid policy alternative been City policy.

The hybrid alternative could become City policy no sooner than tax year 2006. The revenue impact in percentage terms would be expected to be less than one (1) percent.

[170] Alternative tax rates can be structured to increase or decrease the expected revenue yield of a hybrid tax.

[171] The 90% estimate is based on comparison of business tax payments from the 2001 tax year that were received during FY 2000-01 and total business tax revenues for that fiscal year as reported by the CAO. The 89% estimate is based on comparison of business tax payments from the 2002 tax year that were received during FY 2001-02 and total business tax revenues for that fiscal year as reported by the CAO.

EXAMPLES OF EFFECTS ON TAXPAYERS

This section illustrates the practical implications of the hybrid tax reform approach using examples of actual business taxpayers without revealing their identity. Following the descriptions, Table 10-4 provides a concise summary of the gross receipts and proposed hybrid taxes for each example:

1. Construction business based at home

This construction company generates $460,000 in gross receipts and owed a business tax of $649 in 2003. The business is located in a private home where it occupies 298 square feet. Only $142,480 constitutes net receipts due to the business' use of subcontractors. Thus, the business would owe $501 under the recommended approach—$5 for its square footage in excess of 250 (taxed at the $0.10 rate) along with $497 for its net receipts activity.

2. Apparel manufacturer based in a warehouse

This apparel manufacturer (subcontractor) generates $439,000 in gross receipts and owed a business tax of $1,822 in 2003. The business owns a warehouse where its operations are based and occupies 17,172 square feet. The business generates net receipts of $180,000 after deducting the raw materials used in production. The business would owe $1,473 under the recommended approach—$846 for its square footage in excess of 250 (taxed at the $0.05 rate) along with $626 for its net receipts activity.

3. Apparel manufacturer based in industrial space

This apparel manufacturer generates $1.6 million in gross receipts and owed a business tax of $1,862 in 2003. The business owns industrial space where its operations are based and occupies 6,175 square feet. The business generates net receipts of $645,000 after deducting the raw materials used in production. The business would owe $2,847 under the recommended approach—$593 for its square footage in excess of 250 (taxed at the $0.10 rate) along with $2,255 for its net receipts activity.

4. Toy manufacturer based at home

This toy-maker reported $12,000 in gross receipts and owed a business tax of $118 in 2003. The business is located in a private home where it occupies less than 250 square feet. Only $6,000 constitutes net receipts due to the business' purchase of raw materials to use in toy making. The business would owe the $145 minimum tax under the recommended approach.

5. Rug importer based in a warehouse

This rug importer reported $1.7 million in gross receipts and owed a business tax of $1,966 in 2003. The business is located in a warehouse where it occupies 17,440 square feet. Only $396,000 constitutes net receipts due to the business' purchase of rugs for resale. The business would owe $2,244 under the recommended approach—$860 for its square footage in excess of 250 (taxed at the $0.05 rate) along with $1,385 for its net receipts activity.

6. Surfboard wholesaler based in a warehouse

This surfboard wholesaler reported $281,000 in gross receipts and owed a business tax of $332 in 2003. The business is located in a warehouse where it occupies 1,321 square feet. Only $70,000 constitutes net receipts due to the business' purchase of surfboards for resale. The business would owe $297 under the recommended approach—$54 for its square footage in excess of 250 (taxed at the $0.05 rate) along with $243 for its net receipts activity.

7. Auto dealer

This auto dealer reported $23 million in gross receipts and owed a business tax of $42,344 in 2003. The business owns the service property where it is located and occupies 50,391 square feet. Only $2.8 million constitutes net receipts due to the business' purchase of cars from wholesalers and importers for resale. The business would owe $14,959—$5,014 for its square footage in excess of 250 (taxed at the $0.10 rate) along with $9,945 for its net receipts activity.

8. Grocery Store

This grocery store reported $19.7 million in gross receipts and owed a business tax of $29,191 in 2003. The business leases the retail property where it is located and occupies 39,528 square feet. Only $5.4 million constitutes net receipts due to the business' purchase of groceries from wholesalers and importers for resale. The business would owe $22,875—$3,928 for its square footage in excess of 250 (taxed at the $0.10 rate) along with $18,948 for its net receipts activity.

9. Sound Recording Studio

This sound recording studio reported $1.1 million in gross receipts and owed a business tax of $1,652 in 2003. The studio owns the communications property where it is located and occupies 3,741 square feet. Only $610,000 constitutes net receipts due to the business' purchase of equipment and use of subcontractors. The studio would owe $2,481—$349 for its square footage in excess of 250 (taxed at the $0.10 rate) along with $2,132 for its net receipts activity.

10. Residential landlord

This residential landlord reported $355,000 in gross receipts and owed a business tax of $527 in 2003. The landlord owns and operates a 29,495 square foot apartment building. Only $301,000 constitutes net receipts due to the landlord's use of subcontractors for building maintenance services. The business would owe $1,638—$585 for its square footage in excess of 250 (taxed at the $0.02 rate) along with $1,053 for its net receipts activity.

11. Commercial landlord

This commercial landlord reported $343,000 in gross receipts and owed a business tax of $509 in 2003. The landlord owns and operates a retail building, where his office and common space occupy 855 square feet. The tenants would pay the remainder of the building square footage tax for the building. Of the gross receipts, $291,000 constitutes net receipts due to the landlord's use of subcontractors for building maintenance services. The business would owe $1,077—$61 for its square footage in excess of 250 (taxed at the $0.10 rate) along with $1,016 for its net receipts activity.

12. Consulting firm that moved into the City in 2003

This economic consulting firm received the start-up tax exemption in 2003 and did not owe any tax. The firm moved into a 900-square foot office space in 2003. Under the recommended approach, the firm would owe the $25 filing fee as a start-up in addition to $0.30 per square foot in excess of 250 (taxed at the $0.30 rate). Thus, the total tax liability under the recommended approach would be $220.

13. Law office

This law office reported $282,000 in gross receipts and owed a business tax of $1,673 in 2003. The law firm leases 1,243 square feet in a professional office building. Of the gross receipts, $270,000 constitutes net receipts due to the law firm's use of subcontractors for private investigation services. The business would owe $1,241—$298 for its square footage in excess of 250 (taxed at the $0.30 rate) along with $943 for its net receipts activity.

14. Full-Service Restaurant

This restaurant reported $1 million in gross receipts and owed a business tax of $1,514 in 2003. The restaurant leases 5,008 square feet in a restaurant building. Of the gross receipts, $647,000 constitutes net receipts due to the restaurant's purchase of food and its use of a pastry subcontractor. The restaurant would owe $2,739—$476 for its square footage in excess of 250 (taxed at the $0.10 rate) and $2,263 for its net receipts activity.

15. Fast-Food Restaurant

This fast-food restaurant reported $1.5 million in gross receipts and owed a business tax of $2,162 in 2003. The restaurant owns its 2,991 square foot property. Of the gross receipts, $925,000 constitutes net receipts due to the restaurant's purchase of food and cooking equipment, and its use of a grease-cleaning subcontractor. The restaurant would owe $3,509—$274 for its square footage in excess of 250 (taxed at the $0.10 rate) along with $3,235 for its net receipts activity.

16. Hotel

This modest hotel reported $1.4 million in gross receipts and owed a business tax of $2,454 in 2003. The hotel owns its 70,420 square foot property. Of the gross receipts, $911,000 constitutes net receipts due to the hotel's purchase of food and toiletries and its use of a laundry subcontractor. The hotel would owe $6,693—$3,509 for its square footage in excess of 250 (taxed at the $0.05 rate) along with $3,185 for its net receipts activity.

17. Auto Body Repair Shop

This auto repair shop reported $396,000 in gross receipts and owed a business tax of $1,252 in 2003. The shop owns its 3,880 square foot service property. Of the gross receipts, $236,000 constitutes net receipts due to the shop's purchase of auto parts. The shop would owe $1,186—$363 for its square footage in excess of 250 (taxed at the $0.10 rate) along with $823 for its net receipts activity.

18. Dry Cleaner

This dry cleaner reported $337,000 in gross receipts and owed a business tax of $500 in 2003. The cleaner owns its 3,604 square foot service property. Of the gross receipts, $257,000 constitutes net receipts due to the cleaner's purchase of cleaning supplies and coat hangers. The cleaner would owe $1,235—$335 for its square footage in excess of 250 (taxed at the $0.10 rate) along with $899 for its net receipts activity.

Table 10-4: Examples of Effects on Taxpayers

Example Business Description	Existing Gross Receipts Tax	Recommended Hybrid Tax	Net Receipts	Square Footage	Type of space
Construction business	$ 649	$ 501	142,480	298	Home
Apparel manufacturer (subcontractor)	$ 1,822	$ 1,473	179,560	17,172	Warehouse
Apparel manufacturer	$ 1,862	$ 2,847	644,769	6,175	Industrial
Toy manufacturer	$ 118	$ 145	6,056	225	Home
Rug importer	$ 1,966	$ 2,244	396,145	17,440	Warehouse
Surfboard wholesaler	$ 332	$ 297	70,138	1,321	Warehouse
Auto dealer	$ 42,344	$ 14,959	2,842,041	50,391	Service
Grocery store	$ 29,191	$ 22,875	5,414,155	39,528	Retail
Sound recording studio	$ 1,652	$ 2,481	609,711	3,741	Communication
Residential landlord	$ 527	$ 1,638	301,318	29,495	Multi-Family
Commercial landlord	$ 509	$ 1,077	290,883	855	Retail
Consulting firm (start-up)	$ -	$ 220	205,000	900	Office
Law office	$ 1,673	$ 1,241	270,068	1,243	Office
Full-service restaurant	$ 1,514	$ 2,739	647,230	5,008	Restaurant
Fast food restaurant	$ 2,162	$ 3,509	924,748	2,991	Restaurant
Hotel	$ 2,454	$ 6,693	910,534	70,420	Hotels
Auto body repair shop	$ 1,252	$ 1,186	235,853	3,880	Service
Dry cleaner	$ 500	$ 1,235	257,463	3,604	Service

Economic Effects

The effects discussed in the two prior sections do not take into account economic responses to the tax policy.

Owners of local businesses facing higher taxes under the policy will decide to what extent the money will come from profits, wages, higher prices, reduced output and employment, or reduced capital in light of the market forces facing their industries. Owners whose taxes are lower under the hybrid tax face similar decisions about how to spend the dollars that once were sent to the government. After these decisions are made and if, on average, most firms have more money to invest, this will generate additional sales in the City as companies buy more from their suppliers and hire more workers. Newly hired workers stimulate the economy further by spending their new earnings on housing, food, and other consumer items. To the extent that the local economy grows, the City earns additional tax revenues from the new activity.

For each industry, the response to a tax change differs due to competitive conditions in the industry and the share of business taxes in operating costs. The model estimates the full set of interactive economic effects among local industries.

Table 10-5: Hybrid Scenario Economic Impacts ($millions)

	Status Quo	Policy Impact	
	Amount	Amount	%
Output	$ 279,143	$ 2	0.0%
Wages	$ 82,747	$ 7	0.0%
Employment	1,903,055	(192)	0.0%
Tax Revenues			
Business Taxes	$ 357.3	$ (2.3)	-0.6%
Sales Taxes	$ 363.2	$ 0.4	0.1%
Hotel Taxes	$ 94.2	$ (0.1)	-0.2%

Additional complexity in the model comes from the spillover effects between the City and the rest of the County. Finally, the model estimates the extent to which the City earns additional tax revenues from the economic changes induced by this tax policy.

These results are summarized in Table 10-5. The range of estimates derives from our model estimates of businesses' responsiveness to changes in their operating costs due to tax policy changes.

The overall effect of the hybrid policy on job creation in the City is negligible because the policy has been structured to be revenue-neutral. Under this policy, the City is reducing taxes by $0.9 million, which constitutes a negligible share of business operating expenses in the City. Hence, the economic stimulus is also negligible. As indicated in Table 10-5, an inconsequential number of jobs is expected to be lost as a result of this policy.

EVALUATION

Economic Benefit

This type of tax would improve economic benefits. By eliminating multiple taxation, businesses with low profit margins but high gross receipts will no longer be discouraged by inequitably large tax burdens from doing business.

The approach eliminates multiple taxation and the 'cascading' of the tax through stages of production. When multiple taxation occurs, the price of a taxed item can actually rise by more than the posted tax rate. This form of hidden taxation raises more revenue than consumers and businesses think they are paying, but from an efficiency standpoint there are reasons to dislike it: (1) the effective tax rate by industry and even firm will vary arbitrarily based upon number of stages of production and (2) the taxation approach creates an undesirable incentive for a firm to vertically integrate simply to reduce taxes rather than to improve overall efficiency.

Administrability

This alternative would reduce compliance costs for the lion share of businesses that would be paying a simple minimum tax to recoup business license costs. For over half of the business taxpayers, compliance would be straightforward. For businesses with over $42,000 in gross receipts, the taxpayer would be required to complete certain tax calculations to determine whether or not the taxpayer's net receipts exceed $42,000. For the 97,000 businesses with net receipts in excess of this threshold, the business tax calculation would be less complicated in the sense that there are no separate tax categories and more complicated in the sense that the deductions from net receipts must be accounted for and reported.

This tax alternative would most likely increase the costs of compliance for a minority of business taxpayers compared with the existing gross receipts tax. These businesses would have the incentive and likely be willing to track their deductions to reduce their tax liability. Businesses that do not wish to report deductions would simply pay a higher tax.

This tax alternative would tend to promote compliance by adding additional enforcement mechanisms both through the landlord's deduction of tax-compliant tenants and through the prime contractors' reporting of subcontractors deducted.

Stability

This alternative would increase the stability of the tax base due to the lesser volatility of square footage than cyclical measures like gross receipts.

Equity

Horizontal Equity

This type of tax would improve horizontal equity, as businesses that have higher costs are not penalized. The tax eliminates the multiple taxation caused by the pyramiding effect of the gross receipts tax. This tax is an improvement over the current system if implemented within a very simple structure and with minimal exemptions.

Vertical Equity

Firms that are producing greater 'value' are paying more taxes as opposed to firms generating greater revenue. Most people would consider this an improvement in fairness. A special tax rate for apartment owners may be considered to eliminate the negative impact of a tax increase on this sector on apartment renters in Los Angeles.

Grocery stores and drug stores would receive business tax relief compared with the status quo policy, and this would generally reduce the regressive burden of the business tax on low-income consumers. On the other hand, the tax increase on residential landlords would increase the regressive burden of the business tax on low-income renters.

The approach eliminates multiple taxation, which becomes highly regressive taxes because the poor devote a greater percentage of their income to purchases of goods than do the rich. For instance, a ½-percent gross receipts tax on all goods and services produced in the City of LA could cause the price of these goods and services to rise by much more than ½-percent.

CHAPTER 11: CONCLUSIONS

FINDINGS

The current tax is not economically efficient, as it penalizes businesses that rely heavily on subcontractors and merchandise purchased from other businesses. The current tax is not competitive when compared with most neighboring jurisdictions; however, improving compliance is the City's best option for reducing tax rates without losing revenue yield. The current tax is complicated due to inconsistent tax bases[172], a multitude of tax categories, and a lack of transparency in apportionment rules.

The City's current gross receipts tax is not equitable, primarily because it taxes business-to-business transactions multiple times and it lacks consistency in the definition of the tax base. Under the current tax, professionals, auto dealers, grocery stores, and many wholesalers are relatively over-taxed when comparing the taxes paid to their value-added. By comparison, motion picture companies, landlords, television broadcasting, restaurants and hotels are relatively under-taxed compared with other businesses.[173]

Other large cities tend to rely on property taxes and income taxes for business taxation, but these are not legal alternatives for California cities. San Francisco and Philadelphia rely on payroll taxes paid by employers. Most California cities tax businesses based on number of employees or gross receipts.

In assessing gross receipts taxation in the states, the panel found that the gross receipts taxation approach is unpopular. In Washington, a State tax reform study recommended that the gross receipts tax be replaced with a value-added tax approach. In West Virginia, the receipts tax was replaced with a corporate income tax; however, a recent study recommended replacing the corporate tax with a value-added tax. In the last year, three State legislatures have rejected gross receipts tax measures in favor of more equitable approaches to business taxation.[174]

There are numerous alternatives to the City's gross receipts tax. The flat tax, employee tax, and lump-sum tax approaches were evaluated as inequitable. The commercial rentals, square footage, value-added, and modified receipts approaches were chosen for in-depth analysis.

Upon closer evaluation, the panel found that the commercial rental tax would be either inequitable or administratively complicated due to complexities in taxing the 30-40 percent of businesses that are owner-occupied. In-depth evaluation of user fees indicated that there are

[172] "Inconsistent tax bases" refers to inconsistency in the tax base across industries: production costs in the motion picture industry, various presumptive bases in the amusement industries, lump-sum in the money-lending industries, payroll in the construction industry, and gross receipts in most of the remaining industries.

[173] See chapter 4 section on equity evaluation of existing tax.

[174] State business tax reform efforts are discussed in Chapter 4.

relatively few opportunities for increasing user fees that are primarily paid by businesses; residents primarily pay those user fees that could bear increases.

The square footage tax approach was viewed favorably in its simplicity and its ability to promote compliance by giving the landlord an incentive to encourage tenants to comply with the business tax. The net receipts approach was viewed favorably in its equity and economic benefits and its ability to promote compliance because prime contractors would be reporting their subcontractors. These two approaches are complementary in that the square footage approach provides equity based on use of city services, whereas the net receipts approach provides equity based on ability to pay.

RECOMMENDATIONS

The team recommends that the City restructure its current business license tax as a Business Enterprise Tax (BET). The Business Enterprise Tax achieves the City's goal of developing an alternative tax system that provides greater simplicity, economic efficiency, equity and revenue stability than the current Gross Receipts Tax.

In order to achieve these goals, the BET would be structured with a square footage and net receipts component.

SQUARE FOOTAGE

A portion of the BET revenue would be raised through a tax on square footage. Any business with a fixed location in the City of Los Angeles would pay the square footage component. The tax base would include all improved space, including non-leasable space (i.e. common areas like elevators), and would also include exterior space used for inventory (such as the outdoor portions of home improvement centers and car dealership lots), except that the first 250 square feet would be deducted.

The team recommends several rate categories be used:

- Multi-Family Housing: Residential landlords would pay at the lowest rate ($0.02 per square foot)

- Warehouse: Warehouse occupants and hotels would pay at the second rate ($0.05 per square foot)

- Industrial/Retail/General: Industrial, retail and service occupants would pay at the third rate ($0.10 per square foot)

- Office: Office occupants would pay at the highest rate ($0.30 per square foot)

Commercial tenants would pay this tax on all space they lease. However, so long as space in a building is offered for lease by a landlord or used for business purposes, the landlord would be required to pay the tax on all space not occupied by tenants.

The landlord would be required to report the tenants along with their business license or business license exemption number in order to deduct the tenant-occupied square footage from the landlord's tax base. The landlord would have incentives to encourage tenants to comply with the business tax and to report non-compliant tenants to the Office of Finance. Landlords would no longer be allowed to report their activity in a consolidated fashion for their various locations, as that would undermine the compliance benefits of this tax approach.

Philosophical Basis

The square footage component of the BET is based on the benefit principle of equity. Although legally structured as a tax, the equity of the square footage component of the BET is based on a 'user fee' theory. Each business that operates in the City of Los Angeles causes the city to provide a variety of public safety and infrastructure maintenance services. Tying a portion of the BET to the public service that business receives promotes economic efficiency.

The square footage component has two additional benefits. First, the square footage tax is expected to increase business tax compliance, which will improve equity and promote business tax relief for compliant taxpayers.[175] Second, the tax rates of the square footage would be favorable compared to other jurisdictions because the square footage component would only raise 30 percent of BET revenue.

NET RECEIPTS

The net receipts component of the BET would be levied at a uniform rate across industries and would promote equity based on taxpayers' ability to pay. The taxable basis would be defined as gross receipts less deductions for cost of materials[176] and subcontractor payments[177]. This approach has the following effects compared with the present system of a tax on gross receipts:

Pros:

1. This tax approach is economically efficient in that it eliminates multiple taxation and tax-pyramiding, and does not interfere with market decisions about use of local suppliers and vertical integration.

[175] The panel has no recommendation as to whether the compliance-related revenue increase be deposited into the City's general fund or Tax Reform Fund.

[176] Materials deductions would include the cost of merchandise purchased from a separate company and resold to customers as well as the cost of raw materials that become an "identifiable element" of the goods or services sold directly by the taxpayer. Hence, the purchase of goods for resale by wholesalers and retailers would be deductible, the purchase of raw materials used as part of the manufacturers' final product would be deductible, and the purchase of raw materials resold by service sector companies would be deductible (e.g. hotel toiletries, Kinko's paper supplies).

[177] A subcontractor is a partnership, limited partnership, corporation, business trust, joint stock company, trust, unincorporated association, joint venture, governmental entity or other entity of whatever nature hired by a vendor (other than employees) under separate contractual arrangements to perform portions of the work under an agreement. Subcontractor payments are deductible in Bakersfield, Davis, Santa Ana, Stockton and Berkeley; but the term is not explicitly defined in their respective Municipal Codes.

2. This tax approach involves only one tax classification, which promotes simplicity. For half of all businesses with receipts less than the minimum tax threshold, this approach would be simpler than the current tax. Larger businesses would face an increased reporting burden with respect to tracking deductions; however, deduction tracking is voluntary as it only serves to reduce the tax bill. This tax approach would improve tax compliance by providing information on subcontractors for tax enforcement.

3. This tax approach, if implemented as a ballot measure, would provide revenue stability.[178]

4. This tax approach provides horizontal equity to the City's taxpayers. Further, the approach offers future equity to the City's taxpayers; the uniformity of the tax rate does not promote opportunities for the City to provide special rates to particular industries.

Under current policy, the minimum tax (i.e. the basic tax due from a business regardless of the business's size) cannot be increased without voter approval, and has been declining in real terms due to inflation since the passage of Proposition 218. Most businesses currently pay a minimum tax in the range of $100-125. The minimum tax has lost 26 percent of its value since 1991 when it was last increased.

The minimum tax would be restructured to recover the City's costs of administering the business license program. For small businesses currently exempt from the business tax, the fee would be approximately $25, to recover the relatively minimal costs of issuing licenses. For the majority of businesses, the minimum tax would be $145. For businesses with net receipts less than $42,000, the minimum tax would be paid and there would be no tax due on the receipts.

The panel recommends that the ballot measure index the minimum tax to inflation so that inflation does not continue to erode the minimum tax.[179]

Out-of-state sales are appropriately handled through apportionment formula rather than outright exemptions. Elimination of these exemptions and reliance on the apportionment factors for out-of-state sales would improve the fairness of the tax.

ADMINISTRATIVE REFORMS

The panel recommends that the City implement reform in its tax form, tax instructions, and reporting requirements.

Firstly, the panel recommends that the City clarify its apportionment rules. Both taxpayers and CPAs indicated at the business roundtables that they are confused about the apportionment rules. There is currently a perceived lack of transparency in the application of the existing apportionment formulae for certain classes of taxpayers.

[178] Revenue stability means that a revenue source is no more volatile than the existing business tax, and that the tax structure is expected to be stable with respect to legal challenge and state policy decisions.

[179] The panel recommends that the minimum tax increase annually by the percentage change in the Consumer Price Index for Urban Consumers in the Los Angeles metropolitan area.

Secondly, the panel recommends that the City clarify and enforce its reporting requirements. The City is not adequately tracking the situs of the taxpayer, thus severely limiting the City's ability to identify commercial buildings where there are currently no business taxpayers. In fact, the City should be tracking both the enterprise (federal employer identification number) and the situs (parcel identification) for each business. Armed with this information, the City can more readily identify non-reporters among landlords as well as commercial tenants, and can use computer techniques for auditing and identifying businesses not currently paying the business tax. Further, the analysis of square footage taxation would be greatly improved if the City were to more strictly enforce the requirement that businesses report on each site.

Thirdly, the panel recommends that the City clarify and revise its tax instructions and tax form. Taxpayers reported a great level of confusion about how to file their business taxes in the taxpayer survey and at the business roundtables. The taxpayer should be required to report gross receipts both before and after apportionment. This would greatly aid the ability to identify those taxpayers that should be audited and whether apportionment rules should be changed.

Fourthly, the panel recommends that the City reduce its non-discretionary tax penalty cap from 40 percent to 25 percent, so that the penalties are comparable to State penalties and not perceived as onerous. In addition, the City's 20 percent deficiency determination penalty exceeds the State ten percent penalty for under-reporting, and also merits reconsideration.

IMPLEMENTATION PLAN

PHASE 1: IMPLEMENTATION PLANNING (MARCH – APRIL 2005)

1) **Team Appointment**: Office of Finance appoints implementation team members, including key staff and contractors. Contractors are expected to include the computer systems consultant, the training consultant, a focus group leader, and a public relations firm. Staff would conduct this step with no outside costs.

2) **Planning Review and Meetings**: Implementation team resolves detailed implementation issues relating to computer system, audit, enforcement and collections. Estimated cost of consultant review and attendance at meetings is $30,000.

3) **Plan Finalized**: Office of Finance prepares and provides implementation plan including detailed implementation approach and process to team members. Office of Finance provides estimated consultant costs and staffing changes to CAO for FY 05-06 budgeting purposes. Staff would conduct this step with no outside costs.

4) **Public Plan Disseminated**: Communications staff or a public relations firm would prepare a brochure describing the new business tax policy for the taxpayers. The brochure and new ordinance would be made available to taxpayers at all field offices, and would be made available in electronic form on the website. Estimated cost of the public relations firm's activities is $40,000.

Phase 2: Internal Conversion (May – August 2005)

5) **LATAX Conversion**: LATAX programmers convert system programming for tax year 2006.

   a. Registration: Programming would be conducted to accommodate the re-registration of taxpayers with new/updated information on situs location, parcel identifier, and enterprise location of each taxpayer. Programming would involve changes to online filing, potentially routing taxpayers to the City's online ZIMAS system for looking up the parcel location of each taxpayer situs. Programming changes would involve coding and conversion of account identifiers.

   b. Subcontractor Reporting: Programming would be conducted to accommodate taxpayer reporting of subcontractors' name, address and business volume for purposes of prime contractors' deductions and for purposes of business tax discovery and compliance.

   c. Net Receipts: Programming would be conducted to accommodate the taxpayer's reporting of deductions and apportionment calculations for the net receipts portion of the tax, in addition to programming related to identifying taxpayers with excessive deductions for potential audit.

   d. Square Footage Classification: Programming would be conducted to link the parcel identifier to the property use as well as the tax classification for that property use. In addition, programming changes would involve assigning taxpayers to the highest square footage rate category if the taxpayer does not provide the parcel on which it is located.

   e. Square Footage: Programming would be conducted to determine if the taxpayer's site is within the City limits, to require the taxpayer to report square footage, to deduct the first 250 square feet, and to calculate the tax rate and liability. In addition, programming would be conducted to calculate the tax liability of landlords by accounting for square footage reported by tenants with business tax registration or exemption certificates.

   f. Penalties: Programming would be conducted to reduce the penalty cap of 40 percent to 25 percent.

   Estimated cost of LATAX conversion using an outside consultant is based on 4 programmers working for three to four months. Estimated cost is $250,000 - $335,000 for computer programming and systems manual revisions. In addition, the estimated cost is $25,000 for focus group review of online tax instructions to ensure that the online instructions are understandable to the typical taxpayer.

6) **Forms Conversion**: Printed tax forms, instructions and correspondence letters would be revised to reflect the new tax policy. This task would involve staff review of approximately 100-125 forms and letters, and the work of an outside printing consultant

to make the appropriate revisions. This task would also involve focus group review of tax forms and instructions to ensure that the forms are understandable to the typical taxpayer. Estimated cost includes $50,000 for the printing consultant and $20,000 for the focus group consultant.

7) **Audit Conversion**: Audit conversion would involve planning and training on audit approaches to identify taxpayers with excessive deductions, with excessive apportionment, with relatively low square footage, or with other indicators of potentially misreported activity. Audit conversion would coordinate with LATAX systems conversion to maximize desk-audit opportunities. Audit conversion would involve management planning related to the increased audit rate required in the first year of tax reform and be conducted by internal staff. The business tax discovery consultant is compensated on a commission basis and would not require direct compensation.

8) **Collections Conversion**: The conversion of collections and revenue management activities would be conducted by internal staff and would include rewriting of personnel manuals.

9) **Enforcement Conversion**: The conversion of enforcement activities would be conducted by internal staff and would include rewriting of personnel manuals.

PHASE 3: STAFFING CONVERSION (SEPTEMBER - OCTOBER 2005)

10) **Staffing Changes**: The new business tax approach is expected to involve a temporarily increased need for auditors and potentially a means of providing telephone assistance to taxpayers. The new business tax approach may involve a change in the need for data entry personnel; however, this need must be assessed in light of the decreased need for data entry personnel caused by improvements in, and increased taxpayer use of, online filing.

11) **Staff Training:**

a. Reform Overview: Approximately 300 Office of Finance staff play a role in business tax administration and would require one day of training in the policy and procedural changes under the new business tax policy. In addition, the staff involved in fielding telephone calls would receive an additional day of training. Estimated cost of training provided by an outside consultant is $2,600.

b. Systems Training: Approximately 300 Office of Finance staff members play a role in business tax administration and would require one day of training in the changes to the business tax computer system. Estimated cost of training provided by an outside consultant is $1,300.

PHASE 4: TAXPAYER EDUCATION (SEPTEMBER 2005 – APRIL 2006)

12) **Business Tax Booklet**: Revise the booklet to address frequently asked questions about the new business tax. Staff would conduct this task.

13) **Tax Reform Seminars**: Prepare and offer seminars targeted separately for a) paid tax preparers and b) taxpayers.

14) **Taxpayer Re-registration**: The Office of Finance's increased efforts to track accurately the enterprise and the location of each taxpayer will require re-registration of existing taxpayers. Certain taxpayers that are not currently reporting each of their sites in the City will need to register those sites. The Office of Finance would mail out re-registration forms in the fall of 2005 to all landlords and to taxpayers with over $100,000 in receipts to ensure that multi-location taxpayers are correctly registered in the system prior to the effective date of the new policy. Estimated cost of the special mailing is $58,000.

15) **Presumptive Taxpayer Conversion**: The Office of Finance's efforts to convert taxpayers currently paying presumptive taxes (e.g. dance halls, bowling alleys, and money lenders, motion picture producers) will require special efforts. Renewal notices and instructions for these taxpayers should be sent out in advance of the regular renewal mailing to avoid bottlenecks.

16) **Renewals**: The Office of Finance would mail out the revised renewal instructions and forms for tax year 2006. This activity is included in the Office of Finance's existing budget.

17) **Telephone Assistance**: The Office of Finance would assign staff to provide telephone assistance on the business tax policy changes before and after the January 1, 2006 effective date.

PHASE 5: TAX POLICY CHANGE (JANUARY–DECEMBER 2006)

On Sunday, January 1, 2006, the new tax policy will become effective.

18) **Increased Audit Rates**: During the first year of tax reform, the Office of Finance will utilize interim staff or outside consultants to increase the audit rate to ensure that taxpayers do not take undue advantage of deduction opportunities.

19) **Computerized Audit**: During the first year of tax reform, the Office of Finance will exploit its improved information to capture non-reporters through the new information on subcontractors and on commercial building occupants, and to capture under-reporters with new information on apportionment rates.

20) **Landlord Compliance Activities**: During the first year of tax reform, the Office of Finance should anticipate an increased volume of calls and inquiries from landlords relating to tenants without business registration certificates.

REFERENCES

BOOKS, REPORTS AND ARTICLES

Alm, James. "Tax Evasion" in Joseph J. Cordes, Robert D. Ebel and Jane G. Gravelle. *Encyclopedia of Taxation and Tax Policy*. Washington, DC: Urban Institute Press, 2001.

Alm, Joseph. "What is an Optimal Tax System?," *National Tax Journal*, Vol. 49, No. 1, March 1996: pp. 117-33.

Bardach, Eugene. A Practical Guide for Policy Analysis: The Eightfold Path to More Effective Problem Solving. New York: Chatham House Publishers, 2000.

Bird, Richard M. *Managing the Reform Process*. Draft paper for World Bank course on Practical Issues of Tax Policy in Developing Countries, April 28-May 1, 2003.

Blue Ribbon Tax Reform Commission. *Options Adopted by the Commission* and *Options Considered by the Commission.* Albuquerque: Blue Ribbon Tax Reform Commission, 2003.

Burr, Beverly, Elaine Reardon and Paul Coomes. *The City of Los Angeles Tax Policy Model: User's Guide and Revenue Scenarios.* Santa Monica: Milken Institute, September 1997.

Burr, Beverly and Michael Cragg. *City of Los Angeles' Economic Base and Taxes.* Santa Monica: Milken Institute, September 1997.

California State Controller's Office. *State of California Cities Annual Report.* Sacramento: FY 1999-00.

City of Los Angeles, Office of Finance, Tax & Permit Division. *Request for Proposal: Review of Alternatives to the City's Gross Receipts Business Tax,* November 15, 2002.

City of Los Angeles, Office of Finance. *Report on Neighboring Cities' Business Taxes and Tax Structure*, July 22, 2003.

Fisher, Ronald C. *State and Local Public Finance.* Chapter 17, Business Taxes, pp. 440-461, Chicago: Irwin, 1996.

Governor's Commission on Fair Taxation. *Recommendations to the Governor.* Presented to Gov. Cecil H. Underwood, December 1999.

Governor's Task Force on Tax Policy in Nevada. *Analysis of Fiscal Policy in Nevada.* Nov. 15, 2002

Hammer, Rusty. *The Business Perspective: A Simpler Tax System in LA.* Los Angeles Area Chamber of Commerce, April 21, 2003.

Hammer, Rusty. *The Business Perspective: LA Tax Reform Still Top Priority.* Los Angeles Area Chamber of Commerce, June 30, 2003.

Hawaii Tax Review Commission. *Report of the 2001-2003 Tax Review Commission.* Honolulu: Tax Review Commission, 2003.

Hines, James R., Jr. *Michigan's Flirtation with the Single Business Tax.* Working Paper, University of Michigan Office of Tax Policy and Research, December 2002.

Henderson, Rick. "Nevada, Washington and the Gross Receipts Tax: The kiss of death for business and economic growth", *Las Vegas Review-Journal*, Feb. 16, 2003.

Honey, Jean. "The States' Reactions: A Comparative Analysis" in *University of Memphis Business Perspectives*, Spring 2002.

Kenyon, Daphne. "A New State VAT? Lessons from New Hampshire," *National Tax Journal*, Vol. 49, No. 3, September 1996: pp. 381-399.

Kohn, Mel and Jack Walker. *Proposed City Business Tax Reforms: Report to the City Council of Los Angeles.* Los Angeles: Business Tax Advisory Committee, September 11, 2002.

Kosmont Companies. *Kosmont-Rose Institute Cost of Doing Business Survey.* Claremont: Rose Institute, 2003.

House Legislative Analysis Section. *Business Taxes: Governor's Proposal.* Lansing, Michigan. July 16, 1999.

League of California Cities. *Municipal Revenue Sources Handbook*, 2001 edition. Sacramento: League of California Cities, 2001.

Los Angeles Economic Development Corporation. *City of Los Angeles Business Tax Study, 2003 Update.* Los Angeles: Los Angeles Economic Development Corporation, 2003.

Loveman, Charles E., Jr. and Timothy Sales. *Taxes and Fees in Los Angeles: A Survey of Competitor Cities.* Los Angeles: Landmark Partners, January 1997.

MBIA MuniServices Company. *Initial Evaluation of Alternatives to the City's Gross Receipts Business Tax.* Report to the City of Los Angeles, April 21, 2003.

Musgrave, Richard A. and Peggy B. Musgrave. *Public Finance in Theory and Practice*, third edition. New York: McGraw-Hill, 1980.

Oakland, William H. and William A. Testa. "State-Local Business Taxation and the Benefits Principle" in Economic Perspectives, a publication of the Federal Reserve Bank of Chicago, January 1996.

Pacific Gas and Electric Company. *Commercial Buidling Survey Report.* San Francisco: Pacific Gas and Electric Company, 1999.

Ragas, Wade R. "Office Space Demand", *University of New Orleans Real Estate Market Data Center Technical Report 978*. February 1993.

Riordan, Richard J. and Richard Alatorre. *Los Angeles Business Tax Reform: An Economic Cornerstone for the 21st Century.* Los Angeles: City of Los Angeles, December 15, 1998.

San Francisco Chamber of Commerce. *The Impact of the Payroll Tax in San Francisco.* San Francisco: San Francisco Chamber of Commerce, 2001.

Selter, Marvin R. "Business Tax Reform Proposals", *Report to Members of the Business Tax Advisory Committee.* Los Angeles: Business Tax Advisory Committee's Tax Reformation Subcommittee, July 2002.

Slemrod, Joel. "Optimal Taxation and Optimal Tax Systems", *Journal of Economic Perspectives*, Vol. 4, No. 1, pp. 157-178, 1990.

Slemrod, Joel. *Why People Pay Taxes: Tax Compliance and Enforcement.* Ann Arbor: University of Michigan Press, 1992.

Slemrod, Joel and Shlomo Yithzaki. "Tax Avoidance, Evasion and Administration" in Handbook of Public Economics, Vol. 3 (eds. A.J. Auerbach and M. Feldstein). North Holland, 2002.

Steurle, C. Eugene. "And Equal (Tax) Justice for All?", in Tax Justice: The Ongoing Debate (eds. Joseph J. Thorndike and Dennis J. Ventry, Jr.). Washington, DC: Urban Institute Press, 2002.

Strauss, Robert P. "Apportionment" in *Encyclopedia of Taxation and Tax Policy* (eds. Joseph J. Cordes, Robert D. Ebel and Jane G. Gravelle). Washington, DC: Urban Institute, 2001.

U.S. Census Bureau. *Business Expenses, 1997 Economic Census.* Washington: Census Bureau, Dec. 2000.

UT Strategies, Inc., Arthur Andersen, and Landmark Partners. *Competitiveness of City Taxes and Fees: Final Report.* Los Angeles: UT Strategies, Inc., September 15, 1997.

Valley Industry and Commerce Association. *Position Paper on Elimination of City of los Angeles Gross Receipts Tax.* January 14, 2002.

Valley Vote. *Los Angeles Business Tax Reform: A White Paper.* November 3, 2003

Washington State Tax Structure Study Committee. *Tax Alternatives for Washington State: A Report to the Legislature.* Washington State Tax Structure Study Committee: Olympia, November 2002.

DATA

Building Characteristics: Pacific Gas and Electric Company; U.S. Department of Energy Commercial Building Energy Consumption Survey 1999

Building Lease Rates: CB Richard Ellis; Marcus & Millichap; NAI

Business Expenses: U.S. Bureau of the Census, Economic Census 1997

Business Income and Value-Added: U.S. Internal Revenue Service, Statistics of Income, 2000

Business Taxpayers: City of Los Angeles Office of Finance 2001-2003

Employment and Payroll: California Employment Development Department, Labor Market Information Division, 1996-2002

Geographic Location: County of Los Angeles, Urban Research Division

Property Taxpayers: County of Los Angeles, Assessor

Sales Taxpayers: California Board of Equalization

APPENDIX A: SUPPLEMENTAL TABLES

Table A-1: Los Angeles City and County Trade Indicators by Industry, 2001

		2001 Private Sector Jobs (1000s)			LA County Trade		LA City Trade	
NAICS	Industry	USA	LA County	LA City	Location Coefficient	Trade Flow Type	Location Coefficient	Trade Flow Type
	ALL INDUSTRIES	109,305	3,549	1,375	1.0		1.0	
	CONSTRUCTION	6,774	137	44	0.6		0.5	
2361	Residential Building Construction	775	18	6	0.7		0.7	
2362	Nonresidential Building Construction	793	14	4	0.6		0.4	Import
2371	Utility System Construction	398	5	1	0.4	Import	0.2	Import
2372	L& Subdivision	89	3	2	1.1		1.7	
2373	Highway, Street & Bridge Construction	344	4	1	0.4	Import	0.3	Import
2381	Foundation, Structure & Building Exterior Contractors	923	19	6	0.6		0.5	
2382	Building Equipment Contractors	1,888	35	12	0.6		0.5	
2383	Building Finishing Contractors	870	26	9	0.9		0.8	
2389	Other Specialty Trade Contractors	575	10	2	0.5		0.3	Import
	MANUFACTURING	16,386	578	178	1.1		0.9	
3113	Sugar & Confectionery Product Manufacturing	91	2	2	0.8		1.5	
3114	Fruit & Vegetable Preserving & Specialty Food Manufacturing	198	6	2	0.9		0.7	
3116	Animal Slaughtering & Processing	514	6	1	0.3	Import	0.2	Import
3117	Seafood Product Preparation & Packaging	47	1	1	1.0		2.3	Export
3118	Bakeries & Tortilla Manufacturing	302	18	6	1.8		1.5	
3119	Other Food Manufacturing	151	4	1	0.9		0.8	
3121	Beverage Manufacturing	175	5	2	0.8		0.9	
3132	Fabric Mills	167	5	1	0.9		0.7	
3133	Textile & Fabric Finishing & Fabric Coating Mills	93	7	3	2.2	Export	2.7	Export
3141	Textile Furnishings Mills	121	6	2	1.4		1.1	
3149	Other Textile Product Mills	83	4	2	1.4		1.8	
3152	Cut & Sew Apparel Manufacturing	335	75	41	6.9	Export	9.8	Export
3159	Apparel Accessories & Other Apparel Manufacturing	30	3	2	3.5	Export	5.3	Export
3219	Other Wood Product Manufacturing	329	5	2	0.5	Import	0.4	Import
3222	Converted Paper Product Manufacturing	399	11	1	0.9		0.3	Import
3231	Printing & Related Support Activities	765	29	11	1.2		1.1	
3254	Pharmaceutical & Medicine Manufacturing	281	7	4	0.7		1.1	
3256	Soap, Cleaning Compound & Toilet Preparation Manufacturing	127	8	3	1.9		1.8	
3261	Plastics Product Manufacturing	695	21	3	0.9		0.3	Import
3272	Glass & Glass Product Manufacturing	135	5	2	1.2		1.3	
3323	Architectural & Structural Metals Manufacturing	418	9	3	0.7		0.5	Import
3327	Machine Shops; Turned Product; Screw, Nut & Bolt Manufacturing	344	15	3	1.3		0.8	
3328	Coating, Engraving, Heat Treating & Allied Activities	164	11	4	2.1	Export	1.8	
3329	Other Fabricated Metal Product Manufacturing	321	11	3	1.0		0.9	
3335	Metalworking Machinery Manufacturing	248	6	1	0.7		0.4	Import
3339	Other General Purpose Machinery Manufacturing	319	7	1	0.7		0.3	Import
3342	Communications Equipment Manufacturing	237	4	1	0.6		0.4	Import
3343	Audio & Video Equipment Manufacturing	47	2	1	1.5		2.4	Export
3344	Semiconductor & Other Electronic Component Manufacturing	643	13	6	0.6		0.7	
3345	Navigational, Measuring, Control Instruments Manufacturing	472	41	9	2.7	Export	1.4	
3346	Manufacturing & Reproducing Magnetic & Optical Media	63	3	1	1.5		1.7	
3351	Electric Lighting Equipment Manufacturing	78	5	2	2.1	Export	1.8	
3363	Motor Vehicle Parts Manufacturing	768	12	2	0.5	Import	0.2	Import
3364	Aerospace Product & Parts Manufacturing	506	48	8	2.9	Export	1.3	
3371	Household & Institutional Furniture & Cabinet Manufacturing	417	22	6	1.6		1.2	
3372	Office Furniture (including Fixtures) Manufacturing	171	7	2	1.2		0.8	
3379	Other Furniture Related Product Manufacturing	55	3	1	1.7		1.8	
3391	Medical Equipment & Supplies Manufacturing	311	10	3	1.0		0.8	
3399	Other Miscellaneous Manufacturing	402	18	9	1.4		1.7	

		2001 Private Sector Jobs (1000s)			LA County Trade		LA City Trade	
NAICS	Industry	USA	LA County	LA City	Location Coefficient	Trade Flow Type	Location Coefficient	Trade Flow Type
	WHOLESALE	5,730	221	75	1.2		1.0	
4231	Motor Vehicle & Motor Vehicle Parts & Supplies Wholesalers	345	16	4	1.4		0.8	
4232	Furniture & Home Furnishing Wholesalers	112	10	3	2.8	Export	2.0	
4233	Lumber & Other Construction Materials Wholesalers	219	4	1	0.6		0.4	Import
4234	Professional & Commercial Equipment & Supplies Wholesalers	690	23	7	1.0		0.8	
4236	Electrical & Electronic Goods Wholesalers	402	15	5	1.1		0.9	
4237	Hardware, Plumbing & Heating Equipment Wholesalers	238	9	2	1.2		0.6	
4238	Machinery, Equipment & Supplies Wholesalers	698	17	4	0.8		0.5	Import
4239	Miscellaneous Durable Goods Wholesalers	270	21	11	2.4	Export	3.2	Export
4241	Paper & Paper Product Wholesalers	167	6	2	1.2		0.8	
4242	Drugs & Druggists' Sundries Wholesalers	201	5	2	0.8		1.0	
4243	Apparel, Piece Goods & Notions Wholesalers	153	20	10	4.0	Export	5.3	Export
4244	Grocery & Related Product Wholesalers	675	28	11	1.3		1.3	
4248	Beer, Wine & Distilled Alcoholic Beverage Wholesalers	130	2	1	0.5		0.6	
4249	Miscellaneous Nondurable Goods Wholesalers	367	15	6	1.3		1.3	
4251	Wholesale Electronic Markets & Agents & Brokers	607	17	6	0.9		0.8	
	RETAIL	15,180	399	145	0.8		0.8	
4411	Automobile Dealers	1,227	35	9	0.9		0.6	
4413	Automotive Parts, Accessories & Tire Stores	493	15	5	0.9		0.8	
4421	Furniture Stores	282	8	2	0.8		0.6	
4422	Home Furnishings Stores	256	7	3	0.9		1.0	
4431	Electronics & Appliance Stores	557	21	7	1.2		1.1	
4441	Building Material & Supplies Dealers	984	21	7	0.7		0.5	
4451	Grocery Stores	2,532	64	25	0.8		0.8	
4452	Specialty Food Stores	266	13	6	1.5		1.8	
4453	Beer, Wine & Liquor Stores	141	4	2	0.9		1.0	
4461	Health & Personal Care Stores	938	28	10	0.9		0.9	
4471	Gasoline Stations	920	11	4	0.4	Import	0.3	Import
4481	Clothing Stores	961	35	15	1.1		1.2	
4482	Shoe Stores	189	7	3	1.2		1.1	
4483	Jewelry, Luggage & Leather Goods Stores	174	6	3	1.0		1.3	
4511	Sporting Goods, Hobby & Musical Instrument Stores	442	14	4	1.0		0.8	
4512	Book, Periodical & Music Stores	240	10	5	1.3		1.5	
4521	Department Stores	1,764	44	13	0.8		0.6	
4529	Other General Merch&ise Stores	1,057	15	6	0.4	Import	0.4	Import
4531	Florists	125	3	1	0.7		0.6	
4532	Office Supplies, Stationery & Gift Stores	456	14	6	0.9		1.1	
4533	Used Merch&ise Stores	106	3	1	0.9		1.0	
4539	Other Miscellaneous Store Retailers	304	8	3	0.8		0.9	
4541	Electronic Shopping & Mail-Order Houses	240	5	2	0.6		0.6	
4543	Direct Selling Establishments	170	3	1	0.6		0.6	
	TRANSPORTATION	4,138	158	66	1.2		1.3	
4811	Scheduled Air Transportation	569	27	22	1.5		3.1	Export
4812	Nonscheduled Air Transportation	46	1	1	0.9		1.8	
4841	General Freight Trucking	986	23	3	0.7		0.2	Import
4842	Specialized Freight Trucking	397	9	3	0.7		0.5	
4853	Taxi & Limousine Service	71	3	1	1.1		1.2	
4854	School & Employee Bus Transportation	153	4	1	0.7		0.6	
4881	Support Activities for Air Transportation	141	7	4	1.5		2.5	Export
4883	Support Activities for Water Transportation	95	12	3	4.0	Export	2.6	Export
4884	Support Activities for Road Transportation	67	4	2	2.1	Export	2.3	Export
4885	Freight Transportation Arrangement	178	15	5	2.7	Export	2.1	Export
4921	Couriers	544	19	11	1.1		1.6	
4922	Local Messengers & Local Delivery	53	5	3	2.8	Export	3.8	Export
4931	Warehousing & Storage	511	18	4	1.1		0.7	

	2001 Private Sector Jobs (1000s)			LA County Trade		LA City Trade	
Industry	USA	LA County	LA City	Location Coefficient	Trade Flow Type	Location Coefficient	Trade Flow Type
INFORMATION SERVICES	3,546	198	96	1.7		2.2	Export
Newspaper, Periodical, Book & Directory Publishers	743	17	11	0.7		1.2	
Software Publishers	271	6	1	0.7		0.4	Import
Motion Picture & Video Industries	338	95	44	8.7	Export	10.4	Export
Sound Recording Industries	29	5	4	5.5	Export	9.8	Export
Radio & Television Broadcasting	248	13	11	1.6		3.5	Export
Cable & Other Subscription Programming	94	6	3	2.0	Export	2.7	Export
Internet Publishing & Broadcasting	44	3	2	2.3	Export	3.1	Export
Wired Telecommunications Carriers	726	3	2	0.1	Import	0.2	Import
Wireless Telecommunications Carriers (except Satellite)	201	6	3	0.9		1.0	
Satellite Telecommunications	21	6	1	8.1	Export	4.7	Export
Internet Service Providers & Web Search Portals	171	9	3	-	Import	1.3	
Data Processing, Hosting & Related Services	315	7	2	-	Import	0.6	
FINANCE, INSURANCE & REAL ESTATE	7,656	231	115	0.9		1.2	
Depository Credit Intermediation	1,699	49	23	0.9		1.1	
Nondepository Credit Intermediation	660	15	6	0.7		0.7	
Activities Related to Credit Intermediation	233	8	3	1.1		1.2	
Securities & Commodity Contracts Intermediation & Brokerage	567	13	8	0.7		1.1	
Other Financial Investment Activities	257	13	7	1.5		2.1	Export
Insurance Carriers	1,304	31	18	0.7		1.1	
Agencies, Brokerages & Other Insurance Related Activities	802	27	14	1.0		1.4	
Lessors of Real Estate	607	20	9	-	Import	1.1	
Offices of Real Estate Agents & Brokers	293	11	6	-	Import	1.5	
Activities Related to Real Estate	437	20	9	1.4		1.6	
Automotive Equipment Rental & Leasing	207	8	4	1.2		1.7	
Consumer Goods Rental	294	8	3	0.9		0.9	
Commercial & Industrial Machinery & Equipment Rental & Leasing	104	5	3	1.4		2.0	
SERVICES	47,266	1,600	642	1.0		1.1	
Legal Services	1,088	48	36	1.4		2.6	Export
Accounting, Tax Preparation, Bookkeeping & Payroll Services	878	65	35	2.3	Export	3.1	Export
Architectural, Engineering & Related Services	1,268	31	11	0.8		0.7	
Specialized Design Services	129	8	4	2.0		2.5	Export
Computer Systems Design & Related Services	1,279	27	9	0.6		0.6	
Management, Scientific & Technical Consulting Services	749	26	11	1.1		1.2	
Scientific Research & Development Services	531	14	4	0.8		0.7	
Advertising & Related Services	476	25	14	1.6		2.3	Export
Other Professional, Scientific & Technical Services	473	19	8	1.2		1.3	
Management of Companies & Enterprises	1,716	84	36	1.5		1.7	
Office Administrative Services	265	13	5	1.5		1.6	
Employment Services	3,412	124	40	1.1		0.9	
Business Support Services	771	17	9	0.7		1.0	
Travel Arrangement & Reservation Services	284	13	7	1.4		1.9	
Investigation & Security Services	703	40	20	1.7		2.3	Export
Services to Buildings & Dwellings	1,607	41	16	0.8		0.8	
Other Support Services	282	9	2	1.0		0.7	
Waste Treatment & Disposal	119	4	1	1.1		0.8	
Elementary & Secondary Schools	514	17	7	1.0		1.1	
Colleges, Universities & Professional Schools	902	39	10	1.3		0.9	
Business Schools & Computer & Management Training	88	3	2	1.1		1.8	
Technical & Trade Schools	94	3	2	1.0		1.3	
Other Schools & Instruction	198	9	4	1.5		1.5	
Offices of Physicians	1,911	60	26	1.0		1.1	
Offices of Dentists	704	25	8	1.1		0.9	
Offices of Other Health Practitioners	456	12	4	0.8		0.7	
Outpatient Care Centers	400	14	5	1.1		1.0	
Medical & Diagnostic Laboratories	169	7	2	1.3		1.2	
Home Health Care Services	635	11	5	0.6		0.6	

	2001 Private Sector Jobs (1000s)			LA County Trade		LA City Trade	
Industry	USA	LA County	LA City	Location Coefficient	Trade Flow Type	Location Coefficient	Trade Flow Type
Other Ambulatory Health Care Services	179	4	2	0.7		0.9	
General Medical & Surgical Hospitals	3,791	97	39	0.8		0.8	
Psychiatric & Substance Abuse Hospitals	86	3	2	1.1		1.9	
Specialty Hospitals	131	2	1	0.4	Import	0.6	
Nursing Care Facilities	1,540	31	10	0.6		0.5	
Residential Mental Health & Substance Abuse Facilities	457	18	10	1.2		1.7	
Community Care Facilities for the Elderly	499	8	3	0.5		0.4	Import
Other Residential Care Facilities	163	5	1	0.9		0.6	
Individual & Family Services	722	18	10	0.8		1.1	
Community Food & Housing & Emergency & Other Relief Services	124	4	3	1.1		1.9	
Vocational Rehabilitation Services	303	10	4	1.0		1.1	
Child Day Care Services	698	15	5	0.7		0.6	
Performing Arts Companies	127	5	3	1.3		2.1	Export
Spectator Sports	132	5	1	1.1		0.8	
Promoters of Performing Arts, Sports & Similar Events	67	2	1	0.9		1.6	
Agents & Managers for Artists, Athletes, Entertainers, Public Figures	15	4	1	8.5	Export	7.2	Export
Independent Artists, Writers & Performers	37	11	4	8.9	Export	8.5	Export
Museums, Historical Sites & Similar Institutions	115	4	3	1.0		2.2	Export
Other Amusement & Recreation Industries	993	22	9	0.7		0.7	
Traveler Accommodation	1,764	38	17	0.7		0.8	
Full-Service Restaurants	3,878	115	42	0.9		0.9	
Limited-Service Eating Places	3,495	113	43	1.0		1.0	
Special Food Services	507	12	7	0.7		1.0	
Drinking Places (Alcoholic Beverages)	393	7	3	0.5		0.6	
Automotive Repair & Maintenance	899	31	11	1.1		0.9	
Commercial & Industrial Machinery Repair & Maintenance	159	4	1	0.8		0.6	
Personal & Household Goods Repair & Maintenance	85	3	1	1.0		1.2	
Personal Care Services	505	13	4	0.8		0.6	
Drycleaning & Laundry Services	377	13	5	1.1		1.0	
Other Personal Services	227	16	9	2.2	Export	3.0	Export
Religious Organizations	159	6	3	1.2		1.6	
Grantmaking & Giving Services	124	8	5	2.1	Export	3.0	Export
Social Advocacy Organizations	154	4	2	0.8		1.2	
Civic & Social Organizations	412	9	4	0.7		0.7	
Business, Professional, Labor, Political & Similar Organizations	425	11	6	0.8		1.0	

Table A-2: Business Tax Base, Los Angeles County Cities

						Gross		Square	Operating
	City	**Primary Base**	**Jobs 2000**	**No Tax**	**Flat**	**Receipts**	**Employee**	**Feet**	**Costs**
	TOTAL			6	4	30	36	5	1
1	Los Angeles	Gross Receipts	1,362,050			X			
2	Long Beach	Employee	136,557				X		
3	Burbank	Employee	114,054				X		
4	Torrance	Employee	101,756				X		
5	Pasadena	Employee	98,276				X		
6	Glendale	None	77,332	X					
7	Santa Monica	Gross Receipts	71,701			X			
8	Industry	None	67,594	X					
9	Commerce	Employee/Square Feet	61,023				X	X	
10	Santa Fe Springs	Employee	59,533				X		
11	Vernon	Employee/Square Feet	55,728				X	X	
12	El Segundo	Employee/Square Feet	54,173				X	X	
13	Carson	Employee	51,717				X		
14	Beverly Hills	Receipts/Employee	46,634			X	X		
15	Santa Clarita	None	45,109	X					
16	Culver City	Gross Receipts	42,315			X			
17	Pomona	Receipts/Employee	40,004			X	X		
18	Cerritos	Employee/Square Feet/Flat	38,080		X		X	X	
19	Downey	Receipts/Employee	30,906			X	X		
20	Compton	Gross Receipts	27,806			X			
21	Inglewood	Gross Receipts	26,882			X			
22	El Monte	Gross Receipts	26,443			X			
23	West Covina	Employee	26,017				X		
24	Gardena	Gross Receipts	25,660			X			
25	Alhambra	Gross Receipts	25,552			X			
26	Monterey Park	Employee	24,631				X		
27	Redondo Beach	Employee	24,627				X		
28	Montebello	Gross Receipts	24,315			X			
29	South El Monte	Employee	24,252				X		
30	Lancaster	Employee	24,035				X		
31	Whittier	Receipts/Employee	23,106			X	X		
32	West Hollywood	Receipts/Costs	22,829			X			X
33	Covina	Employee	21,701				X		
34	Palmdale	Employee	21,450				X		
35	Hawthorne	Gross Receipts	21,384			X			
36	Arcadia	Employee	20,457				X		
37	South Gate	Gross Receipts	19,982			X			
38	La Mirada	Receipts/Square Feet	19,006			X		X	
39	San Dimas	Employee	18,449				X		
40	Paramount	Employee	18,311				X		
41	Lakewood	Receipts/Employee	17,288			X	X		
42	Signal Hill	Employee	15,862				X		
43	Pico Rivera	Gross Receipts	15,391			X			
44	Azusa	Gross Receipts	15,144			X			
45	Monrovia	Employee	14,693				X		
46	Manhattan Beach	Receipts/Employee	14,545			X	X		
47	Huntington Park	Gross Receipts	14,389			X			
48	Baldwin Park	Employee	14,083				X		
49	Norwalk	Receipts/Employee	14,069			X	X		
50	Diamond Bar	None	13,990	X					

	City	Primary Base	Jobs 2000	No Tax	Flat	Gross Receipts	Employee	Square Feet	Operating Costs
51	Bellflower	Employee	13,969				X		
52	Rosemead	Flat	13,896		X				
53	Calabasas	None	13,812	X					
54	Claremont	Gross Receipts	13,306			X	X		
55	Irwindale	Gross Receipts	13,091			X			
56	Glendora	Gross Receipts	12,939			X			
57	Agoura Hills	Flat	11,545		X				
58	San Fernando	Gross Receipts	10,168			X			
59	San Gabriel	Employee	9,988						
60	Lynwood	Employee	8,439				X		
61	Westlake Village	None	8,284	X					
62	Duarte	Employee	8,278				X		
63	South Pasadena	Employee	7,798				X		
64	La Verne	Gross Receipts	7,137			X			
65	Bell Gardens	Flat	6,772		X				
66	Artesia	Receipts/Employee	6,246			X	X		
67	Bell	Gross Receipts	6,001			X			

Sources: Kosmont (2003); City finance departments; Municipal Codes; Los Angeles County Urban Resarch Division (jobs)

Table A-3: General Fund Revenues ($1,000s), Selected California Cities, FY 2000-01

	General Fund Total	Sales and Use Tax	Property Tax	Vehicle License Fees	Utility Tax	Licenses, Permits, Fees & Fines	Transient Occupancy Tax	Business Tax	Franchise Income
Anaheim	$ 168,613	$ 49,882	$ 22,360	$ 16,763	$ -	$ 1,187	$ 58,112	$ 5,364	$ 2,244
Burbank	81,775	20,678	16,496	5,538	15,455	2,775	3,068	1,549	1,364
Beverly Hills	100,164	19,110	17,502	1,844	-	6,293	17,818	23,413	1,130
Glendale	74,832	15,389	14,412	11,639	19,223	-	2,240	-	2,233
Long Beach	245,950	42,632	46,600	29,906	56,717	395	6,668	8,052	23,707
Los Angeles	2,389,598	357,222	536,359	201,020	557,401	691	108,538	344,605	60,351
Santa Ana	123,126	41,738	18,384	17,200	23,285	1,346	4,367	6,854	3,694
Santa Monica	188,116	26,244	14,740	5,028	25,156	18,011	19,218	17,100	705
San Diego	556,604	179,602	156,925	67,163	-	3,901	-	14,359	53,981
San Jose	589,770	164,320	79,322	48,703	67,446	11,898	27,320	37,216	29,172
West Hollywood	34,444	8,648	5,487	2,080	-	1,916	9,610	1,251	1,146
All CA Cities	13,662,184	3,952,059	2,503,706	1,458,785	1,464,405	985,287	875,638	763,885	613,003
All CA Cities except LA	11,272,586	3,594,837	1,967,347	1,257,765	907,004	984,596	767,100	419,280	552,652

Source: California Controller, Cities Annual Report FY 2000-01

Table A-4: Revenue Sources as % of General Fund, Selected California Cities, FY 2000-01

	General Fund Total	Sales and Use Tax	Property Tax	Vehicle License Fees	Utility Tax	Licenses, Permits, Fees & Fines	Transient Occupancy Tax	Business Tax	Franchise Income
Anaheim	100%	30%	13%	10%	0%	1%	34%	3%	1%
Burbank	100%	25%	20%	7%	19%	3%	4%	2%	2%
Beverly Hills	100%	19%	17%	2%	0%	6%	18%	23%	1%
Glendale	100%	21%	19%	16%	26%	0%	3%	0%	3%
Long Beach	100%	17%	19%	12%	23%	0%	3%	3%	10%
Los Angeles	100%	15%	22%	8%	23%	0%	5%	14%	3%
Santa Ana	100%	34%	15%	14%	19%	1%	4%	6%	3%
Santa Monica	100%	14%	8%	3%	13%	10%	10%	9%	0%
San Diego	100%	32%	28%	12%	0%	1%	0%	3%	10%
San Jose	100%	28%	13%	8%	11%	2%	5%	6%	5%
West Hollywood	100%	25%	16%	6%	0%	6%	28%	4%	3%
All CA Cities	100%	29%	18%	11%	11%	7%	6%	6%	4%
All CA Cities except LA	100%	32%	17%	11%	8%	9%	7%	4%	5%

Source: California Controller, Cities Annual Report FY 2000-01

Table A-5: Prototype Business for Municipal Business Tax Comparison

	SALES	EMPLOYEES	PAYROLL
Retail	$ 2,473,917	13	$ 247,870
Professional	$ 1,072,274	10	$ 414,577
Manufacturing	$ 7,681,663	37	$ 1,330,747
Wholesale	$ 9,489,194	13	$ 516,502

Source: Economic Census, 1997 for Los Angeles County

Table A-6: Business Tax for Prototype Business by Municipality

	Retail	Wholesale	Manufacturing	Professionals
Anaheim	$ 235	$ 901	$ 730	$ 102
Burbank	121	122	219	155
Beverly Hills	3,092	11,861	9,602	10,750
Glendale	None	No Tax	No Tax	No tax
Long Beach	346	348	507	468
Los Angeles	3,661	11,197	9,065	6,337
San Jose	252	255	443	232
San Diego	189	190	308	34
Santa Ana	-	1,009	828	221
Santa Monica	3,092	11,861	9,602	5,136
West Hollywood	1,212	4,580	3,712	1,569

Source: Municipal Codes

Table A-7: Value-Added as % of Receipts by Industry

Industry	Value-Added
ALL CORPORATIONS	42%
Agriculture, forestry, fishing and hunting	49%
Mining	53%
Utilities	28%
Construction	36%
Building, developing, and general contracting	30%
Land subdivision and land development	42%
Building construction and general contracting	29%
Heavy construction	36%
Special trade contractors	44%
Plumbing, heating, and air-conditioning contractors	41%
Electrical contractors	41%
Other special trade contractors	45%
Manufacturing	39%
Food manufacturing	38%
Beverage and tobacco product manufacturing	61%
Textile mills and textile product mills	36%
Apparel manufacturing	39%
Leather and allied product manufacturing	43%
Wood product manufacturing	33%
Paper manufacturing	39%
Printing and related support activities	46%
Petroleum and coal products manufacturing	32%
Petroleum refineries (including integrated)	31%
Asphalt paving, roofing, other petroleum, and coal products	38%
Chemical manufacturing	48%
Plastics and rubber products manufacturing	38%
Nonmetallic mineral product manufacturing	42%
Primary metal manufacturing	29%
Fabricated metal product manufacturing	42%
Machinery manufacturing	41%
Computer and electronic product manufacturing	43%
Electrical equipment, appliance, and component manufg	46%
Transportation equipment manufacturing	30%
Motor vehicles and parts	29%
Aerospace product and parts	34%
Furniture and related product manufacturing	41%
Miscellaneous manufacturing	49%
Medical equipment and supplies	57%
Wholesale trade	20%
Wholesale trade, durable goods	23%
Motor vehicle and motor vehicle parts and supplies wholesalers	22%
Lumber and other construction materials wholesalers	22%
Professional and commercial equipment and supplies wholesalers	25%
Metal and mineral (except petroleum) wholesalers	14%
Electrical goods wholesalers	21%
Hardware, plumbing, and heating equipment and supplies wholesalers	27%
Machinery, equipment, and supplies wholesalers	24%
Furniture, sports, toys, recycle, jewelry, and other durables	25%
Wholesale trade, nondurable goods	17%
Paper and paper product wholesalers	21%
Drugs and druggists' sundries wholesalers	17%
Apparel, piece goods, and notions wholesalers	31%
Grocery and related product wholesalers	16%
Farm product raw material wholesalers	9%

Industry	Value-Added
Retail trade	26%
Motor vehicle dealers and parts dealers	15%
New and used car dealers	12%
Other motor vehicle and parts dealers	27%
Furniture and home furnishings stores	39%
Electronics and appliance stores	32%
Building material and garden equipment and supplies dealers	30%
Homes centers; paint and wallpaper stores	31%
Hardware stores	36%
Other building material dealers	26%
Lawn and garden equipment and supplies stores	31%
Food, beverage and liquor stores	27%
Food and beverage stores	27%
Beer, wine, and liquor stores	22%
Health and personal care stores	25%
Gasoline stations	15%
Clothing and clothing accessories stores	45%
Sporting goods, hobby, book, and music stores	38%
General merchandise stores	28%
Miscellaneous store retailers	36%
Nonstore retailers	34%
Transportation and warehousing	73%
Air, rail, and water transportation	76%
Truck transportation	72%
Transit and ground passenger transportation	75%
Warehousing and storage	74%
Information	75%
Publishing industries	76%
Newspaper publishers	76%
Periodical publishers	65%
Book publishers	71%
Database, directory, and other publishers	77%
Software publishers	83%
Motion picture and sound recording industries	62%
Motion picture and video industries (except video rental)	63%
Sound recording industries	55%
Broadcasting and telecommunications	77%
Radio and television, cable networks, and program distribution	76%
Telecommunications (including paging, cellular, satellite, and other telecommunicatio	77%
Information services and data processing services	76%
Finance and insurance	43%
Nondepository credit intermediation	87%
Securities, commodity contracts, and other financial investments and related activities	96%
Investment banking and securities dealing	97%
Securities brokerage	96%
Commodity contracts dealing and brokerage	59%
Securities and commodity exchanges and other financial investment activities	99%
Insurance carriers and related activities	31%
Insurance agencies and brokerages	77%
Other financial vehicles and other investment companies	98%
Real estate and rental and leasing	77%
Real estate	83%
Lessors of buildings	85%
Lessors of miniwarehouses, self-storage units, and other real estate	85%
Offices of real estate agents and brokers	77%

Industry	Value- Added
SERVICE SECTOR	77%
Professional, scientific, and technical services	76%
Legal services	96%
Accounting, tax preparation, bookkeeping, and payroll services	88%
Architectural, engineering, and related services	69%
Specialized design services	61%
Computer systems design and related services	77%
Management, scientific, and technical consulting services	78%
Scientific research and development services	73%
Advertising and related services	70%
Management of companies (holding companies)	94%
Administrative services	76%
Administrative and support services	75%
Employment services	72%
Travel arrangement and reservation services	63%
Waste management and remediation services	82%
Educational services	85%
Health care and social assistance	89%
Offices of health practitioners and outpatient care centers	90%
Offices of physicians	96%
Offices of dentists	97%
Offices of other health practitioners	87%
Outpatient care centers	60%
Misc. health care and social assistance	81%
Hospitals, nursing, and residential care facilities	92%
Arts, entertainment, and recreation	81%
Accommodation and food services	64%
Accommodation	65%
Food services and drinking places	63%
Other services	67%
Repair and maintenance	59%
Automotive repair and maintenance	59%
Other repair and maintenance	58%
Personal and laundry services	76%
Religious, grantmaking, civic, professional, and similar organizations	78%

Source: U.S. Internal Revenue Service, 2000 Returns of Active Corporations