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Date: April 25, 2017

To: Members, Senate Governance and Finance Committee

From: Peter Blocker, Legislative Advocate

Subject: OPPOSITION to SB 567 (Lara), as introduced on February 17, 2017

The above-listed organizations are in opposition to SB 567, a tax increase that would take California out of conformity with federal tax law, raise the charitable remainder for trusts, and make foreign earned income includable in income apportioned to California for corporate tax purposes by eliminating the Water's Edge Election for California taxpayers. For more information on the Water's Edge Election, please see the attached [fact sheet](#). We are opposed to this bill for the following reasons:

Timing. Now is not the time for the state to make significant changes to the state's tax system, while Congress is debating a federal tax reform package that will have significant impacts on the way California administers its tax system and how taxpayers comply with it. California should take a cautious approach, and wait until federal tax reform is enacted before making changes to its own tax system. State Controller Betty Yee recently echoed the call for the Legislature to hold, so that the state can take a more informed approach when addressing the state's tax code.

Double Taxation. The elimination of the Water's Edge Election would inappropriately expand the scope of California's taxing jurisdiction outside the United States and make income earned

in other countries taxable in California. Our international trading partners believe this would impose a significant level of double taxation on taxpayers doing business in California. This is a major departure from the tax practices of competing states and those promoted by the United States to our foreign trading partners – no other state mandates worldwide combined reporting. This significant tax increase would discourage investment and economic activity in California.

Adversely Impacts Foreign Relations. In an attempt to target taxpayers that do business abroad, this bill threatens to undermine foreign relations. Our trading partners view worldwide combination as taxation beyond our borders, and they could retaliate against California businesses operating abroad should we erode the Water's Edge Election. This bill runs contrary to the intent of the Water's Edge Election, which is to ensure that corporations are taxed based on operations within the water's edge of the United States. The Water's Edge Election was enacted in part to avoid threatened retaliation from several foreign countries as a result of California's imposition of the worldwide combination method.

Prior to the adoption of the Water's Edge Election in state law in 1986, the Franchise Tax Board used the worldwide combination method for taxation of unitary groups, requiring foreign affiliates to be included in the unitary group's combined report. Significant objection to worldwide combination came from many of our trading partners, in particular Britain and Japan. Our federal government maintains treaties with the international community to maintain equitable trade policies that do not result in double taxation on our foreign trading partners.

Compliance Issues. Multinational taxpayers doing business in California have affiliated entities spanning the globe, so this change in law would require the Franchise Tax Board to audit overseas records. When California's tax formula applies to income and activities in other countries, gross distortions are created through wide ranges of wage rates and labor productivity, and substantial differences in business costs (e.g., plant, equipment, inventory and other property). In addition, there are differing risk factors, rates of return, and sales practices. Also, businesses in other countries have different bookkeeping, incentives, and fringe benefits (such as lifetime employment). Further, currency fluctuations and currency restrictions create problems in translating income for inclusion in a California tax return. To translate foreign currencies to the dollar, what exchange rate will be used? The result will be different at different times of the year.

Breaks Conformity With Federal Tax Laws. Practices prohibited by this bill will continue to be allowed under federal law, thus creating state and federal differences. SB 567 would de-conform California from federal law by disallowing a corporate income tax deduction for performance pay in excess of \$1 million to a publicly traded company's top five highest paid executives. The bill also de-conforms from federal law by requiring taxpayers who earn in excess of \$1 million to pay capital gains tax on the appreciation of inherited property. Tax conformity helps improve California's business tax climate and simplifies tax compliance, both for taxpayers and state government.

Retroactive. Two provisions of this legislation – the elimination of the Water's Edge Election and the elimination of the deduction for executive performance pay – have retroactive operative dates. Taxes with retroactive operative dates run contrary to the principles of good tax policy because they make it impossible for taxpayers to properly plan to ensure they have the ability to pay.

For the foregoing reasons, the organizations listed below must oppose this legislation.

California Taxpayers Association
Advanced Medical Technology Association, AdvaMed
Air Logistics Corporation

Association of California Life & Health Insurance Companies (ACLHIC)
Biocom
Biotechnology Innovation Organization
California Bankers Association
California Business Properties Association
California Life Sciences Association
California Manufacturers & Technology Association
California Tank Lines, Inc.
Chemical Transfer, Co.
CompTIA
Contra Costa Taxpayers' Association
Council on State Taxation
Distilled Spirits Council
Family Business Association of California
Kern County Taxpayers Association
National Federation of Independent Business
Orange County Business Council
Orange County Taxpayers Association
Organization for International Investment
San Gabriel Valley Economic Partnership
Securities Industry and Financial Markets Association
Solano County Taxpayers Association (SCTA)
Superior Tank Wash, Inc.
West Coast Leasing, LLC
Western States Petroleum Association

cc: The Honorable Ricardo Lara, California State Senate