

*'Open for Business' Updated:
Los Angeles Pioneers Local Tax
Reforms in a Challenging
Economic Environment*



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Business Privilege and License Taxes

In their March 2012 article “Open for Business: Los Angeles Pioneers Local Tax Reforms in a Challenging Economic Environment,” authors Susan Ferlianto and Patrick Kennedy, of Deloitte Tax LLP, recounted the history of the Los Angeles Business Tax (LABT) as a framework for considering the City’s tax reform efforts. The authors have updated their article, which we republish below, to address new developments in the City’s rejuvenated efforts to reform the LABT.

‘Open for Business’ Updated: Los Angeles Pioneers Local Tax Reforms in a Challenging Economic Environment

BY SUSAN FERLIANTO AND PATRICK KENNEDY

In recent months, multiple cries to “Axe the tax!” have been heard in the Los Angeles business community.¹ The City of Los Angeles (the “City” or “Los Angeles”), the second largest city in the United States,² imposes the Los Angeles Business Tax (“LABT”), a gross-receipts-based tax on persons and business entities doing business within the City. A movement to completely eliminate the tax, and not just reduce or

modify it, has received a surprisingly large amount of support—not only from the taxpayers, but also from politicians and members of the local government, whose budgets rely on the revenue generated by this tax. This article seeks to present both the history and current developments concerning the LABT, including the past and present tax reform efforts of the City Council, the Mayor’s office, BTAC I, and BTAC II, as a framework for considering future tax reform efforts.

Introduction to Reform

Taxpayers and city politicians in Los Angeles frequently discuss the need for tax reform. Criticisms levied against the LABT include that it:

- is unwieldy in that it contains a confusing range of business classifications,
- contains inequities in its tax rates and sourcing rules, and
- is plagued by inefficient and inconsistent administration.

Such issues can cause uneasiness among taxpayers who crave certainty and consistency in their tax liabilities. Many of the more frequently cited issues with the tax stem from the City’s archaic municipal code provisions, sections of which date back to the 1930s, which do not take into consideration drastic changes in the City’s economic footprint. In the most extreme cases, businesses have moved out of Los Angeles in search of lower tax jurisdictions such as Glendale and other

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² “Largest” city determined by population, per 2010 national census data. POPULATION DISTRIBUTION AND CHANGE: 2000 TO 2010, March 2011, <http://www.census.gov/prod/cen2010/briefs/c2010br-01.pdf> (last visited Jan. 6, 2012).

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neighboring cities in Los Angeles County. These businesses often cite the LABT as an influential factor in choosing to leave Los Angeles. For companies that choose to remain in the City, the LABT continues to be an important business consideration.

Through the years, taxpayer frustration with the LABT and its effect on the local economy has not gone unnoticed by local lawmakers and politicians. The past decade has seen significant reform efforts. In 2000, the first Business Tax Advisory Committee (“BTAC I”) was convened at the request of the Los Angeles City Council. BTAC I was charged with providing specific tax reform recommendations to the City Council, with the goal of modifying the LABT to make it more taxpayer friendly. BTAC I’s term expired in 2004, but in 2010 the Committee was reconvened (“BTAC II”).

Over the last two years, BTAC II has pursued reforms to bring equity and parity to the LABT in an effort to stimulate growth and increase Los Angeles’ competitiveness among other municipalities on a state-wide and nation-wide scale. One of the latest proposals from BTAC II to the City Council has called for a complete elimination of the LABT, leading to cries to “Axe the tax!” by many in the Los Angeles community.

History of Los Angeles Taxes

The LABT was first codified in the 1930s and remained substantially unchanged for decades. The tax was implemented to raise revenue for Los Angeles by requiring businesses to register and obtain licenses to conduct business within the City. The resulting business license tax was based on a taxpayer’s gross receipts, which were originally required to be reported on an accrual basis. While Los Angeles was one of the first cities in California to codify a local tax on business activity, most California cities have followed suit and currently impose some type of business tax or license fee on businesses operating within their jurisdictions. Los Angeles and other California municipalities adopted non-income based tax structures (like the gross receipts tax) because of limitations to imposing an income tax under the U.S. Constitution³ and the California Constitution.⁴ California municipalities are also prohibited by state law from implementing an income tax on any per-

³ In *General Motors v. City of Los Angeles*, the court noted that the validity of local taxing schemes is tested under the same principles that must apply to state taxes. *General Motors v. City of Los Angeles*, 35 Cal. App. 4th 1736, 1742 (Cal. Ct. App. 1995). These principles, stemming from the Commerce Clause of the U.S. Constitution, are that:

“the tax [1] is applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the state.’ If a local taxing scheme fails any one of the four requirements to comply with the commerce clause, we are required to invalidate it.” *Id.* (citing *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

⁴ “In spite of the absence of a specific ‘commerce clause’ in our state Constitution, other provisions in that Constitution — notably those provisions forbidding extraterritorial application of laws and guaranteeing equal protection of the laws. . . — combine with the *equal protection clause of the federal Constitution* to proscribe local taxes which operate to unfairly discriminate against intercity businesses by subjecting such businesses to a measure of taxation which is not fairly apportioned to the quantum of business actually done in the taxing jurisdic-

tion.”⁵ The same statute, however, explicitly authorizes business license taxes measured by gross receipts.⁶

While the LABT was developing in Los Angeles, between 1968 and 1970, San Francisco also instituted a gross-receipts-based tax. San Francisco, however, simultaneously imposed a payroll expense tax.⁷ Under this two-pronged methodology, taxpayers calculated their tax due on both a payroll expense and a gross receipts basis and paid tax on the higher of the two amounts.⁸ Following San Francisco’s example, and in an attempt to include certain taxpayers that were exempt from the gross receipts tax, in 1984 Los Angeles also adopted a payroll tax component to supplement its existing gross receipts tax.⁹ Rather than requiring payment of the higher of the two taxes, the new Los Angeles payroll tax provisions granted an exemption to businesses already paying the gross receipts tax at the time the payroll tax was implemented.¹⁰

The constitutionality of both municipalities’ tax schemes was eventually called into question. Both cities’ tax schemes were challenged in court and found to violate the Commerce Clause of the U.S. Constitution and the California Constitution.¹¹ In *Union Oil Co. v. City of Los Angeles*, the taxpayer sought a refund of business taxes paid to Los Angeles on petroleum products manufactured in the city and sold outside the city.¹² The court held that the combination of the payroll expense tax and the gross receipts tax “directly discriminates against interstate and intercity taxpayers doing business in the City.”¹³ Under the dual tax structure, Los Angeles-based businesses paying the payroll

tion.” *Id.* (citing *General Motors v. City of Los Angeles*, (1971) 5 Cal. 3d 229, 238 (Cal. Ct. App. 1995)).

⁵ “Notwithstanding any statute, ordinance, regulation, rule or decision to the contrary, no city, county, city and county, governmental subdivision, district, public and quasi-public corporation, municipal corporation, whether incorporated or not or whether chartered or not, shall levy or collect or cause to be levied or collected any tax upon the income, or any part thereof, of any person, resident or nonresident. This 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.” CAL. REV. & TAX. CODE § 17041.5.

⁶ *Id.*

⁷ S.F., CAL., BUS. TAX & REG. CODE art.12-B, §§1001-1009.5 (repealed 2001); S.F., CAL., BUS. TAX & REG. CODE art. 12-A (1970).

⁸ See *Macy’s Dep. Stores Inc. v. City and County of San Francisco*, 143 Cal. App. 4th 1444, 1447 (Cal. Ct. App. 2006) (citing S.F. MUN. CODE, pt. III, former arts. 12-A & 12-B).

⁹ *Union Oil Co. of Cal. v. City of Los Angeles*, 79 Cal. App. 4th 383, 386 (Cal. Ct. App. 2000) (citing L.A., CAL., MUN. CODE art. 1.11 §§21.11.1-21.11.7 (repealed 2001)).

¹⁰ The intent of the payroll expense tax was to tax businesses otherwise exempt from the existing gross receipts tax including the liquor industry, railroads, air freight carriers, steamboats, telegraph, and electric companies. *Union Oil Co. of Cal. v. City of Los Angeles*, 79 Cal. App. 4th at 387. (citing a November 1983 Majority Report of the Finance and Revenue Committee to the Los Angeles City Council).

¹¹ See *Macy’s Dep. Stores Inc. v. City and County of San Francisco*, 143 Cal. App. 4th 1444 (Cal. Ct. App. 2006) (challenging San Francisco’s tandem payroll expense and gross receipts tax scheme); *Union Oil Co. of Cal. v. City of Los Angeles*, 79 Cal. App. 4th 383 (Cal. Ct. App. 2000) (challenging Los Angeles payroll expenses and gross receipts tax scheme).

¹² *Union Oil* at 386.

¹³ *Id.* at 388.

tax were exempt from the gross receipts tax. However, businesses located outside the City and doing business in Los Angeles were subject to the gross receipts tax. This created a discriminatory situation whereby two businesses performing the same activities in Los Angeles were not subject to the same tax due to their location inside or outside the City.¹⁴

Taxpayers are frequently unaware of their reporting obligation until after receiving a notice of delinquency.

The court further found that the dual tax scheme also failed the internal consistency test—the federal doctrine that requires a court to test the validity of a tax structure by assuming that all jurisdictions impose the tax structure under review.¹⁵ The tandem tax structure fails the internal consistency test because taxpayers are given a competitive advantage in their home market, where they are only subject to one of the taxes.¹⁶ However, taxpayers selling into another jurisdiction would be subject to the payroll tax in their home jurisdiction and the gross receipts tax in the other jurisdiction. The result inequitably levies a gross receipts tax on out-of-city taxpayers selling into the City, but not on in-city taxpayers, who are only subject to the payroll tax.¹⁷

San Francisco was faced with a similar challenge in *Macy's v. San Francisco*. In *Macy's*, the taxpayer challenged the validity of the City's dual payroll and gross receipts tax structure.¹⁸ As in *Union Oil*, the trial court determined that San Francisco's tax structure failed the internal consistency test and was unconstitutional.

In the face of these constitutional challenges, both San Francisco and Los Angeles were forced to choose between a gross receipts tax and a payroll expense tax. In 2001, both cities passed local ordinances limiting tax imposition to that of either a payroll or a gross receipts tax. San Francisco chose to keep its payroll tax and repealed its gross receipts tax retroactively, effective Jan. 1, 2000.¹⁹ Alternatively, Los Angeles chose to keep its gross receipts tax and repealed its payroll expense tax effective in 2002.²⁰

The surviving Los Angeles gross receipts tax (otherwise known as the LABT) is levied on the gross receipts of most businesses in the City — that is, anyone “engaged in business” within the statutory definition and not specifically exempted.²¹ The Los Angeles Municipal Code (the “Code” or “L.A.M.C.”) includes within the definition of doing business:

- maintaining a fixed place of business within the City;

- owning or leasing real property within the City for business purposes;
- maintaining inventory in the City for sale;
- regularly soliciting business within the City;
- performing work on a regular basis within the City for at least seven days per year; and
- operating a motor vehicle on City streets for business purposes.²²

As evidenced by the activities included within the definition, the Code broadly interprets who is doing business in the City for purposes of the tax. A physical location within the City is not required, as the tax is imposed on anyone performing regular business activities within the City. Additionally, the boundaries of the City extend beyond what is traditionally considered a “Los Angeles” address. Thus, businesses in unincorporated communities within the boundaries of Los Angeles (e.g., communities such as San Pedro, Hollywood, Studio City, Sherman Oaks and parts of Torrance) are subject to the tax. Conversely, cities within Los Angeles County such as Pasadena, Santa Monica, and Culver City, are examples of separately incorporated cities, many of which impose their own tax on local businesses. Businesses operating exclusively within these separately incorporated cities are not subject to the LABT.

As a result of this uncertainty, taxpayers are frequently unaware of their tax reporting obligation until they receive a notice of delinquency or upcoming audit from the City. Historically, the City posted a list identifying the zip codes and partial zip codes within Los Angeles's boundaries where a business might be subject to the tax. Often this method was unclear and required taxpayers to do additional research to determine if they were located or doing business in the City. In late 2011, the City helped streamline the process by placing an address finder on the front page of the Office of Finance's website, making it relatively simple to determine whether taxpayers are located or doing business within the City's boundaries.²³

Early Tax Reform Efforts (1993-1999)

In 1993, Richard Riordan was elected mayor of Los Angeles. As a former member of the business community, one of his primary goals while in office was to create a more business-friendly environment in Los Angeles. Mayor Riordan's efforts commenced with a multi-year Los Angeles Tax Equity Study. During 1996 and 1997 several published reports examined different aspects of the City's economic climate and tax system, including comparisons of taxes and fees across residents and businesses, Los Angeles business migration and growth, surveys of Los Angeles' position relative to competitor cities across the nation, and various tax policy models and revenue scenarios. The study period culminated in 1998 with Mayor Riordan's Business Tax Reform Proposal (the “1998 Proposal”). The 1998 Proposal identified Los Angeles' tax system as overly confusing, uncertain, costly, and a major hindrance to the attraction of new businesses, expansion of existing

¹⁴ *Id.* at 389.

¹⁵ *Id.*

¹⁶ *Id.* at 390.

¹⁷ *Id.*

¹⁸ *Macy's*, *supra* note 11.

¹⁹ S.F., Cal., Ordinance 63-01 (Apr. 25, 2001).

²⁰ L.A., Cal., Ordinance 174272 (Oct. 22, 2001).

²¹ “‘Engaged in Business’ shall mean the conducting, operating, managing or carrying on of a business, whether done as owner, or by means of an officer, agent, manager, or employee.” L.A., CAL., MUN.CODE §21.00(i).

²² See L.A., CAL., MUN. CODE §21.00(i)(1)-(6).

²³ This address finder is located on the front page of the Office of Finance website. See *Address Finder*, City of Los Angeles Office of Finance, <http://finance.lacity.org> (last visited Nov. 27, 2011).

businesses, and overall creation of jobs.²⁴ The 1998 Proposal sought to create a simplified, more competitive tax system that would recapture lost revenue through greater internal efficiency and increased taxpayer compliance. The highlights of Mayor Riordan's 1998 Proposal included a one-year business tax exemption for newly established businesses, an exemption for small businesses earning less than \$5,000 in gross receipts, a transition from calendar year to fiscal year filing, an exemption for inter-company transactions, and a comprehensive overhaul of the LABT's classification system.²⁵

Taxpayers were expected to track and pay tax on each receipts-generating activity separately, by location.

Mayor Riordan's proposal to overhaul the tax classification system was a pivotal step needed to simplify the tax. Under the existing structure, the tax was imposed on each type of business activity performed at each location.²⁶ As such, taxpayers were expected to track and pay tax on each receipts-generating activity separately, by location. Further, the applicable tax rate for each business activity varied. When Mayor Riordan took office, the Code divided activities into sixty-four different "Fund Classes" (i.e., "business activities").²⁷ Each of the Fund Classes had varying rules for calculating the tax base, the rate to be applied, and apportioning in-city and out-of-city receipts.²⁸ With so many different sets of rules, it was difficult for taxpayers to properly comply with the tax. Many taxpayers struggled to accurately classify their business activities, properly calculate in-city taxable receipts, and apply the applicable tax rate. Often taxpayers had no certainty that they had been filing properly until audited.

When Mayor Riordan came to office, the rates ranged from \$1.18 to \$5.91 per \$1,000 in gross receipts.²⁹ Given that each business activity classification had a tax rate associated with it, misclassification of a taxpayer's receipts could result in a drastically different amount of tax due. Furthermore, a taxpayer doing business in the City could easily be subject to a number of different tax classifications due to various business activities performed in the City and would have to classify and pay tax on each different revenue stream. A 2004 study on the gross receipts tax determined that certain businesses were subject to as many as eight different tax classifications in any given reporting year.³⁰

Mayor Riordan's proposal sought to replace the Fund Class system with a classification system based on a business's Standard Industrial Classification (now known as a NAICS Code), as reported on the taxpayer's federal income tax return filed with the Internal Revenue Service.³¹ Under this method, the uncertainty and confusion caused by multiple tax classifications and tax rates would be eliminated and each taxpayer would be subject to a single rate based on the corresponding federal business classification.³²

Despite the City Council's approval of the general concept behind Mayor Riordan's proposals (including simplification of the Fund Class system), many of the details of his comprehensive reform were never enacted.³³ However, three significant parts of the proposal were passed by the City Council in 1999.³⁴ First, newly established start-up businesses were exempted from paying tax on the first \$500,000 of taxable gross receipts during their first year of operations.³⁵ Second, small businesses with less than \$5,000 in total gross receipts (including both taxable and non-taxable, within and outside the City) were specifically exempted from the LABT.³⁶ Third, businesses were given the option to elect to file their LABT renewals on a fiscal year basis rather than a calendar year basis.³⁷ This fiscal year filing election is permanent and cannot be changed unless the taxpayer's fiscal year changes or a waiver is received from the Director of Finance. The fiscal year filing election continues to provide flexibility in filing periods for taxpayers. The new business and small business exemptions have also had long-lasting impact and continue to be important economic stimulants that have been expanded by subsequent reform efforts.

In 2005, the threshold for exempting a small business from the tax was increased from \$5,000 to \$50,000 of total annual gross receipts.³⁸ The exemption was doubled to \$100,000 in 2006.³⁹ Additionally, a special exemption was enacted for gross receipts attributable to "Creative Activities" engaged in by individuals earning less than \$300,000 annually.⁴⁰ This exemption targeted actors, directors, artists, authors, and other creative professions that are pursued in Los Angeles. The exemption for new businesses has also proved to be an important tax reform measure. In 2003, the exemption was expanded to apply not only to the first year of op-

³¹ RIORDAN, *supra* note 24, at 34.

³² The proposal assigned each of the numerous federal classifications to one of eight different rate classes ranging from \$1.20 per \$1,000 to \$5.40 per \$1,000 in gross receipts. RIORDAN, *supra* note 24, at 34-41.

³³ The city's Ad Hoc Committee on Tax Reform approved and referred to City Council several alternate overhauls of the tax classification system. However, they were never approved by City Council. OFFICE OF THE CITY CLERK, CITY OF LOS ANGELES, LOS ANGELES BUSINESS TAX REFORM, COUNCIL FILE 98-2358, <http://cityclerk.lacity.org/lacityclerkconnect/index.cfm?fa=ccfi.viewrecord&cfnumber=98-2358> (last visited Nov. 28, 2011).

³⁴ L.A., CAL., Ordinance 172820 (Sept. 16, 1999).

³⁵ *Id.* at Sec. 4.

³⁶ *Id.* at Sec. 3.

³⁷ *Id.* at Sec. 2.

³⁸ L.A., CAL., MUN. CODE §21.29(a).

³⁹ *Id.*

⁴⁰ This exemption applies to individuals doing business as sole proprietors as well as corporations so long as they consist of a single shareholder and a single employee as single member limited liability companies. L.A., CAL., MUN. CODE §21.29(b).

²⁴ RICHARD J. RIORDAN, MAYOR OF LOS ANGELES, BUSINESS TAX REFORM PROPOSAL 12-13 (1998).

²⁵ *Id.* at 5-6.

²⁶ L.A., CAL., MUN. CODE §21.06(a).

²⁷ L.A., CAL., MUN. CODE §§21.41-21.49.

²⁸ MBIA MUNISERVICES COMPANY, EVALUATION OF ALTERNATIVES TO THE CITY'S GROSS RECEIPTS BUSINESS TAX 9 (2004).

²⁹ RIORDAN, *supra* note 24. Today, the tax rates range from \$1.01 to \$5.07. See *City of Los Angeles Business Tax Rate Table for 2009-2011*, City of Los Angeles Office of Finance, http://finance.lacity.org/form/TaxRateTable_2011.pdf (last visited Nov. 28, 2011).

³⁰ MBIA MUNISERVICES COMPANY, *supra* note 28.

erations, but to the first two years of operations for businesses generating less than \$500,000 in gross receipts annually. In 2010, the exemption was further expanded to cover all receipts generated during the first three years of operations for businesses that commence operations between Jan. 1, 2010 and Dec. 31, 2012.⁴¹ On Oct. 5, 2012, Mayor Villaraigosa signed a law extending the three-year exemption, making it applicable to new businesses commencing operations on or before Dec. 31, 2015.⁴² The City Council's motion approving this extension indicates that additional extensions beyond 2015 may follow, but not without evidence that the new business tax holiday is having an effect on economic growth in Los Angeles commensurate with the amount of foregone business tax revenues.⁴³ Policies such as these are apparently directed at continued business tax reform in a manner that promotes growth and stability in the City's economy.

Mayor Villaraigosa has signed a new law extending the LABT exemption for new businesses.

In addition to small and new business exemptions, Mayor Riordan focused on business tax relief based on a taxpayer's location within the City. First, Empowerment Zones were created in which taxpayers received an exemption on their first \$500 in business tax liability after payment of the \$25 minimum tax for a period of five years.⁴⁴ Second, entertainment and multimedia businesses located in the zones known as the Hollywood Redevelopment Area and North Hollywood Redevelopment Area received relief in the form of a "cap" on maximum tax liability.⁴⁵ Business tax liability was limited to \$25,000, plus 10 percent of the amount of tax in excess of \$25,000.⁴⁶ The Empowerment Zones expired as of 2009, but the relief for multimedia businesses in the Hollywood and North Hollywood Redevelopment Areas is ongoing.

Although Mayor Riordan never received the support from the City Council in his efforts to drastically overhaul the LABT, the piecemeal reforms that originated with Mayor Riordan's efforts, such as the new and small

⁴¹ L.A., CAL., MUN. CODE §21.30.

⁴² Report RE: Draft Ordinance to Amend Los Angeles Municipal Code Section 21.30(a) to Extend the New Business Exemption From Business Taxes, Los Angeles City Attorney, (March 20, 2012)(Council File 12-0402) available at <http://cityclerk.lacity.org/lacityclerkconnect/index.cfm?fa=ccfi.viewrecord&cfnumber=12-0402> (last visited Oct. 10, 2012); *Mayor Extends Tax Holiday to Draw New Businesses to LA*, CBS LOS ANGELES, Oct. 5, 2010, <http://losangeles.cbslocal.com/2012/10/05/mayor-extends-tax-holiday-to-draw-new-businesses-to-la/> (last visited Oct. 10, 2012).

⁴³ Motion, Item No. 30, Council File No. 12-0402 (Sept. 28, 2012) <http://cityclerk.lacity.org/lacityclerkconnect/index.cfm?fa=ccfi.viewrecord&cfnumber=12-0402> (last visited Oct. 10, 2012).

⁴⁴ L.A., CAL., MUN. CODE §21.26.

⁴⁵ This tax relief applies to businesses that generate more than 50 percent of their gross receipts from entertainment and/or multimedia business activities. L.A., CAL., MUN. CODE §21.27(a)-(e).

⁴⁶ L.A., CAL., MUN. CODE §21.27(a).

business exemptions, proved to be long-lasting and important first steps to a more business-friendly tax environment. Most importantly, Mayor Riordan's proposal focused a lens on the LABT that would spur future reform efforts by the City and future elected officials.

The Era of BTAC I (1999-2004)

At the request of the City Council, BTAC I was established in 1999.⁴⁷ This committee, comprised of civic-minded citizens with a variety of backgrounds from the business community, was appointed by the City Council to follow Mayor Riordan's example and further examine tax reform in Los Angeles. Ultimately, BTAC I was expected to make recommendations to the City Council. In partial fulfillment of this expectation, one year later, in November 2000, BTAC I produced its "Blueprint for Reform."⁴⁸ The *Blueprint for Reform* summarized the current state of the LABT, including previous reforms, flaws in the system, and targeted areas for improvement. From this study, BTAC I made specific recommendations to the Mayor and City Council regarding much needed tax reform measures.

BTAC I's Blueprint for Reform (2000)

The *Blueprint for Reform* report produced by BTAC I identified several key deficiencies within the LABT. Most significantly, the report noted that many problems with the tax stem from the fact that it is levied on the gross receipts of a business rather than net income, like many state taxes. Gross receipts-based taxes do not take into account a taxpayer's ability to pay. In that sense, the report rightly calls the gross receipts tax a "blunt instrument" when compared to an income tax.⁴⁹ However, because California municipalities are statutorily restricted from imposing an income tax,⁵⁰ it is necessary for the City to attempt to achieve the same effect (i.e., imposing a tax that takes into account taxpayer ability to pay) by using varying tax rates and classifications. The variety of rates attempts to approximate a given taxpayer's ability to pay, as high-margin business activities are taxed at higher rates than low-margin activities.⁵¹ Recognizing the inherent difficulty in tailoring a gross receipts tax to the needs of a diverse group of taxpayers and business activities, BTAC I noted that the LABT must be "structured as soundly as possible" because this taxing structure is the only one available to the City by law.⁵²

With the inherent limitations of the tax in mind, the *Blueprint for Reform* identified the following five specific flaws in the current LABT system, which it believed to be hindering economic growth in Los Angeles and promoting rampant non-compliance:

- The Tax and Permit Division has been chronically underfunded and unsupported. It is relatively easy to duck the tax.

⁴⁷ "The BTAC was created out of the ashes of the most recent effort to reform the Business Tax, in March 1999." Los Angeles Business Tax Advisory Committee, *Blueprint for Reform: Report of the City of Los Angeles Business Tax Advisory Committee*, 1 (2000).

⁴⁸ *Id.*

⁴⁹ *Id.* at 2.

⁵⁰ See *Cal. Rev. & Tax. Code* §17041.5, *supra* note 5.

⁵¹ Los Angeles Business Tax Advisory Committee, *Blueprint for Reform* *supra* note 47, at 2.

⁵² *Id.*

■ Complying with the tax rules is unduly complex and expensive. Even good citizens are exasperated.

■ Business tax has significant, unfair double-tax provisions. Many tax professionals feel justified in ignoring some of these provisions.

■ Effective tax rates are too high relative to neighboring cities, and they are insensitive to economic and job development needs.

■ The appeals system for assessments and refund claims is archaic, impenetrable, and understaffed. Millions of collectible dollars fall through the cracks.⁵³

In response to each of the five flaws identified in the *Blueprint for Reform*, BTAC I recommended actions needed to explore and develop potential solutions for presentation to the Mayor and City Council. Among the recommendations set forth in the *Blueprint for Reform* were the following:

■ increasing funding and support to the City's compliance departments and streamlining the compliance system,⁵⁴

■ providing an election for one-category filing;⁵⁵

■ eliminating certain intercompany transfers and pass-through income from the gross receipts base;⁵⁶

■ re-examining and re-aligning tax rates and tax classifications to maximize both economic and revenue growth;⁵⁷

■ implementing a new appeals and dispute resolution system and an impartial settlement bureau;⁵⁸ and

■ developing an amnesty program.⁵⁹

The report also stressed the importance of revenue neutral reform.⁶⁰ At the time of these recommendations, revenue generated by the LABT for the City accounted for approximately 16 percent of the City's annual budget.⁶¹ With this in mind, BTAC I noted the importance of increasing compliance as a means of broadening the tax base. By broadening the base through increased compliance, lower tax rates could provide relief to taxpayers, without reducing the overall amount contributed to the City's budget each year. However, the report did state that to the extent revenue neutrality was not possible, reform should take precedence so that progress with the tax reform efforts could continue to make headway.⁶²

Over the next four years, BTAC I members met and continued to explore tax reform and refine the proposals outlined in the *Blueprint for Reform*. Many of the administrative reforms proposed in BTAC I's blueprint were enacted by the City Council, including an expedited appeals process,⁶³ an amnesty program,⁶⁴ the establishment of a Settlement Bureau in the City Attorney's Office,⁶⁵ and the exemption of certain inter-

company transactions from the gross receipts base of the tax.⁶⁶

In January 2004, another report, *Evaluation of Alternatives to the City's Gross Receipts Business Tax*, was commissioned by BTAC I. The report examined the LABT and various potential alternatives to the current gross receipts tax structure.⁶⁷ The report provided an in-depth analysis of the tax, compared it with the taxes imposed by neighboring municipalities, and evaluated the strengths and weaknesses of various alternatives to the current tax structure. The report concluded that the best alternative to the current system was a combination of a net receipts tax and a square footage tax.⁶⁸ However, little appetite existed for such sweeping reforms.

Additional Proposals for Tax Reform Under BTAC I (2004)

Between 1999 and 2004, reforms enacted based upon BTAC I's recommendations had already produced \$18 million in annual tax reductions to Los Angeles businesses.⁶⁹ In 2004, two comprehensive tax reform proposals were considered—the Greuel-Garcetti proposal (named after the sponsoring City Council members) and the BTAC I proposal. Both proposals shared eight common reforms:

■ across-the-board rate relief;

■ small business exemption for gross receipts of less than \$100,000;

■ the \$300,000 "Creative Artists" exemption;

■ rate reduction specifically for small and medium-sized motion picture producers

■ exclusion of bad debts from the tax base;

■ penalty reductions for late-filers from 40 to 25 percent;

■ compliance-related reporting requirements that landlords identify their commercial tenants and all businesses identify their subcontractors;

■ enhanced resources for business tax discovery and tax collection activities within the Office of Finance.⁷⁰

The Greuel-Garcetti proposal also recommended greater rate reductions, certain rate reclassifications, and green energy incentives. BTAC I's proposal included comprehensive reform of the tax classifications. At the time of BTAC I's proposal, there were 45 fund classes based on gross receipts and 30 fund classes based on other methodologies.⁷¹ The BTAC I proposal sought to consolidate the entire business tax structure into seven categories, plus a special category for Motion Picture Productions, which are taxed based on production costs. Further, BTAC I proposed that the threshold at which production companies were required to pay more than the minimum tax of \$145 on their production costs be raised from \$50,000 to \$2.5 million.⁷² Finally, BTAC I proposed rate reductions that would be offset

⁵³ *Id.*

⁵⁴ *Id.* at 3-4.

⁵⁵ *Id.* at 5.

⁵⁶ *Id.* at 5-7.

⁵⁷ *Id.* at 7.

⁵⁸ *Id.* at 8.

⁵⁹ *Id.* at 4.

⁶⁰ *Id.* at 2.

⁶¹ At the time (November 2000), business tax receipts were approximately \$300 million of the City's total annual revenue of \$1.8 billion. *Id.*

⁶² "If we must we will defer our revenue enhancement efforts and proceed with reform alone." *Id.*

⁶³ L.A., CAL., MUN. CODE §§21.16(d)-(k).

⁶⁴ L.A., CAL., MUN. CODE §§21.12.1 et. seq.

⁶⁵ L.A., CAL., MUN. CODE §21.31.

⁶⁶ L.A., CAL., MUN. CODE §21.00(a)(5).

⁶⁷ See *MBIA Muniservices Company*, *supra* note 28.

⁶⁸ *Id.* at 17-19.

⁶⁹ William T. Fujioka, City Administrative Officer & Ron F. Deaton, Chief Legislative Analyst, Business Tax Reform Proposals (Oct. 27, 2004).

⁷⁰ *Id.*

⁷¹ *Id.* at 3.

⁷² *Id.* See also L.A., CAL., MUN. CODE §21.109(c).

by several revenue-generating proposals, many of which relied upon increased efforts to discover non-compliant businesses and an increase in the number of and comprehensiveness of LABT audits.

The Conclusion of BTAC I (2004)

In November 2004, the Mayor and City Council adopted a number of the reforms set forth in the BTAC I and Greuel-Garcetti proposals, including the new business exemption, the small business exemption, and the “Creative Artists” exemption. The City Council also adopted the Fund Class reforms proposed by BTAC I, consolidating similar business activities into a mere nine Fund Classes.⁷³ Additionally, a rate reduction plan was established that provided for up to a 15 percent reduction in tax rates over five years.⁷⁴ Taxpayers were also given the option to report on either an accrual or cash basis, where previously accrual basis reporting was required.⁷⁵ Viewed as a whole, this decade-long reform process produced significant improvements to the LABT and contributed significantly to reform.

During this period, entrepreneurship was encouraged and small businesses were incentivized to grow untaxed due to the reforms that were implemented. The entertainment industry in Los Angeles was bolstered by the “Creative Artists” exemption and accommodations to the motion picture, television, and radio production companies. The tax classification structure underwent drastic simplification—paring down several dozen different Fund Classes to the nine currently in use.⁷⁶ Additionally, compliance efforts were bolstered through additional funding and improvements were made in the efficiency of the audit and appeals processes. Overall, the reforms enacted during this period reduced the average tax paid by local businesses by 11 percent and completely exempted 60 percent of small businesses from the tax.⁷⁷

Tensions Increase Between Businesses And the City Over the LABT (2005-2009)

The nation-wide economic downturn, which began in 2007, greatly affected Los Angeles and the City faced a significant budget deficit. To shore-up budget shortfalls, the City looked to business tax revenue collections, including increased audit activity. While the Code had seen targeted improvements over the years, it was still somewhat outdated and overly complex in certain sections. This provided the City’s tax auditors with significant interpretive latitude to increase tax assessments in the City’s favor. Such actions fueled tensions between the City and taxpayers who claimed the LABT

and its enforcement efforts were stifling economic growth.

One taxpayer in particular, Creators Syndicate, found itself in a difficult position as a result of the City’s enforcement efforts. Founded in 1987, Creators Syndicate is a successful independent newspaper syndication company headquartered in Los Angeles. In 1992, a dispute with the City arose as to whether Creators Syndicate’s Los Angeles business activities should be taxed as a retailer (at the lowest rate) or as a service provider in the Professions and Occupations classification (at a much higher rate).⁷⁸ A two-year dispute ensued, resulting in a decision by the City that categorized Creators Syndicate as a “wholesaler and retailer” and taxed them at the lowest rate.⁷⁹ However, in 2007, the City attempted to reclassify Creators Syndicate under the Professions and Occupations classification. The reclassification was based on the claim that only taxpayers — not the City—are bound by past rulings. As such, Creators Syndicate received an assessment from the City showing tax deficiencies for the current year and retroactively back to 2004, including interest and penalties.⁸⁰ Creators Syndicate sued the City of Los Angeles for a refund of the \$105,000 assessment.⁸¹ In 2009, Creators Syndicate president, Rick Newcombe, authored an opinion piece in the Wall Street Journal entitled “Why We’ll Leave L.A.”⁸² Mr. Newcombe labeled the City and its tax a “job-killing machine” and expressed his intention to leave the City in the absence of meaningful reform.⁸³ In 2010, the City settled, and Creators Syndicate received its refund and assurance that it would continue to be taxed under the Retail Sales classification.⁸⁴

The Creators Syndicate suit brought the City’s economic struggle and issues with the LABT to national attention as the taxpayer leveraged its media connections to critique the City’s business tax in editorial columns across the country. It also exemplified the ease with which many media and technology-based businesses in Los Angeles, with no physical ties to the City, can move to neighboring jurisdictions. Burdensome taxes, fees and regulations were frequently blamed for the City’s suffering economy, loss of jobs, and the exodus of a growing number of businesses to locations outside the City. In fact, between 1995 and 2008 Los Angeles had lost nearly 30,000 jobs.⁸⁵

⁷⁸ Rick Newcombe, *Why We’ll Leave L.A.*, WALL ST. J., July 10, 2009, at A15.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ Council Action, Los Angeles City Council, Settlement in the Case Entitled *Creators Syndicate Inc. v. City of Los Angeles*, Los Angeles Superior Court Case No. BC 418416 (Nov. 10, 2010) (City Council File 10-1509).

⁸² Rick Newcombe, *supra* note 78.

⁸³ *Id.*

⁸⁴ Council Action, Los Angeles City Council, Settlement in the Case Entitled *Creators Syndicate Inc. v. City of Los Angeles*, Los Angeles Superior Court Case No. BC 418416 (Nov. 10, 2010) (City Council File 10-1509).

⁸⁵ Press Release, Los Angeles Economy & Jobs Committee, Independent Committee Makes Recommendations to Create High-Quality Jobs and Strengthen L.A.’s Economy, 2 (Jan. 23, 2008). Perhaps even more startling is the decline in employment relative to population growth in the City since 1980. Between 1980 and 2010, the City’s population increased by 823,440 or 27.7 percent, while employment decreased by 165,077 or 9.1 percent. BUSINESS TAX ADVISORY COMMITTEE, REPORT OF RFP SUBCOMMITTEE RECOMMENDING HOW TO ELIMINATE GROSS RE-

⁷³ L.A., CAL., MUN. CODE §§21.33 et. seq.

⁷⁴ The maximum annual rate reduction allowable under the plan was 4 percent per year. This maximum annual reduction was predicated on a proportional increase in business tax receipts for that year and was limited to a maximum reduction of 15 percent from the rates imposed as of December 31, 2005. L.A., Cal., Ordinance 176324, (Dec. 6, 2004).

⁷⁵ L.A., CAL., MUN. CODE §21.00(a) (amended by L.A., Cal., Ordinance 172326 (Jan. 16, 2005)).

⁷⁶ L.A., CAL., MUN. CODE §§21.41-21.49.

⁷⁷ Press Release, City of Los Angeles, Council Moves to Re-convene Business Tax Advisory Committee (Nov. 4, 2009) (on file with author).

During this period of increased tension between taxpayers and the City, Los Angeles was looking for ways to bolster economic activity. In 2006, Mayor Villaraigosa assembled the Los Angeles Economy & Jobs Committee (“LAEJC”) to devise a strategy for improving the City’s business climate.⁸⁶ After 15 months of deliberations, the LAEJC issued a report on how best to promote economic development in the City. As with prior efforts, a prominent issue in the report was reform of the LABT. The LAEJC called for more tax credits and incentives for the entertainment and technology industries, a continued reduction in the tax rates, and greater efforts to assist both new and existing businesses to “navigate the city bureaucracy.”⁸⁷ In November 2009, following these efforts to target solutions to the City’s economic struggles, the City Council unanimously adopted a motion to reconvene BTAC and re-examine how best to approach LABT reforms.⁸⁸

The Era of BTAC II (2010-Present)

As directed by the City Council, the Business Tax Advisory Committee was reconvened in early 2010. “BTAC II” is currently in session, and is composed of nine new members from the business community (with the exception of one returning member) who possess a variety of backgrounds and experience.

One of the first accomplishments of BTAC II was an extension of the new business exemption to three years (from two) and the repeal of the gross receipts ceiling for the application of this exemption (previously the exemption applied only to new businesses with total taxable gross receipts not exceeding \$500,000 during the initial three years of doing business in the City).⁸⁹ Following this initial accomplishment, BTAC II proceeded to have several other tax reform measures enacted. Additional reform items passed by the City Council under BTAC II include:

- clarification of the applicable statutes of limitation that apply in a variety of situations;⁹⁰
- extension of the time taxpayers have to appeal an assessment from 15 to 45 days;⁹¹
- establishment of the precedential effect of appeals decisions regarding classification;⁹²
- institution of a voluntary disclosure program;⁹³
- exemption of mutual funds;⁹⁴ and
- simplification of processing minor overpayments or underpayments of tax.⁹⁵

Currently, the City has begun the process of evaluating BTAC II’s proposal to eliminate the LABT. The initial proposal was a four-year phase out of the current LABT. After lengthy discussions and concerns over the speed at which such a large loss to the City’s General Fund could be otherwise recouped from alternate revenue sources, the proposal was revised. Currently the

proposal spans 15 years, with significant rate reductions and other Fund Class simplifications in the first five years.

In 2011, the LABT yielded \$420 million in annual collections for the City and accounted for approximately 10 percent of the City’s General Fund.⁹⁶ BTAC II realized that any proposals it made would not likely succeed if they jeopardized such a large portion of the City’s budget. With this in mind, BTAC II pursued reforms that would stimulate job creation and economic growth while remaining, at a minimum, revenue neutral to the City.

To further assess what measures could be taken to create economic and job growth, BTAC II commissioned a study to examine the current state of the LABT, its effect on the local economy, and its competitiveness among other California municipalities. The study was conducted by Charles Swenson, a state and local tax specialist,⁹⁷ and modeled the economic effects on the City of eight different tax reform proposals set forth by BTAC II.⁹⁸ The study focused on the different reforms’ effects on job creation and revenue gains or losses to the City. Among these proposals was a total elimination of the tax.⁹⁹ In August 2011, Dr. Swenson submitted the *Report to the City of Los Angeles on Potential Revisions to the Business Tax* (“2011 Report”) to BTAC II detailing the results of the study.

According to the 2011 Report, “all of the [BTAC II] Proposals are expected to generate jobs.”¹⁰⁰ Furthermore, although many of the “worst-case” scenarios associated with implementation of each proposal could result in a net decrease in City revenue, almost all of the “average” or “best-case” scenarios associated with implementation of the proposals are revenue neutral or revenue positive.¹⁰¹ Surprisingly, the study concluded that the largest and most positive impact on economic growth and job creation would result from a total elimination of the LABT. The report stated that elimination of the tax would be revenue neutral in the worst-case scenario. Under the best-case scenario, estimated revenue gains could exceed \$260 million annually and result in the creation of more than 130,000 new jobs.¹⁰² This estimated revenue increase stems from corresponding increases in other revenue sources, including secured and unsecured property tax, utility tax, sales

⁹⁶ CHARLES SWENSON, REPORT TO THE CITY OF LOS ANGELES ON POTENTIAL REVISIONS TO THE BUSINESS TAX, 7 (2011).

⁹⁷ Dr. Swenson is a Professor and Leventhal Research Fellow and the Marshall School of Business at the University of Southern California. Dr. Swenson has authored more than 50 academic research and professional articles on taxation, has presented economics-based tax research before the State of California, and is the author and editor of several tax texts and treatises including *Bender’s State Taxation: Principles and Practice* (LexisNexis, 2009). *Id.* at 61.

⁹⁸ *Id.* at 3.

⁹⁹ Other proposals included: 1) targeted rate reductions for certain service industries; 2) rate reductions for all industries; 3) limitation on the annual tax payable to \$2 million per taxpayer; 4) rate reductions for large companies establishing headquarters in Los Angeles; 5) rate reductions for companies close to public transportation centers; 6) rate reductions for existing businesses that remain in Los Angeles; 7) new business tax exemption; and 8) tax reductions based on hiring and job creation. *Id.* at 3-4.

¹⁰⁰ *Id.* at 58.

¹⁰¹ *Id.*

¹⁰² *Id.* at 50.

CEIPTS BUSINESS TAX, 5 (2011) (citing Southern California Association of Governments, RTP Database).

⁸⁶ Press Release, *supra* note 85 at 1.

⁸⁷ *Id.* at 4-5.

⁸⁸ Press Release, *supra* note 77.

⁸⁹ L.A., CAL., MUN. CODE §21.30.

⁹⁰ L.A., CAL., Ordinance 181857 (Aug. 24, 2011).

⁹¹ *Id.*

⁹² L.A., CAL., Ordinance 181858 (Aug. 24, 2011).

⁹³ L.A., CAL., Ordinance 181859 (Aug. 24, 2011).

⁹⁴ L.A., CAL., Ordinance 181951 (Nov. 23, 2011).

⁹⁵ L.A., CAL., Ordinance 181860 (Aug. 24, 2011).

tax, and other licenses and fees resulting from an increase in economic growth and employment gains in the City.¹⁰³ However, Dr. Swenson notes, “such gains may not occur in the same years as the direct business tax revenue loss, i.e., a lagged response time.” This lagged response time would vary based on the source of the indirect revenue gain and would require a gradual phase-in of any reduction or elimination of the tax to allow for the offsetting indirect revenue gains. Dr. Swenson also recommended that “for any Proposals adopted, their effectiveness be evaluated a year or two after adoption.”¹⁰⁴

In response to the positive findings of the report, BTAC II submitted a formal recommendation to the City Council in September 2011 to eliminate the business tax completely, utilizing a four-year phase-out period.¹⁰⁵ This recommendation was first considered by the City Council’s Jobs & Business Development Committee, which referred it to the Chief Legislative Analyst and the City Administrative Officer to analyze both Dr. Swenson’s report and BTAC II’s recommendation. The report issued by these two administrative agencies expressed concern about losing such a large revenue stream and cast doubt on the estimated revenue gains projected by Dr. Swenson’s report.¹⁰⁶ The report was then reviewed by the City’s Office of Economic Analysis, which contracted with Blue Sky Consulting Group, an outside firm, to perform an independent economic analysis at the request of the City Council.

The City faces a need to create jobs and a healthy business climate, and a decline in revenues.

While Blue Sky Consulting Group’s analysis (“Blue Sky Report”), released March 23, 2012, concluded that elimination of the LABT would increase economic activity, the magnitude of the Blue Sky Report’s projections contrasted starkly with Dr. Swenson’s projections.¹⁰⁷ The Blue Sky Report concluded that the elimination of the LABT would lead to modest job growth (creating approximately 7,500-16,000 new jobs) and even more modest revenue growth (generating between \$13 million and \$27 million in revenue).¹⁰⁸ The Blue Sky Report drew its own criticism from Dr. Swenson¹⁰⁹ as well as other independent consulting firms such as the

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 59.

¹⁰⁵ BUSINESS TAX ADVISORY COMMITTEE, REPORT OF RFP SUBCOMMITTEE RECOMMENDING HOW TO ELIMINATE GROSS RECEIPTS BUSINESS TAX (2011).

¹⁰⁶ Miguel A. Santana, City Administrative Officer & Gerry F. Miller, Chief Legislative Analyst, Business Tax Relief, (Nov. 7, 2011).

¹⁰⁷ BLUE SKY CONSULTING GROUP, ECONOMIC AND FISCAL EFFECTS OF ELIMINATING THE LOS ANGELES BUSINESS TAX, (March 22, 2012) (Council File No. 09-1914-S8).

¹⁰⁸ *Id.* at 5.

¹⁰⁹ Charles Swenson, Comments on “Economic and Fiscal Effects of Eliminating the Los Angeles Business Tax” by Blue Sky Consulting Group, (April 15, 2012) (Council File No. 09-1914-S8).

Milken Institute.¹¹⁰ The crux of this criticism was that the Blue Sky Report relied heavily on research examining “intra-region” economic effects rather than “intra-metropolitan” economic effects of a given tax change.¹¹¹ Essentially, a change in local taxes in a given metropolitan area will have a much higher “elasticity” or economic response relative to the tax change (“intra-metropolitan”) than the elasticity related to state or local tax changes within a larger region (“intra-region”).¹¹²

Due to the potential positive impact on expansion and retention of existing local businesses, attraction of new businesses to Los Angeles, local job creation, and most importantly, City revenues, the proposal to eliminate the LABT garnered a significant amount of support among both City officials and taxpayers. However, concern over the resulting loss of 10 percent of the City’s General Fund revenue without a guaranteed replacement was widespread. Ultimately, BTAC II adopted a more cautioned approach that would be more palatable to those concerned with potential revenue losses.

The revised recommendation from BTAC II was submitted to the Jobs and Business Development Committee on April 18, 2012.¹¹³ As in the case of the prior recommendation, it proposed significant rate reductions and ultimate elimination of the LABT, but extended the phase-out period from four to 15 years and implemented milestone years to assess whether revenue gains were sufficient to offset the ongoing tax reductions. The revised recommendation proposes elimination in three five-year stages. Each stage implements rate reductions and classification consolidation.

Stage 1 (years 1-5) consolidates the nine current tax classifications into three classifications—Wholesale, Retail and Media, and Professions and Occupations. In these initial years, the top tax rate is reduced from \$5.07 to \$2.55 per thousand gross receipts.¹¹⁴ Additionally, in years three and five the revenue gains are measured to assess revenue neutrality of the tax reductions. If at any of these milestone years, revenue gains are not sufficient to offset losses from the tax reductions, further rate reductions are suspended until revenue collected reaches a pre-determined baseline level.¹¹⁵ Stage 1 provides the most significant reforms, reducing rates on taxpayers subject to the highest tax rates and drastically reducing the number of tax classifications.

The revised recommendation from BTAC II proposed significant rate reductions.

Stage 2 (years 6-10) further reduces the top tax rate from \$2.55 to \$1.27 per thousand gross receipts.¹¹⁶ While Stage 2 retains three tax classifications, in year

¹¹⁰ Letter from Milken Institute to Mayor of Los Angeles and City Council, (May 9, 2012) (Council File No. 09-1914-S8).

¹¹¹ Charles Swenson, *supra* note 109.

¹¹² *Id.*

¹¹³ REPORT OF BUSINESS TAX ADVISORY COMMITTEE RECOMMENDING HOW TO REFORM GROSS RECEIPTS BUSINESS TAX, (April 18, 2012) (Council File No. 09-1914-S8).

¹¹⁴ *Id.* at 27.

¹¹⁵ *Id.* at 30-31.

¹¹⁶ *Id.* at 27, 36.

ten, taxpayers are subject to either the \$1.01 rate or the \$1.27 rate—effectively reducing the number of classification to two. As in Stage 1, years eight and ten are milestone years at which further reductions can be frozen if sufficient offsetting revenues are not realized.

In Stage 3 (years 11-15), the phase out is completed as the rates for all three classifications are dropped to \$0 by year 15.¹¹⁷ As in prior stages, years 12 and 14 are milestone years to assess whether offsetting revenues materialize as projected. BTAC II's revised recommendation seeks to assuage any fears that lost revenues from the LABT will not be sufficiently offset by revenue gains from increased business activity, leaving a large gap in the City's budget. The recommendation has support from City Council's Jobs and Business Development Committee, but has not yet been scheduled to come before the full City Council.

Regardless of whether the LABT is eliminated, taxpayers should be heartened by the renewed focus on tax reform sparked by BTAC II and the current City Council, which has paved the way for many reforms that have already begun to take effect. For example, the City Council recently passed an ordinance exempting new car dealerships located in the City from the LABT through 2020, effective August 20, 2012.¹¹⁸ The exemption, co-sponsored by Councilmen Eric Garcetti and Mitch Englander last fall, seeks to combat the exodus of car dealerships from the City, which has lost 95 dealerships over the last 25 years.¹¹⁹ BTAC II's accomplishments and presence has brought the LABT to the forefront of fiscal policy discussions in Los Angeles as businesses and City officials seek to reestablish the City's economic well-being. BTAC II's term was set to expire early in 2012, but was extended until the end of the year. However, the members may soon agree to a second term extension to assist in shepherding their recommendations for reform through the City Council.

LABT Reform Efforts Through the Years

The City's tax landscape has changed significantly over the past decades through various tax reform efforts originated by mayors, City Councils, and special committees. However, with the fast-paced and ever-changing nature of business in the 21st century, some may query whether the City's efforts to modernize the LABT have been sufficient or merely reactionary.

For example, the sourcing rules used to determine taxable gross receipts were first written in the 1970s and most have remained unchanged since their original issuance. These sourcing rules may cause inequities when applied to many of today's modern business models. In many cases, such inequities may be traced to City Clerk's Rulings—administrative guidance that was never codified. According to the sourcing guidance, retailers and wholesalers must follow one set of sourcing rules if they have a fixed place of business in the City, but another set of sourcing rules apply if the taxpayer sells goods into Los Angeles from locations outside the City. Generally, a taxpayer located outside Los Angeles who sells goods into the City is deemed to be doing

business in the City and is subject to LABT on 30 to 35 percent of gross receipts from sales to Los Angeles customers.¹²⁰ Conversely, a business with a fixed location in Los Angeles selling to customers both inside and outside the City is subject to tax on 100 percent of its receipts generated on sales to Los Angeles and other California destinations.¹²¹ Additionally, the taxpayer may deduct a percentage of receipts based on various elements of the "selling process" performed outside the City.¹²² A similarly complex set of sourcing rules applies to businesses providing services.¹²³ Finally, because these sourcing rules strictly reference the "Wholesale and Retail" and "Professions and Occupations" Fund Classes, there is no direct guidance for taxpayers filing under other Fund Classes. In practice, sourcing for these other classifications generally follows similar sourcing rules. These inherent uncertainties in the sourcing rules and lack of specific guidance may force taxpayers to derive their own sourcing methodologies, susceptible to being overturned by City auditors who determine what constitutes proper sourcing for these categories.

The sourcing provisions have not garnered enough attention over the years to be changed through tax reform, yet taxpayers regularly struggle to apply them properly. It is conceivable that many taxpayers may not properly interpret the City's sourcing rules without enlisting the help of tax professionals with significant LABT experience. Such professional assistance can often reveal significant overpayments or underpayments of tax. BTAC II has apparently hesitated to tackle these issues in hopes that their recommendations to phase out the LABT will eliminate any need to address the sourcing rules. Future reform efforts should include clarification and simplification of the City's complex sourcing rules. It is possible that given the complex nature of the sourcing rules, BTAC and City Council members have been hesitant to tackle this challenge. However, greater clarity of these rules may increase compliance, reduce the cost of administration, and decrease the burden of the LABT on both taxpayers and the City.

On a positive note, other areas of the tax have recently received the attention of City officials and have undergone significant reforms. For example, over the

¹²⁰ TAX AND PERMIT DIV., OFFICE OF FIN., CITY OF LOS ANGELES, CITY CLERK'S RULING NO. 13 (NEW SERIES): PERSONS SELLING GOODS, WARES AND MERCHANDISE IN LOS ANGELES, WITH NO FIXED PLACE OF BUSINESS IN LOS ANGELES (1972).

¹²¹ TAX AND PERMIT DIV., OFFICE OF FIN., CITY OF LOS ANGELES, CITY CLERK'S RULING NO. 14 (NEW SERIES): PERSONS SELLING GOODS, WARES AND MERCHANDISE, WHO HAVE A FIXED PLACE OF BUSINESS IN LOS ANGELES (1996).

¹²² These "selling" percentages are as follows:

"1) Up to **30%** for the location where the sale is negotiated or solicited by the taxpayer. . 2) Up to **20%** for . . .the office from which the sales activities are directed or controlled. 3) Up to **10%** for the location where orders or contracts are accepted or approved. . .4) Up to **20%** for any facility, operated by the taxpayer, where the goods, wares or merchandise are stored immediately prior to shipment or delivery. 5) Up to **5%** for the location which gives the order for . .shipment or delivery of articles sold. 6) Up to **5%** for the place where billing procedures are performed. 7) Up to **5%** for the place where the collecting of receipts is performed. 8) Up to **5%** for the place to which the merchandise is delivered. . ." (emphasis added) *Id.*

¹²³ TAX AND PERMIT DIV., OFFICE OF FIN., CITY OF LOS ANGELES, CITY CLERK'S RULING NO. 15 (NEW SERIES): GROSS RECEIPTS ATTRIBUTABLE TO BUSINESS ENGAGED IN WITHIN CITY (Nov. 22, 1971).

¹¹⁷ *Id.* at 27, 39.

¹¹⁸ L.A., Cal., Ordinance 182184 (July 11, 2012).

¹¹⁹ Motion, Jobs and Business Development Committee, Los Angeles City Council, (Nov. 15, 2011) (Council File No. 09-1914-S11).

past decade Los Angeles has been struggling to compete with other jurisdictions in becoming a home for rapidly growing Internet-based businesses. In response, in 2010 the City revised the Code to create separate classifications for “Multimedia Businesses,” “Internet-based Application Service Providers,” and “Internet-Based Data Manipulation.”¹²⁴

Prior to adding these classifications, such businesses were frequently included in the City’s “Professions and Occupations” Fund Class and taxed at the highest rate. Acknowledging Los Angeles’ positioning as a creative center, the City clarified the “Multimedia Businesses” classification to specifically include many internet-based companies, and incentivized their growth by taxing them at the lowest rate. These new classifications are effective for the 2010 through 2014 tax years.

In June 2012 the City Attorney submitted a draft ordinance to the City Council’s Budget and Finance Committee amending the internet-based business section to remove the existing sunset provision and make the ordinance permanent.¹²⁵ Making this ordinance permanent would be a positive step for the City in promoting clarity and certainty to taxpayers filing under this Fund Class.

Another example of recent reform progress relates to the LABT as applied to mutual funds. Unlike other local jurisdictions that tax only the entity managing the mutual fund, the LABT was imposed on both the manager and the fund itself. This “double tax” put Los Angeles at a significant competitive disadvantage for retaining and attracting businesses in this industry. In November 2011, an ordinance was approved by the City Council and signed by the Mayor that will fully exempt qualified mutual funds from the LABT by Jan. 1, 2014.¹²⁶ This ordinance, which applies to tax years beginning on or after Jan. 1, 2012, relies on federal law and the Internal Revenue Code (“IRC”) to define exempt mutual funds.¹²⁷ A qualifying fund must be registered as an open-end mutual fund under the Investment Company Act of 1940; must qualify as a Regulated Investment Company under IRC, Subchapter M; and must not receive more than ten percent of its gross income from other than qualifying “passive income” sources as described in IRC §851(b)(2).¹²⁸ While this new ordinance may increase the City’s ability to attract and retain mutual funds, it is also narrowly tailored and does not ad-

dress similarly situated entities such as private equity funds, hedge funds, and other investment funds. It remains unclear how such entities should be taxed for LABT purposes.

Making permanent the lowest LABT tax rate for internet-based companies would be a positive step.

In recent years, under the direction of BTAC II and a City Council focused on economic growth and job creation, Los Angeles has successfully pioneered a number of tax reforms. Some such as the Internet-based business classification, the mutual fund exemption, and small and new business exemptions are targeted reforms that remove barriers to the City’s competitiveness in attracting and retaining businesses. Others, like the Voluntary Disclosure Program and the statute of limitations reform, are structural changes that focus on efficient administration of the LABT. In addition to these reforms, larger conversations such as whether Los Angeles should eliminate its gross receipts tax altogether continue to pave the way for meaningful change. The LABT is undoubtedly a significant source of revenue for the City, and its elimination would likely require a leap of faith that many may be unwilling to take. Such a drastic reform may also be unnecessary as taxpayers’ largest complaints concern the complexity of the LABT and their inability to easily file and pay the proper amount of tax. Over the years, however, the City has made it clear that it is evaluating every alternative in removing the LABT as a barrier to the economic growth of Los Angeles. This focus on reforming the LABT has already begun to increase the City’s competitiveness among other California municipalities as Los Angeles continues to broadcast the message that it is “open for business.”

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¹²⁴ L.A., CAL., MUN. CODE §21.41(b)-(d).

¹²⁵ Report RE: Revised Draft Ordinance Amending Section 21.41 of the Los Angeles Municipal Code to Address the Classification of Internet Businesses, Los Angeles City Attorney, (June 12, 2012) (Council File No. 09-1914-S12).

¹²⁶ L.A., Cal., Ordinance 181951 (Nov. 23, 2011).

¹²⁷ *Id.*

¹²⁸ *Id.*