

Cal-Tax Digest

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The Year in Review



Significant California Tax Developments in 2000

By David R. Doerr and Chris Micheli

Tax decisions made in the 20th Century determined the big tax news in the first year of the 21st Century. An obscure provision in Governor Pete Wilson's 1991 income tax package triggered a surprise announcement by Governor Gray Davis in October that the state sales tax would be reduced by 0.25 percent in 2001. And the vehicle license fee tax reduction trigger established by Governor Wilson and legislative leaders in 1998 also drove tax reduction policy this year.

The Legislature bowed to the inevitable conclusion that the trigger would reduce the car tax to .65 percent by 2003, so the cut was accelerated to begin in 2001. Another relic of the 20th Century that required legislation was a \$300 smog fee that had been imposed in 1990 on out-of-state vehicles. The courts ruled it unconstitutional. After months of agonizing delay, a refund program for all of the illegal taxes paid was adopted at the end of May.

The November general election brought major change affecting property owners' taxes, making it easier to pass local school bonds. The two-thirds vote requirement, established in the 19th Century, was reduced to 55 percent. On local ballots, an unprecedented number of tax measures were decided at the polls, with most of them failing.

The year 2000 was unique from a tax standpoint in several other ways. For the first time in over 60 years, the personal income tax will give one occupational group (teachers) special preference over all others. Taxpayers found a state government reducing taxes, although not as much as some had urged, considering a \$12 billion windfall state surplus, while taxes were being increased by local



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governments in various areas of the state. While tax administration was seeking to be more taxpayer friendly, the state was ranked least friendly of all states to business taxpayers by a national magazine.

Almost as important as the tax developments that occurred were those that did not materialize. There was no federal conformity bill for the second year in a row. An end-of-session tax package that had become custom in the last few legislative sessions, was not adopted this year. The Assembly made a feeble effort to continue the tradition by adopting an eleventh-hour, backroom deal that had no support in the Senate.

A proposed extension of the Internet Tax Freedom Act also failed, although it passed the Legislature and was signed by the governor in what he called a symbolic gesture. Democrats decided to hold the proposal hostage through a rider in the bill providing that it could only become law if another bill to expand nexus to certain Internet sales was passed. That bill, which was opposed by the American Electronics Association, was vetoed.

After much big talk about reforming state-local fiscal relationships and recommendations from two citizens advisory panels (one appointed by the State Controller and the other by the Assembly Speaker) proposing significant changes, a conference committee of the Legislature labored for months on the issue and came up with nothing but the status quo.

Sales Tax Cut

As a result of Governor Davis' announcement of a 0.25 percent sales tax cut, California taxpayers will pay an estimated \$1.2 billion less in sales tax in 2001.

The governor said the tax cut is a "substantial effort to share with the taxpayers of this state the bounty they have created." He said the tax cut was possible because of the vibrant economy and his fiscal discipline - vetoing \$4 billion in spending bills in 2000.

In 1991, to make Governor Wilson's record \$7.3 billion tax increase more palatable, a provision was added that would trigger a 0.25 percent sales tax reduction if and when budget reserves exceeded the state's general fund revenue by 4 percent in back-to-back fiscal years. The state finished last year with reserves 10 percent above the threshold, and revenues this year are again substantially exceeding estimates. The sales tax rate will be

Editor's note: Cal-Tax Policy Analyst Lisa Martin assisted with this article by compiling local election data on tax measures.

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increased to its prior level in 2002 if reserves drop below the 4 percent level next year.

Budget Tax Package

As part of state budget negotiations over the disposition of a \$12 billion windfall surplus, the governor and legislators eventually agreed on a tax reduction package estimated to reduce taxes by \$4.6 billion in the first three years. The key provision in the package accelerates to 2001 a vehicle license fee (VLF) cut to .65 percent that was set to trigger in 2003 (AB 858, Kuehl and AB 511, Alquist). The package also included a credentialed teacher tax credit (AB 2879, Jackson), giving teachers up to a \$1,500 tax break (not to exceed 50 percent of the tax on teacher income).

The vehicle license fee (or "car tax") cut did not come easily and continues to be controversial. Originally, Governor Davis, in his revised budget in May, suggested a \$150 income tax rebate (\$300 for joint returns) up to the extent of tax liability. Senators of his own party told the governor to stuff his income tax proposal and suggested a \$1.4 billion sales tax rebate. (The governor's plan, a \$1.76 billion prosperity dividend, would have reduced state taxes by a larger amount than the Senate plan.) Senate president Pro Tem John Burton and Senator Steve Peace tried to justify their plan on the basis that personal income taxes are deductible, while sales taxes are not. However, the plan was structured like an income tax rebate with adult taxpayers getting \$50 and dependents \$25. (A family of four paying at least \$300 in income tax would have been better off under the governor's plan even after federal interaction.) Eventually, the sales tax rebate was modified to a sliding scale program, patterned after a similar plan in Minnesota.

At the last minute, Republicans discovered that the Democrats' program would have triggered an \$850 million reduction in the previously enacted vehicle license fee reduction. (One provision in the 1998 car-tax reduction plan provided the "car-tax" reductions would be reduced if the Legislature approved other tax cuts exceeding \$100 million.) To emphasize their objection, Republicans in the Assembly withheld votes on the state's budget, preventing it from getting the two-thirds votes necessary for passage.

As a result, legislative leaders and the governor huddled and came up with a new plan. The VLF cut to .65 percent, due to trigger in 2003, would be advanced to 2001 and the talk of sales tax and income tax rebates was dropped. In addition, legislation repealed a

provision requiring a cut in the VLF if other tax relief measures were passed.

However, because the VLF cut to .65 percent in 2001 and 2002 was designed as a tax rebate, instead of a simple rate reduction, howls of protest ensued. (Under the plan, taxpayers pay the VLF at the current rate and they are sent a rebate check from the state for the difference.) Critics, such as Assembly Member Tom McClintock, said it would cost taxpayers at least \$45 million in state administrative costs to run the rebate program. These costs could be eliminated if the tax rate was reduced to the .65 percent rate in the first place. This was a popular idea in the Assembly and legislation eliminating the "rebate" and reducing the VLF tax rate instead to .65 percent (SB 540, Dunn) passed the lower house in the closing days of the session. However, Senate Democratic leaders refused to let the measure come to a vote, so it failed to reach the governor's desk. Mr. McClintock, now in the Senate, has vowed to introduce legislation next year to fix this problem.

The credentialed teacher tax credit included in the final package (AB 2879, Jackson) was very controversial as many observers objected to singling out one occupational group for tax relief. This had not been done since federal government employees were exempt from tax in the 1930s. Even teacher groups objected to the original proposal to exempt all teacher income from tax. The mechanics of the credit were complex and required teachers to compute two tax returns. However, a trailer bill (AB 1080, Villaraigosa) simplified the calculation of the credit, but also reduced the tax relief provided to teachers.

Other elements in the budget tax package were a one-time 150 percent increase in the senior citizen property tax relief program (SB 1664, Karnette and AB 2416, Machado); an exclusion from income of specified amounts paid by employers to employees for graduate-level education (AB 511, Alquist); a \$500 tax credit for eligible providers of long-term care (AB 511, Alquist); a land-donation tax credit (SB 1647, O'Connell and AB 522, Wayne); a partial sales tax exemption for specified purchases of machinery and equipment for use in high-unemployment counties (AB 511, Alquist); an increase in the allowable net operating loss (NOL) carryforward from 50 percent to 65 percent (AB 511, Alquist); an increase in the research and development tax credit to 15 percent (AB 511, Alquist); an increase in the alternative research and development tax credit percentage of the federal credit to 90 percent (AB 511, Alquist); a refundable child-care tax credit

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graduated by income, providing from a 63 percent to 42 percent credit, depending on income, up to \$100,000 of adjusted gross income (AB 480, Ducheny), and earmarking of the sales tax on gasoline for transportation for five years (AB 2928, Torlakson). For a more complete discussion of the budget tax package provisions, see *Cal-Tax Digest* of September 2000.

Smog Tax Refunds

In October 1999, a state appellate court ruled that a \$300 smog fee imposed by the state since 1990 was unconstitutional (*Jordan v. State of California*). The decision was not unexpected because Legislative Counsel Bion Gregory warned legislators in 1990 that the proposal had constitutional defects. The question before the 2000 session of the Legislature was how to refund the tax. Republicans urged that the statute of limitations be suspended and all motorists who paid the tax be given refunds. They also said the refunds should be automatic and the state should take the initiative in contacting taxpayers. The governor and Democratic leaders agreed, and in January two bills (SB 215, Karnette, and AB 809, Lowenthal) providing for a \$665 million smog tax refund began to move. Despite general agreement, the legislation was stalled until the end of May over issues such as how much to pay the attorneys who litigated the suit. According to *Sacramento Bee* columnist Dan Walters, San Diego attorney Bill Lerach was seeking \$33 million, while the State Board of Equalization was attempting to limit the fee to \$1 million. To resolve the issue, the legislation provided for compulsory arbitration.

Two-Thirds Vote Requirement

After narrowly turning down a proposal in March to reduce the vote required to approve school bonds from two-thirds to a majority (Proposition 26), California voters in November narrowly approved a reduction in the vote requirement to 55 percent (Proposition 39).

The lower constitutional voter-approval threshold was packaged with statutory accountability reforms (AB 1908, Lempert, and AB 2659, Lempert). These bills limit the size of a school bond that can be passed with 55 percent of the vote to those that will not raise property taxes in a unified district by more than \$60 per \$100,000 of assessed value. Critics said this creates severe *Serrano* (equal protection) problems in school funding, as districts with higher assessed values can raise more revenue per student to build facilities. AB 1908 also requires that the 55 percent-approval bonds

be submitted to voters at regularly scheduled state or local elections.

Governor Davis and former Governor Wilson led the \$30 million "yes" campaign on Proposition 39, which was bankrolled by some large contributions from wealthy individuals in the Silicon Valley. The Howard Jarvis Taxpayers Association, with a much smaller campaign budget (\$4 million), was the primary opponent of the measure.

The two-thirds requirement was also an issue in Proposition 37, sponsored by the business community. It sought to require two-thirds votes on "specified" fee increases. The objective was to reverse a 1997 California Supreme Court decision that held "fees" imposed to mitigate the actual or anticipated adverse effects of the feepayer's operations are not subject to the two-thirds approval requirement (*Sinclair Paint v. State Board of Equalization*).

Proposition 37, narrowly defeated at the polls, would have required that fees imposed for mitigating societal effects of an activity, while imposing no regulatory obligation on the payer, must be passed by a two-thirds vote.

Proponents argued that the *Sinclair* decision created a significant "loophole" for passage of "hidden" taxes by majority vote. They stressed that the measure would not prevent companies from being held responsible for their products. Opponents contended that the initiative was intended to let polluters off the hook.

Local Tax Increases

Despite the fact that California's booming economy was pumping unprecedented, Midas-like amounts of revenue into state and local coffers, local governments throughout California attempted to increase taxes. There were more local tax measures on the November ballot than at any time in the history of the state.

While voters seemed willing to extend existing taxes, most of the new tax proposals were turned down. Of 94 direct tax-increase measures found in a Cal-Tax survey of local November ballots, approximately 58 percent were rejected. Most school bonds were approved this year, even with a two-thirds vote requirement.

Voters this year approved sales tax rate increases in four relatively small areas: Avalon, on Santa Catalina Island (with a 0.5 percent increase making the combined 8.75 percent rate the highest in the

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state), Woodland in Yolo County (with a 0.5 percent general sales tax increase), Mariposa County (with a 0.5 percent tax increase), and the Baker Community Services District (with a 0.5 percent tax increase) in San Bernardino County.

As discussed below, extensions of existing 0.5 percent sales taxes for transportation were approved in Santa Clara and Alameda counties.

Sales tax increases failed in counties of Sonoma, Santa Barbara, Tuolumne, Fresno, Placer and Contra Costa, and in the city of Sebastopol (Sonoma County).

Local utility user taxes continued to be unpopular. Long Beach voters approved a citizens' initiative to cut the tax in half over five years. Increases were also defeated in Kingsburg (Fresno County), King City (Monterey County), Huntington Beach (Orange County), Upland (San Bernardino County) and Cloverdale (Sonoma County). In the little town of San Joaquin in Fresno County, a proposed 10 percent utility user tax got 13 votes in favor and lost by a margin of 6.3 percent "yes" and 93.6 percent "no."

Voters in the unincorporated area of Alameda County and in the city of Arcata (Humboldt County) approved extensions of existing utility user taxes.

Transportation Funding

Transportation tax proponents spent much of 2000 laboring for legislation on a premise that turned out to be unfounded. Concerned that it would be impossible to achieve a two-thirds vote, now required by Proposition 218, to renew local transportation sales taxes, they worked hard to place SCA 3 (Burton) on the ballot.

The constitutional amendment, which had passed the Senate in 1999 and was pending in the Assembly, created a statewide plan that, in effect, allowed a majority vote in a county to adopt or continue a local transportation sales tax. Despite heavy lobbying all year, proponents could not secure enough votes in the Assembly to place SCA 3 on the November ballot.

Governor Davis said early in the year that he disliked the proposal and his advisors did not think voters would approve it. Assembly Republicans called for use of existing state resources, particularly

sales tax revenue from the portion of the tax levied on gasoline, to fund more transportation infrastructure.

As an alternative, Governor Davis presented a plan using part of the windfall surplus to fund various high-profile projects throughout the state. As a part of the budget, \$2 billion was allocated to fund the governor's "Transportation Congestion Relief Plan." In addition, the Legislature acquiesced to Republican demands and agreed to transfer all state revenues from the sales tax on gasoline through 2005-2006 to a Transportation Infrastructure Fund (AB 2928, Torlakson).

In the November election, the premise behind SCA 3 - that no county could persuade two-thirds of the voters to continue its local transportation tax - proved to be a fallacy, at least as far as the counties of Santa Clara and Alameda were concerned. In Santa Clara, 70.6 percent of voters approved Measure A, a 30-year extension of a 0.5 percent sales tax that will be used to extend the Bay Area Rapid Transit District light rail service to San Jose and fund several other transit improvements. In Alameda County, 81.3 percent of voters approved Measure A, an extension of a 0.5 percent sales tax that is to pay for a number of transportation projects, including an extension of BART.

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Other Noteworthy Tax Legislation Approved

In addition to the budget tax package, a number of other noteworthy tax changes were enacted this year:

- **Boxing Promoter Tax Relief.** AB 52 (Cedillo) places a cap on the state's 5 percent boxing and wrestling admissions tax that has been in existence since 1924. It provides that no more than \$100,000 in admissions taxes (or "gate tax") can be collected by the State Athletic Commission for any single boxing event. The bill also provides that if a gate tax exceeds \$70,000, then one-half of that excess amount shall be paid to the Boxers' Pension Account. Proponents said the cap is needed to attract "big name" fights to California.
- **Tax Practitioner-Client Privilege.** AB 1016 (Briggs) conforms to the 1998 federal law until January 1, 2005 to extend the lawyer-client privilege to communications between clients and any federally authorized tax practitioners. The bill applies to any non-criminal tax matter before the Franchise Tax Board, State Board of Equalization or Employment Development Department.

- **Assessor Loan Program.** AB 1036 (Wesson) extends the sunset date by one year of the State-County Property Tax Administration Loan Program that provides loans (which are routinely forgiven) to counties to assist their administration of the property tax system.
- **Low-Income Housing Tax Credit.** AB 1626 (Torlakson) permanently increases the state's annual low-income housing tax credit limit from \$35 million to \$50 million.
- **Possessory Interests.** AB 1966 (Wiggins) excludes new month-to-month possessory interests with a value of \$50,000 or less from the supplemental assessment roll.
- **Vineyard Property Tax Treatment.** AB 1790 (Wiggins) allows growers of wine grapes to replace vines damaged by phylloxera, or Pierce's disease, with new, better grapevines with no change in the Proposition 13 base-year value of the vines.
- **Interest on Erroneous Refunds.** AB 2897 (Assembly Revenue and Taxation Committee) provides that interest on erroneous bank and corporation tax and personal income tax refunds begins to accrue 30 days from the notice of repayment.
- **Personal Property Tax Rebate.** AB 1984 (Zettel) permits San Diego County to rebate personal property taxes paid by telecommuting centers on equipment installed in those centers provided certain criteria are met.
- **Taxpayer Rights.** AB 2898 (Assembly Revenue and Taxation Committee) conforms certain BOE-administered tax programs to the IRS Restructuring and Reform Act of 1998. Among other things, the bill allows the BOE to grant innocent spouse relief for equity reasons.
- **Distilled Spirits Tax Exemption.** SB 607 (Chesbro) provides an alcoholic beverage excise tax exemption for sales of distilled spirits to military bases in California.
- **Security Trading Safe Harbor.** SB 1239 (Burton) conforms to federal law effective January 1, 1999, relating to safe harbors for securities trading in California.
- **Personal Property Audit Threshold.** SB 1844 (Kelley) increases the threshold value of personal property from \$300,000 to \$400,000 for requiring a county assessor to audit a business.
- **Assessors' Consultants Confidentiality Requirements.** SB 2170 (Senate Revenue and Taxation Committee) extends confidentiality requirements to consultants hired by assessors.

- **Assignment of Lottery Winnings.** SB 2173 (Senate Revenue and Taxation Committee) precludes state taxation of lottery winnings that are sold or assigned to third parties.
- **Tire "Fee" Increase.** SB 876 (Escutia) increases the state's "fee" on tires from 25 cents to \$1 per tire.

Failure of the Conformity Bill

In the early 1980s, California revised its personal income tax by adopting federal law by reference as of a certain date. Areas where California lawmakers did not wish to conform were separately stated. It was expected a general conformity bill would be enacted each year, moving the reference date forward. As no general federal conformity bill passed in 1999, taxpayers were optimistic that a two-year conformity bill would be a high priority for the Legislature in 2000. Legislative staff held meetings with all interested parties and a consensus bill (AB 2763, Knox) was introduced. The bill easily passed the Revenue and Taxation Committee. The Assembly Appropriations Committee interred the bill on its "suspense file," never to see the light of day, due to the FTB estimating gurus' scoring of the bill as a rather small revenue loss.

Late in the session, there were efforts to revive the bill by amending it into an Assembly bill in the Senate (AB 1667, Corbett) and a Senate bill in the Assembly (SB 843, Polanco).

The Richard Polanco version of the measure actually passed the Assembly, but Senate Democratic leaders had decided there would be no general conformity bill in 2000 and refused to allow the bill to come to a vote.

As a result of the Legislature's failure to pass a general conformity bill, California tax law still references federal law as of January 1, 1998.

Thus, California does not conform to a number of federal tax laws, including:

- Suspension of the statute-of-limitations period for certain refund claims for financially disabled taxpayers (IRC § 6511);
- Burden of proof shift in court proceedings (IRC § 7491);
- Elimination of the interest rate differential (so-called "hot interest" rule) (IRC §§ 6601 and 6621);

As a result of the Legislature's failure to pass a general conformity bill, California tax law still references federal law as of January 1, 1998.

- Civil damages for collection actions (IRC §§ 7426 and 7433);
- Refunds when an estate elects installment payments (IRC §§ 7422 and 7479);
- Bond issuer tax-exempt status (IRRA of 1998 § 3105);
- Penalty for failure to deposit payroll taxes (IRC § 6656);
- Personal delivery of 100 percent penalty notice (IRC § 6672);
- Threat of audit to coerce tip reporting (IRRA of 1998 § 3414);
- Increase in levy exemption amounts (IRC § 6334);
- Increase in exemption for liens (IRC § 6323);
- Elimination of extensions for the 10-year statute of limitations period on collections (IRC § 6502);
- Appeal procedures for early referral of non-binding arbitration (IRC § 7123);
- Guaranteed availability of installment agreements (IRC § 6159);
- Prohibition on requests to taxpayers to waive rights to bring an action (IRRA of 1998 § 3468);
- Explanation of joint and several liability (IRRA of 1998 § 3501);
- Explanation of taxpayer rights in interviews (IRRA of 1998 § 3502);
- Disclosure of examination selection criteria (IRRA of 1998 § 3503);
- Cataloging employee misconduct complaints (IRRA of 1998 § 3701);
- State liability offsets against federal overpayments (IRC § 6402).

Internet Taxation Issues

Internet taxation issues were prominent in 2000, with forces seeking to expand Internet taxation and those opposed battling to a stalemate.

Early in the year, a 19-member commission appointed by Congress to study the issue made a number of recommendations to rein in extraterritorial taxation by states, to ban taxes on access to the Internet, and to limit taxes on Internet sales until a simplification program is worked out. However, these recommendations were not "official" as they were adopted by less than a two-thirds vote. State Board of Equalization Chair Dean Andal, a member of the commission, played a key role in developing the nexus limitation recommendations.

The Legislature approved a bill extending California's Internet Tax Freedom Act for three years (AB 1784, Lempert). The Assembly had wanted to make the act permanent, but Senate Democratic leaders "watered it down" to a three-year extension. They also added a "poison pill" amendment that would permit AB 1784 to go into effect only if another bill expanding taxes on Internet sales (AB 2412, Migden) went into effect. AB 2412 was vetoed, so the extension of the Internet Tax Freedom Act did not become effective, although Governor Davis signed AB 1784 as a symbolic gesture of support.

AB 2412, which was opposed by the American Electronics Association, would have provided that an Internet business is presumed to have nexus in California (thus required to collect state sales tax from customers) if a retailer with nexus has at least a 10 percent interest in the out-of-state Internet seller (or vice versa) and the out-of-state retailer sells similar products or uses the same business name or uses facilities of the in-state business. (For example, a California clothing store could buy a 10 percent interest in an Internet seller of clothes and thus subject the Internet seller to California nexus.)

The governor said in this veto message, "In order for the Internet to reach its full potential as a marketing medium and job creator, it must be given time to mature. At present, it is less than 10 years old. Imposing sales taxes on Internet transactions at this point in its young life would send the wrong signal about California's international role as the incubator of the dot-com community."

The governor said in this veto message, "In order for the Internet to reach its full potential as a marketing medium and job creator, it must be given time to mature."

He also noted that the bill "singles out companies that are conducting transactions electronically and attempts to impose tax collection obligations on them to which, according to California courts, they are not subject."

To the end, proponents continued to claim the bill "clarified" existing law, a view challenged by experts such as the chief counsel of the State Board of Equalization. The bill was also scored as a \$14 million revenue gain, further evidence that the bill expanded, rather than clarified, nexus.

Judicial Decisions

Courts ruled this year in three major cases involving the Franchise Tax Board with the government winning one, the taxpayer winning one, and a mixed result on the third.

Early in the year, the U.S. Supreme Court, in *Hunt-Wesson v. Franchise Tax Board*, held California's interest offset provision unconstitutional as it applied to out-of-state businesses. The court said the state, through its interest offset, was taxing income that it has no right to tax directly.

The FTB prevailed on *Guy F. Atkinson Company of California v. Franchise Tax Board* on the specific issue of whether an energy tax credit could offset tax liability of an entire unitary group. The court said Atkinson failed to demonstrate that it was entitled to apply the credit to the combined tax liability of the entire unitary group. However, efforts by the FTB to have the decision published were turned down, so this case cannot be used as precedent.

The tax board clearly prevailed in *Citicorp North America, Inc. v. Franchise Tax Board*, where the First District Court of Appeal said the FTB could have its cake and eat it too. The court held both the *Joyce* and *Finnigan* apportionment schemes constitutional and also said that *Finnigan* could be applied retroactively, but the *Joyce/Huffy* approach could be applied prospectively only. Of interest in this decision was language that it was not unreasonable to interpret the term "taxpayer" in the statute to refer to the entire unitary group.

At issue in this case was whether California sales of Citibank South Dakota could be included in Citicorp North America's sales factor in the apportionment formula. Citibank South Dakota had no physical presence in California. The court used the *Finnigan* theory to include the sales on a retroactive basis (as the sales predated the *Finnigan* decision, but said the new *Joyce/Huffy* theory adopted last year, could be made prospective only, preventing the taxpayer from using this theory.

Tax Administration

As tax agencies were striving to become more taxpayer friendly, *CFO Magazine* in September published results of its latest survey, with California tax administration ranked as least friendly to taxpayers among all states. Senior Editor George Donnelly said California's auditing policy was rated by far the most aggressive in the country.

Congressman Brad Sherman (former chair of the State Board of Equalization), in a letter this year urging state tax administrators to secure confidential tax information, cited a case where the California Franchise Tax Board disclosed an individual's non-

The FTB staff and taxpayers were locked in a bitter struggle over a proposed "protest" regulation to replace the staff's administrative protest policies that had been found to be an illegal

public address and Social Security number to a Las Vegas newspaper in a residency audit. At the request of current BOE Chair (and FTB member) Dean Andal, the FTB asked its staff to develop an audit regulation. He said the regulation needs to get a handle on the audit program and should have time deadlines and provide for even-handed treatment of taxpayers.

"underground regulation."

Meanwhile, the FTB started work on a "portal" filing system, allowing taxpayers to file electronic tax returns directly with the FTB, using private-sector software. A new, simple income tax return form (called the "2EZ" form) was launched successfully this year with 11 percent of taxpayers sent the form using it. FTB staff reported that it reduced the call-waiting time for answering phone calls from taxpayers requesting information by about one third (from 3.18 minutes to 2.14 minutes). The board also modified its 25 percent demand penalty for non-filers so that it only applies to repeat non-filers.

The FTB staff and taxpayers were locked in a bitter struggle over a proposed "protest" regulation to replace the staff's administrative protest policies that had been found to be an illegal "underground regulation." Taxpayers objected to a staff provision allowing re-audits of any taxpayer who had the temerity to protest an FTB audit determination. When the regulation reached the board, it was modified to limit re-audit authority to only specific situations. The board also adopted a 24-month time limit for resolving protests, with certain exceptions. At this writing, the protest regulation seemed to be stuck in limbo, being held up by the Davis Administration. FTB staff strongly opposed the regulation as modified by the board.

Several unitary combination and formula apportionment regulations were adopted this year by the FTB. Combined report regulations (25106.5 and 25106.5-2) were approved, as were a controversial intercompany transaction regulation (25106.5-1) and an occasional sales of intangibles regulation (25137c) that was modified to meet taxpayer concerns.

At the BOE, major reforms were adopted on how to apply the sales tax to "drop shippers," who are manufacturers that send products directly to California customers on behalf of out-of-state retailers. The board adopted a regulation (1706) creating a safe harbor that drop-shippers may use to determine the retail price for purposes of computing sales tax. A presumption is created that the retail price is the drop-shipper's cost, plus 10 percent. The board also changed

its administrative policies so that the sales tax on drop shipments to California customers with sales permits will be collected as use tax from the customers.

The board also adopted a package of sales tax collection reforms, including increasing the "lien" threshold to \$2,000, filing a release of lien directly with the county recorder, and expansion of installment payment agreements.

Several key appellate rulings were made by the BOE this year. In an appeal by Hewlett-Packard, the board put outer limits on the Yamaha case on the extent that gifts to out-of-state parties would be subject to sales tax. The board, by a 3-2 vote, allowed a self-described lesbian who is supporting her partner and a non-biological, non-adopted child, to claim head-of-household income tax status (*Appeal of Helmi Hisserich*). In a sales tax case, the board adopted a written opinion that meals sold by a private contractor to students in a school cafeteria are exempt from sales tax (*Appeal of John Chris Moganman*).

A changing of the guard in state tax administration occurred this year as new faces emerged at key posts. James Speed succeeded Les Sorensen as executive officer of the State Board of Equalization. Elaine Howle succeeded Kurt Sjoberg as state auditor.

At the local level, there were dramatic increases in assessed value in many counties. Riverside County's roll went up 11 percent; Orange County's roll was up 9.6 percent. Los Angeles County's local assessment roll increased by 6.7 percent to a historic high of \$569 billion. In the Bay Area, property values increased 10 percent region wide.

Little Alpine County became the first county to flunk legislative-mandated assessment standards. The county was found to have an average level of assessment of 89.69 percent of value required by law (generally acquisition value). State law requires assessments to be at least 95 percent of lawful value.

Nevada County Assessor Art Green, who had been under fire most of the year due to a controversial computer development contract, resigned and was replaced by Dale Flippin.

In Los Angeles County, Assessor Kenneth Hahn resigned due to health reasons and was succeeded by Rick Auerbach, who was elected in his own right in November.

Several local property tax rules were revised this year. Property Tax Rule 10 was amended, establishing that property is to be valued at its proper trade level. Property acquired from internal sources for self-consumption is to be assessed at the price it could be sold to an outside source for use at the same trade level. This was important for high-technology taxpayers in particular.

The BOE adopted revised rules (305 and 306) for assessment appeals hearings allowing Assessment Appeals Boards to permit taxpayers to amend their assessment appeals.

Filing Their Final Tax Returns

It would be inappropriate to conclude a review of significant 2000 tax developments without noting the deaths of several prominent persons who toiled in the tax area.

Former Senator Ken Maddy, who authored Cal-Tax's 1995 property tax reform bill, died of cancer this year.

Former Assembly Member Joe Gonsalves, who chaired the Assembly Revenue and Taxation Committee from 1971 through 1974 and was one of the first to introduce legislation to limit assessment increases, died this year from complications of a blood disorder.

Carmel attorney Ken Ehrman, who was co-author of *Taxing California Property*, the bible for property tax attorneys, was killed in an automobile crash in Carmel Valley.

We are the poorer for the loss of each of these splendid individuals.
