

CALTAX YEAR IN REVIEW: 2007 – A RELATIVELY UNEVENTFUL YEAR FRAMED BY DISAPPOINTMENT, SORROW AND SPIN

There are not a lot of positive things that can be reported about California tax and fiscal policy in 2007. The year may best be remembered as a prelude to a budget meltdown.

The State Budget

Republicans held up passage of the state budget until August 20 and succeeded in getting the 2007-08 spending plan reduced \$2.7 billion below the amount in the spending plan reported out of the budget conference committee. In a brilliant spin job, budget proponents had much of the public and some of the state's most influential media outlets convinced that this budget was a prudent proposal, and that the Republicans were obstructionists.

Consistent with past practice, the influential Legislative Analyst's Office was silent on the conference committee's budget, and did not inform legislators or the public about what was in the budget, or the plan's future ramifications. Individuals more knowledgeable about the budget were not fooled. Almost all Republican legislators voted against the final version. Senator Tom McClintock, in a speech to the Senate just before the final vote, said, "I am afraid that with this vote, for the second time in a decade, this state is being driven to another Gray Davis-sized fiscal crisis that this vote makes inevitable for exactly the same reasons: Lack of restraint in good times combined with a lack of discipline in bad times."

Just four months after the budget was enacted, word leaked out that the state's structural budget gap had grown from \$6 billion to \$14 billion. Governor Arnold Schwarzenegger indicated that he would declare a fiscal emergency in January to begin the process of getting the state's fiscal house in order.

Tax Legislation

There were no significant state tax increases or meaningful tax reforms in 2007. The teachers' tax credit, always questionable tax policy, was finally repealed. It had been suspended on a year-by-year basis for the last several years. The budget trailer bill that repealed the teachers' tax credit ([SB 87](#), Senate Budget and Fiscal Review Committee) also increased property taxes for fractionally owned aircraft by shifting the liability from owners to fleet managers.

An economic stimulus budget trailer bill ([SB 98](#), Senate Budget and Fiscal Review Committee) passed the Assembly on July 20, but the bill was not taken up in the Senate, on the orders of Senate President Pro Tempore Don Perata. A major drafting error was discovered that would have increased the research-and-development tax credit to federal levels (which the authors did not intend to do), plus the bill inadvertently would have put a sunset date on the credit, which currently is permanent. The bill also contained movie and television commercial tax credits, and would have allowed

corporations to elect to use an additional sales factor in their corporate apportionment formula for each \$250 million invested in California, up to two in any one year.

There was new leadership at both legislative tax policy committees, with Senator Jenny Oropeza and Assemblyman Charles Calderon assuming the chairs in their respective houses.

A tax increase could be in the offing if the Senate approves a health care bill passed by the Assembly in late December. The new program, with a cost of \$14 billion, requires new taxes that would have to be approved by voters next November. (See story on page 7.)

Among the handful of other tax bills signed into law were those to include foster children within the parent-to-child property tax change-of-ownership exemption ([AB 402](#), Ma) and to increase vehicle registration fees and the smog abatement charge ([AB 118](#), Nunez).

The governor vetoed several bills opposed by CalTax, including a Franchise Tax Board-sponsored bill ([AB 1618](#), Feuer) that sought to repeal the "interest offset" provisions for California corporations. He also vetoed an attempt by the Legislature to give local government the authority to impose car tax increases without voter approval ([SB 613](#), Simitian).

In a victory for taxpayers, the governor also vetoed a bill sponsored by the State Board of Equalization that would have required taxpayers to report any use taxes on their personal income tax returns. The legislation ([AB 969](#), Eng) did not require the tax agency to warn taxpayers that they needed to keep records to verify their purchases, nor did it require the tax collectors to specifically explain how to compute the tax. No information would have been provided to taxpayers regarding what purchases are taxable, and to what extent.

Finally, an FTB-sponsored bill, supported by CalTax, was signed into law to repeal the requirement for mandatory annual audits relating to the water's-edge election ([SB 788](#), Cogdill).

For years, there have been complaints about the state's bandit-like unclaimed property program. This year, some changes finally were made. The Controller's Office, using a private firm, had been seizing people's bank accounts and other assets, under a claimed lack of activity (cashing checks from an account or rollover of IRAs apparently do not count as activity), without notifying the owners. During the summer, CalTax published a list of a number of government agencies – including the Unclaimed Property Bureau itself – that had property on the unclaimed property list. Adding impetus for change, the U.S. Ninth Circuit Court of Appeals, in *Taylor v. Westly*, held the state's practices to be illegal and issued an order prohibiting the state from seizing property without telling people. This was not good news for the private firm that was losing a lucrative source of income. This forced the Legislature to act. Legislation forcing the

controller to notify the owners of property that had been seized was passed as a budget trailer bill in August ([SB 86](#), Senate Budget and Fiscal Review Committee) and was signed by the governor, with the support of Controller John Chiang.

Major legislative disappointments this year were the failure to pass a conformity bill and failure to revise the state's 911 Emergency Telephone Surcharge. The conformity bill got stuck on the Senate Appropriations Committee's suspense file, so the state is still conformed, with many exceptions, to federal law as it read on January 1, 2005. Although the changes in the Emergency Telephone Surcharge had been worked out with all interested parties, the bill passed the Assembly so late on the final day of session that it reached the Senate after that body had adjourned for the year.

Also, over the objections of taxpayers, legislation prohibiting full refunds of taxes paid by limited liability companies, should the courts find the existing LLC tax to be illegal, was passed and signed by the governor. Refunds will be limited to the difference between what actually was paid and what would have been paid under the new apportionment provisions in the bill ([AB 198](#), Assembly Budget Committee).

To help taxpayers monitor legislative activity, CalTax contracted with former Senate Revenue and Taxation Committee consultant Martin Helmke to continue his very useful summary spreadsheet on all tax legislation introduced in 2007. This is available to the public on the [CalTax website](#).

Local Taxes

At the local level, taxpayers in some communities will be paying higher taxes, as voters approved some sales tax, parcel tax and utility tax increases. Cities where taxpayers will pay more in tax on what they buy are Selma, Delano, Hollister and Ceres. Successful spin jobs that completely fooled voters were changes in local utility user taxes on telephone services. A number of cities got voters to approve – by huge margins – tax changes by offering a slight rate cut, but not explaining that the tax base would be substantially broadened and that authority would be given to cities to tax Internet access if permitted by federal law.

Local government officials should go to sleep at night saying over and over: "Thank God for Proposition 13." A little-known effect of the taxpayer-protection measure is its counter-cyclical effect in protecting local property tax revenues during housing market downturns. The just-completed year was not a good year for real estate values. Despite the massive decline-in-value assessments in a number of counties, this year's local assessment roll grew 9.6 percent statewide. According to Daniel Weintraub, columnist for *The Sacramento Bee*: "One unexpected and underappreciated consequence of Proposition 13 ... is that the measure acts as a buffer smoothing the flow of government revenues over time. Instead of fluctuating with the real estate market, property tax revenues are much more stable, giving local officials time to adjust. As those long-held properties sell, they are reassessed upward at their market value. The resulting jump

from just one of these sales can be more than the decline in taxes on 100 other homes." In August, the *San Diego Union-Tribune* quoted CalTax Acting President Teresa Casazza saying, "The tax revolt of 1978 showed us that most Californians are more thoughtful, and prefer the current system that protects homeowners from massive tax hikes and provides revenue stability for local governments."

State Tax Agencies

At California's tax agencies, it was another busy year. The Franchise Tax Board continued with its new policy of transparency, with a number of interested parties meetings, a much-improved website and expanded communications. For the first time in recent memory, the board even announced its yearly schedule of meetings at the beginning of the year, a move applauded by taxpayers.

The FTB also approved an important mutual fund apportionment regulation. Regulation 25137-14 establishes shareholder residency, rather than cost of performance, as the sales apportionment factor for mutual funds.

In response to a California Supreme Court decision, a treasury function regulation (see below) also was approved. Geoff Way took over the key post as Franchise Tax Board chief counsel, replacing John Davies, who retired. FTB multi-state taxation guru Ben Miller, who was thinking of retiring, was persuaded to stay on for a while.

The State Board of Equalization was another story. The agency's "state-of-the-art" headquarters building in Sacramento made almost as much news as what went on inside it. Just as the problem of falling windows finally was remedied after a multi-year repair job, an infestation of mold was discovered on the top three floors of the building. Staffers were evacuated, and the floors remain off-limits as we begin 2008. Also, it appears that bats may like the building more than the human inhabitants do. Agonizingly slow elevators did not help staff morale, either.

Despite these combat-pay conditions, important decisions were made by the BOE on key tax policy issues. By defining malt liquor as a distilled spirit rather than beer, the board approved a massive alcoholic beverage tax increase on this product (beer is taxed at 20 cents a gallon, while distilled spirits are taxed at \$3.30 per gallon).

The board approved a request by county assessors to require oil refinery fixtures to be in the same appraisal unit as improvements – a move opposed by taxpayers, who argued that the Legislature, in implementing Proposition 13, called for a separate appraisal unit for fixtures. However, the board rejected an effort by assessors to expand Rule 21 to make it easier for assessors to increase values of possessory interests.

In addition, new Rules of Practice for hearing tax appeals were adopted by the board in September after a monumental effort by staff and interested parties to develop the new

rules. There also were lighter moments at BOE hearings, such as the time the board learned that organized crime outfits were stealing baby formula.

The Courts

California courts continued to impact tax policy with several blockbuster decisions. The California Supreme Court, in a pair of cases (*Microsoft v. Franchise Tax Board* and *General Motors v. Franchise Tax Board*), disagreed with the Franchise Tax Board and held that a company's treasury function receipts are to be included in the sales factor of the standard apportionment formula. However, the taxpayers did not win these cases, because in both, the court said the FTB could use a Section 25137 alternative formula if it found distortion. By the end of 2007, the Franchise Tax Board had adopted a new rule eliminating the treasury function from the sales factor, because of inherent distortion.

Two court decisions that made assessors grumpy were the Second District Court of Appeal's holding that transfers of life estates are not changes in ownership (*Steinhart v. County of Los Angeles*) and the Third District Court of Appeal's holding that the Legislature can exempt properties from changes of ownership generally, and specifically transfers between domestic partners (*Strong v. State Board of Equalization*).

In another reaffirmation of the people's right to vote for property-related fee increases, the Sixth District Court of Appeal held that the Pajaro Valley Water Management District's increase in a groundwater charge without voter approval violated Proposition 218 (*Pajaro Valley Water Management District v. Ray Amrhein*).

An effort by the City of Los Angeles to expand the base of its utility user tax on telephones without voter approval was quashed by the Second District Court of Appeal (*AB Cellular, LA LLC v. City of Los Angeles*). The court said: "A taxing methodology must be frozen in time until the electorate approves higher taxes. This interpretation dovetails with the declarations in Section 2 of Proposition 218... ." The city then placed an expansion of its telephone tax base on the February 2008 ballot, masked by a 0.5 percent reduction in the rate.

In an important decision relating to fees, the Fourth District Court of Appeal told Orange County that it must refund fees exceeding the cost of providing the associated service, by reducing future building and plan check fees (*County of Orange v. Barratt American, Inc.*).

Finally, the U.S. Supreme Court let stand a 2006 California court decision reformulating an illegal business license tax imposed by San Francisco that limited the amount of the refund to the taxpayer (*Macy's v. San Francisco*).

Changes at CalTax

For CalTax, 2007 was a year of sorrow and renewal. CalTax President Larry McCarthy spent most of the year at home battling cancer, and succumbed on December 1 at the age of 59. The people of California lost an articulate and effective voice for fiscal restraint and taxpayer protection.

Also, there were significant staff changes at CalTax. Teresa Casazza, Vice President and Legislative Director, assumed the role of Acting President for most of 2007 during Mr. McCarthy's absence. Long-time Director of Communications Ron Roach retired and was succeeded by David Kline. In May, former legislative consultant Michele Pielsticker joined the staff as general counsel.

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