

CALTAX YEAR IN REVIEW: 2008 – A YEAR DOMINATED BY TAX TALK, BUT OVERT STATE TAX INCREASE PROPOSALS ARE REJECTED

For a while, it appeared that 2008 would usher in the first major state tax increase since 1991. It was not to be – well, at least the revenue-raising proposals were not called tax increases. Despite the efforts of Governor Arnold Schwarzenegger, most legislative Democrats and the Legislative Analyst's Office, no major state tax increase was enacted into law last year – although a "tax penalty" that forces many law-abiding businesses to overpay their taxes by millions of dollars was approved.

In August, in an attempt to get legislative Republicans to support a two-thirds vote, broad tax increase and break the deadlock on the long-overdue 2008-09 state budget, the governor proposed a temporary, three-year sales tax increase (except on gasoline) to be followed by a permanent 0.5 percent sales tax reduction. Over time, the tax increase would have morphed into a net tax reduction. Legislative Democrats were holding out for a broad tax increase as part of the budget solution, and the governor believed the compromise would strike a middle ground, but Republicans rejected the proposal.

As a result, after a record delay, the Legislature on September 19 approved a \$103.4 billion general fund budget that most observers knew was unbalanced. (This spending level compared with proposed general fund spending of \$101 billion in the budget that the governor originally submitted to the Legislature at the beginning of 2008. Thus, the adopted budget was actually \$2.4 billion higher than the one the governor proposed.)

On paper, the overdue budget was "balanced" by unrealistic revenue estimates that were stale by the time the budget was approved; covert tax increases that were not officially "tax increases," although they extracted millions more dollars from taxpayers; accounting gimmicks, such as counting tax revenue received in September 2009 as part of 2008 revenues; and a number of so-called "budget cuts." (It should be noted that when the governor's 2009-10 budget plan was released on New Year's Eve, the general fund spending for 2008-09 was estimated to be \$1 billion higher than the \$103.4 billion estimated in September, absent further spending cuts proposed by the governor. This illustrates that the spending "cuts" advertised in September were overstated.)

In an age-old legislative tradition, reductions in the rate of growth of state spending were counted as "cuts." Further, some of the budget cuts were less than meets the eye. One budget-cutting hoax that has gone virtually unnoticed is the reduction of appropriations for various spending programs even as actual spending continues on a pace to exceed the budgeted appropriation. Routinely, the Legislature, with a two-thirds vote, will later pass a supplemental appropriation for the increased spending, so the original "cut" never materializes. Indeed, in 2008 the Legislature passed deficiency appropriation bills for the 2007-08 budget.

The September 19 budget package was passed without the public having adequate time to review the proposals and "trailer bills," nor were there any public hearings on some very important changes in the tax code. Further, although the legislative analyst in February analyzes the governor's initial budget (little more than a placeholder in recent years) *ad nauseam*, the office is not required to nor does it provide an analysis of the budget that the Legislature is actually going to vote on.

Tax changes made in a September 19 budget trailer bill ([SB 28X](#), Senate Budget and Fiscal Review Committee) included a new, draconian 20 percent penalty on corporate taxpayers that, according to Franchise Tax Board estimates, was designed to get corporations to pay \$504 million more than they actually owe, with the overage to be refunded – possibly in the form of IOUs – years later. This penalty sweeps with a broad brush, forcing even law-abiding taxpayers to fork over millions of dollars to the state up front to ensure that accounting errors will not result in a massive penalty. (**CalTax:** While the measure was presented as doubling an existing penalty for scofflaws, it is just another way to borrow on the backs of taxpayers.)

In addition, a number of tax policy changes were made in another budget trailer bill ([AB 1452](#), Assembly Budget Committee). Major temporary tax increases were implemented (although they were not keyed as such by legislative counsel.) With certain exceptions, business tax credits allowable in 2008 and 2009 were limited to an aggregate of 50 percent of tax liability. But in the future, companies will be able to assign credits of one subsidiary to another to allow for fuller utilization of credits (with some limits relating to enterprise zones). Businesses' net operating loss carryforwards were suspended for the 2008 and 2009 taxable years, but could be claimed later. And by 2011, taxpayers incurring losses in this or future years could also carry back the losses for two years.

Taxpayers will have to keep vehicles, boats and planes out of state for 12 months instead of three to avoid the use tax when these purchases are brought in to California. The bill also requires limited liability companies to pay their tax for the 2009 tax year by way of a June estimate.

Other tax law changes adopted as part of the budget skew estimated tax payments for April and June, so that 60 percent is remitted by the half-way mark (**SB 28X**) and require taxpayers with a high tax liability to remit by electronic payment ([AB 1389](#), Assembly Budget Committee).

Also, the governor used a line-item veto to eliminate \$190 million in property tax relief for low-income seniors and disabled Californians – a program started by Governor Ronald Reagan.

As part of the budget package, a new budget reform plan was approved and will be submitted to voters for approval, presumably this year. [SCA 13](#) (Ashburn) and [SCA 30](#) (Ashburn) require unanticipated revenue (defined as being more than 105 percent of the

estimate in the governor's January budget) to be transferred to a "Rainy Day Fund." Those funds can be transferred back to a budget only when general fund revenues are insufficient to support prior-year spending adjusted by the growth in personal income.

To virtually no one's surprise, it was acknowledged in October that the September budget was out of whack by \$11 billion, which means that the budget passed one month earlier had been put together using exceptionally defective revenue estimates.

Right after the election, the governor called the "lame duck" Legislature back in to special session and proposed a much more massive tax increase. The governor asked the Legislature to impose a 9.9 percent oil severance tax; increase the sales tax by 1.5 percent (without a future reduction); impose the sales tax on specified repairs, veterinary services and admissions to sporting events, theme parks and golf courses; impose a new burden on business to withhold from independent contractors; increase the vehicle registration fee by \$12; and raise alcoholic beverage excise taxes substantially, including a 640 percent increase in the tax on wine.

The governor found no takers for his plan, and lots and lots of opposition.

Instead of going along with the governor's plan, the Democrat legislative leadership, without any public notice or public hearings, on November 25 brought to the Senate and Assembly floors a package that included a suspension of personal income tax indexing (such indexing is required by an initiative approved by voters in 1982), and an increase in the car tax from 0.65 percent to 2 percent. The tax package, which was estimated to produce \$8.1 billion in increased taxes over a two-year period, also non-conformed with federal law with respect to the corporate tax deductibility of built-in losses by banks. The tax bills ([AB 6XXXX](#), Laird and [SB 6XXXX](#), Steinberg), did not get the required two-thirds votes for approval, failing on a 22-15 vote in the Senate and a 41-31 vote in the Assembly. Opposing votes were supplied by Republicans and two Democrats – Senator Lou Correa and Assemblywoman Nicole Parra.

With the newly minted members of the Legislature sworn in December 1, the governor renewed his call for a special session and called for speedy passage of his proposed package of cuts and tax increases. The tax proposals were the same as the ones proposed in November, but again the governor found no takers.

Instead, with the estimates of the budget shortfall increasing to more than \$14 billion for 2008-09 (only an additional \$3 billion estimating error by the state's number crunchers) and \$41 billion by the end of the 2009-10 fiscal year, the Democrats on December 18 concocted a massive tax increase to be passed as a majority-vote bill. Again, there was no public notice or hearing, as the Legislature abandoned any pretense of allowing public input into its decision-making process. Included in the package were \$9.3 billion in tax increases over a two-year period.

Shortly after the Legislature approved the tax increases with majority votes, Governor Schwarzenegger announced that he would veto the plan because it failed to contain provisions to stimulate the economy, which is the surest road to producing increased revenues. As a result, Democrat leaders did not send the bills to the governor's desk, holding them in limbo until January 6, when they finally announced that they were sending the bills to the governor with the expectation that he would veto them. As soon as the bills reached his desk, the governor followed through on his promise to veto the package.

Critics loudly denounced the passage of the tax increase by a majority vote, calling it a violation of Proposition 13's requirement of a two-thirds vote for state tax increases. A court challenge was filed by Republican lawmakers, the Howard Jarvis Taxpayers Association, Insurance Commissioner Steve Poizner and others on the day the Democrats sent the legislation to the governor, but after the legislation was vetoed, the court quickly tossed the suit. "Absent the Legislature's passage and the Governor's signing of such legislation," the court stated, "adjudications of its constitutionality and the other matters raised by the petition are not yet ripe for judicial review."

Local Taxes. Local tax increases were approved in 2008 by voters in a number of jurisdictions. In November, voters approved 25 new parcel taxes, 18 utility users' tax increases, 23 sales tax increases and \$24.7 billion in new local bonds. Public entities seemed to have mastered the art of getting tax increases passed by using public funds to describe the measures in glowing terms without actually asking for a "yes" vote, and by obfuscating ballot language so that voters don't know that they are voting for a tax increase. The latter was especially true for utility users' taxes, where voters were told they were voting for a rate reduction and "modernization of the telephone tax." The modernization was actually an expansion of the tax base to additional communications services, so the net effects of the proposals were increases in revenue.

In February and June (and at other times in special elections), voters in some areas approved tax and bond increases, but not to the magnitude as in November. In February, voters approved four sales tax measures and six proposals to change utility users' taxes to generally reduce the rate and expand the base. Six of eight sales tax increases passed in June, and five of six utility tax "modernizations" also passed that month.

BOE Troubles. The State Board of Equalization had more than its share of troubles during the past year. By year's end, many employees were clamoring to get out of the 450 N Street headquarters building in Sacramento because they felt it was a health hazard. The three top floors were closed all year due to water damage and mold. Also, many break rooms were closed because of the same problems, and elevator shafts seemed to be infected, too. All told, repairs due to water damage cost \$23 million for a building worth an estimated \$81 million (and probably less now, as that appraisal is a year old). However, the board's 57 New York City employees were luckier. They moved to a nice office on Lexington Avenue in mid-Manhattan.

The agency also was foiled in an attempt to increase revenues by using the regulatory process to raise taxes on flavored malt beverages (dubbed "alcopops" by the temperance groups that urged the tax hike). By a 3-2 vote on March 19, the board classified the product as a distilled spirit, instead of beer, raising the tax from 20 cents per gallon to \$3.30 per gallon. Representatives of the industry called the move by the board illegal and filed suit, saying the state constitution does not give the board the authority to regulate alcoholic beverages. Rather, the Department of Alcoholic Beverage Control has exclusive jurisdiction. By December, manufacturers of the popular beverages reformulated their recipes so their products no longer fall within the board's guidelines for a distilled spirit.

The board has spent an unknown amount so far on implementing the tax, and had planned to spend \$1.3 million in 2009-10 to administer the program, even planning to hire chemists to test the beverages. Without the estimated revenue increase of \$38 million, it would appear that such spending would be a waste of tax dollars.

Disclosure by Board Member Michelle Steel in January that the board was holding on to sales tax deposits beyond the statutory three-year limit caused the board to launch an aggressive program in 2008 to return the sales tax deposits to their rightful owners.

According to reports, the board was holding on to approximately \$38.8 million in deposits of 2,000 small businesses.

Bad News for the FTB. A Las Vegas jury delivered some very bad news to the Franchise Tax Board in July. It ordered the agency to pay inventor Gilbert Hyatt a total of \$388 million in damages for an abusive residency audit conducted by the agency during the reign of Executive Officer Gerald Goldberg. According to testimony at the trial, FTB auditors violated Mr. Hyatt's right to a fair audit, breached his confidentiality, and caused him emotional distress by falsely charging him with fraud. An FTB auditor said the lead auditor became obsessed with going after Mr. Hyatt, and at one point said, "I'm going to get that Jew bastard."

During the year, FTB Executive Officer Selvi Stanislaus and Chief Counsel Geoff Way worked to bring more transparency to agency operations and to work with taxpayers on a less adversarial basis. A number of "interested parties" meetings were held with taxpayers to attempt to develop a dialogue on best approaches to solve problems.

Proposition 13's 30th Anniversary. June 6 marked the 30th anniversary of the passage of Proposition 13. At a conference in Berkeley at the University of California on that date, Field Poll Director Mark DiCamillo reported that a recent poll found that Proposition 13 remains as popular with voters now as it was when it passed. In interviews with voters in May, 57 percent said they would vote in favor of Proposition 13, while 23 percent said they would oppose the measure, and the balance was unresponsive.

Research by CalTax, released on the anniversary date, dispelled the myth that Proposition 13 had somehow shifted the property tax burden to homeowners. According to State Board of Equalization data, of properties subject to Proposition 13's acquisition assessment system, the annual percentage growth of homeowner values was a smaller percentage than the annual percentage growth in value of non-homeowner properties since the passage of Proposition 13. It is the value of property still subject to *ad valorem* assessments (personal property and state-assessed property) that has grown more slowly during the past 30 years than either homeowner or non-homeowner property subject to Proposition 13.

Two court decisions in 2008 were very good news to the supporters of Proposition 13. On April 29, the First District Court of Appeal held that Union City's "911" charge on telephone bills, enacted without a vote of the people, was a tax and therefore was illegal. The California Supreme Court refused to hear an appeal of the decision, so the taxpayers' victory stands in *Bay Area Cellular Telephone Company v. City of Union City*, 162 Cal.

App. 4th 686 (1st Dist. 2008). The court wrote: "(T)he City has not suggested any regulatory purpose it might serve. Nor is the Fee imposed for 'service(s)'. The Fee must be paid by all nonexempt telephone service subscribers in the City – encompassing virtually all nonexempt households and businesses – whether or not they ever use 911 services. A fee for access to a government service is not the same as a fee for the use of the service." In a footnote to the latter comment, the court added: "Indeed, if it were, Proposition 218 could easily become meaningless. Taxes paid by the public to fund police or fire services available to all could be renamed 'public safety access fees' and be exempt from the voter approval requirements. Taxes paid to maintain city streets could be renamed 'road access fees.' The list of possibilities is endless."

On July 14, the California Supreme Court unanimously struck down a property assessment that had been imposed by the Santa Clara County Open Space Authority since 2001. In *Silicon Valley Taxpayers Association v. Santa Clara County Open Space Authority*, 44 Cal. 4th 431 (2008), the court said the county's report on the assessment "fails to identify with sufficient specificity the 'permanent public improvement' that the assessment will finance, fails to estimate or calculate the cost of any such improvement, and fails to directly connect any proportionate costs and benefits received from the 'permanent public improvement' to the specific assessed properties." The court added, "An assessment calculation that works backwards by starting with an amount taxpayers are likely to pay, and then determines an annual spending budget based thereon, does not comply with the law governing assessments before or after Proposition 218."

Voters Reject Ballot Box Budgeting. Several attempts at ballot box budgeting were rejected by voters in 2008. In February, community college faculty unions attempted to lock up a portion of the state's general fund budget solely for community college spending. CalTax actively opposed the measure, and voters agreed with the association's position, rejecting Proposition 92 by a 57.3 percent "no" vote to just 42.7 "yes." In November, a costly energy

initiative was soundly defeated, with 64.5 percent of the voters saying "no" to Proposition 7. Also in November, a \$6 billion bond to fund various energy programs supported by the initiative's main proponents went down in flames, with 59.5 percent of voters casting "no" votes on Proposition 10. Both measures were supported by wealthy out-of-state contributors, and both were opposed by CalTax.

In two ballot initiatives, voters clearly signaled their dissatisfaction with the Legislature. In February, a term limit initiative sponsored by Senate President Pro Tempore Don Perata and Assembly Speaker Fabian Nunez was rejected, with 53.6 percent of the voters opposed. The measure, Proposition 93, sought to change term limits to extend the sponsors' tenure in office. The state's major public employee unions poured millions in to the "yes" campaign, in what turned out to be a waste of their members' money. In November, voters approved a historic change in how legislative districts will be drawn.

Proposition 11, an initiative supported by Governor Schwarzenegger, CalTax, the League of Women Voters, AARP and other groups, narrowly passed with 50.9 percent of the voters saying "yes."

In legislative elections, the partisan make-up of the Assembly changed slightly, as Democrats picked up a net of three seats, leaving them with a 51-29 margin (still three shy of the two-thirds majority needed to approve the budget or tax increases without Republican votes). The make-up of the Senate is unlikely to change, with a current line-up of 24 Democrats, 15 Republicans and one vacancy in a heavily Democratic district.

A mid-year recall election of Republican Senator Jeff Denham, launched by Senator Perata, was a flop. On June 3, only 24 percent of the voters voted for the recall.

Second Edition of "California's Tax Machine" Published. A revised edition of CalTax Chief Tax Consultant Dave Doerr's book, "*California's Tax Machine*," was published in late 2008 to very favorable reviews. The 811-page book includes new material on the impact of Proposition 13, full coverage of Governor Gray Davis' term and coverage of the first five years of Governor Arnold Schwarzenegger's administration. Writing in the *Capitol Morning Report*, Bob Fairbanks said the book "is a necessary reference book for everyone in the field." He added: "But it's also a readable reminder that, as the saying goes, the more things change, the more they stay the same."

Implementation of AB 32 Begins. Although the state's controversial Global Warming Solutions Act was approved in 2006 ([AB 32](#), Nunez), major developments took place in 2008. On December 11, the California Air Resources Board, which is responsible for implementing the plan to reduce emissions of carbon dioxide and other gases by 25 percent by 2020, approved a "scoping plan" that will force billions of dollars in higher costs on to consumers and businesses. The AB 32 Implementation Group, a coalition of businesses concerned about the economic impact of the measure, responded that the

board had approved a flawed plan that ignored the advice of several respected economic analysts.

New Faces. California's tax system is not only a body of law and court decisions, it is comprised of people making law, administering the tax system and taxpayers who ultimately pay the freight. In 2008, there were some significant changes in the field of those who make the tax system what it is (and was). Some of the most significant:

- **CalTax:** Teresa Casazza was named President of CalTax in January, replacing long-time President Larry McCarthy, who died of cancer the prior December.
- **Legislative Analyst:** Elizabeth Hill, long-time legislative analyst, retired October 24 and was replaced by her deputy, Mac Taylor.
- **Franchise Tax Board:** Steve Sims was named the taxpayer rights advocate. Titus Toyama, the FTB's chief of the Financial and Executive Services Division, went to work for the state Department of Finance, and was replaced by Lisa Garrison.
- **Governor's Office:** Victoria Bradshaw replaced Dan Dunmoyer as deputy chief of staff and cabinet secretary. Chris Kahn, chief of the Legislative Unit in the Governor's Office, decided to leave, and Mike Prosio is reported to be in line for his job. One of the more interesting appointments made by the governor in 2008: Bo Derek, the Republican actress and animal rights advocate, was appointed to the California Horse Racing Board.
- **Assessors:** Several assessors retired in 2008. Long-time San Diego County Assessor Greg Smith left office at the end of 2008. Placer County Assessor Bruce Dear retired, and was succeeded by Kristen Spears. In Imperial County, Roy Buckner replaced Jose Rodriguez Jr., who retired. Mendocino County Assessor Marsha Wharff retired and was replaced by Susan Ranochek. In Glenn County, Sheryl Thur is replacing the retiring Vince T. Minto. Up in tiny Trinity County, the new assessor is Deanna Bradford, who replaced retiring Dero Forslund. In Mono County, in a rather unusual twist of events, Assessor Jim Lovett resigned four days before a recall election in June. Voters still voted to recall him, and elected Jody Henning in his place. It is interesting to note that five of the six replacements named so far are women. For years, the assessor ranks were dominated by men.