

CALTAX YEAR IN REVIEW: 2009 – FOR TAX AND FISCAL POLICIES, 2009 WAS A BAD YEAR

Californians will have to look long and hard to find any good fiscal and tax policy news from 2009. How bad was it? The Legislature tried twice to produce a balanced budget for 2009-10 and failed abysmally. The budget approved in February was out of balance within months, and a revised budget passed in July is currently estimated to be \$6 billion out of balance. Taxes were increased substantially, but not as much as intended by the Legislature and governor, as voters turned down a two-year extension of the temporary taxes with the defeat of Proposition 1A in May. That measure, which also included budget reforms, garnered the support of only 34 percent of the voters, with 66 percent opposed. Spending was cut, but by not as much as the tax hikes, and the Department of Finance came up with more of its seemingly inexhaustible supply of "gimmicks."

General fund spending was 7.6 percent below 2008-09, and that percentage will shrink (spending will rise) as agencies spend more than budgeted and ask the Legislature for more money, while courts are overturning spending cuts. Meanwhile, in February, the Legislature passed a tax package requiring taxpayers to cough up more than \$9 billion in 2009-10 for the general fund – roughly 11.4 percent above what would have been collected without the tax increase.

Specifically, the sales tax rate was increased by 1 percent until June 30, 2011, the personal income tax rate was increased across the board by 0.25 percent for 2009 and 2010 tax years, the car tax was increased from 0.65 percent to 1.15 percent until June 30, 2011 and the dependent exemption credit was reduced from \$309 to \$99 for the 2009 and 2010 tax years. These changes were expected to increase revenues by more than \$10 billion in 2009-10, but it appears that they will fall about \$1 billion short, based on the shortfall in revenues collected during the first half of the fiscal year, as reported by Controller John Chiang.

Later in the year, a bill to restore funding for the Healthy Families Program ([AB 1422](#), Bass) imposed a 2.35 percent gross premium tax on certain Medi-Cal managed care plans.

Two kinds of budget "gimmicks" were used in 2009, and both are bad! First, there are the one-time "gimmicks" that leave a big hole in the following year's budget and must continue in effect, or else the deficit will become twice as big. Some examples of this in the budget: deferring employee pay from June 30 to July 1, imposing 10 percent over- withholding, and moving a portion of income tax estimated payments from one fiscal year to the prior year. Second, there are one-time gimmicks that have to be paid back, with interest. This leaves a double-hole, as the revenue stream does not continue and revenues have to be found to pay back the one-time "gimmick." For example, if you borrow \$2 billion to help balance the budget, the \$2 billion will not be available in the following year and the original \$2 billion must be paid back, leaving a \$4 billion deficit.

Some examples of the second type in the 2009-10 budget are the \$1.9 billion raid on city and county property taxes (by a suspension of Proposition 1A of 2004) and the raid on special funds.

The Legislature and governor also created an additional huge budget problem for future years by promising schools a Proposition 98 maintenance factor of \$11.2 billion, when only \$1.4 billion was owed. This allows school spending to escalate as if there were no economic downturn, and adds to the massive amount of debt owed by the state. In October, State Treasurer Bill Lockyer issued a warning about the massive amount of state debt that is outstanding or has been authorized. Interest on state bonds is now one-third higher than projected. The state has only sold approximately \$66.4 billion of \$130 billion of authorized bonds. Within 10 years, debt service will consume 10 percent of state general fund outlays.

New Tax Incentives

As part of the February budget package, several new tax incentives were authorized. For 2009 and 2010, a \$3,000 per net new employee hiring credit was passed (to a maximum of \$400 million total). An income tax credit of up to \$10,000 for taxpayers who purchased newly built homes by March 2010, up to a maximum of \$100 million total, was established. The credit was extremely popular, and stimulated home purchases for a few months, but it reached the maximum \$100 million allowed by July, eight months before the official termination date. Beginning in 2011-12, a new income and corporate tax credit to provide an incentive for film production will go into effect, as will a change in the method of apportioning corporate income to California. Taxpayers will have the option of using an apportionment factor of sales only, rather than using property, payroll and sales as the factors.

Local Taxes Up, Too

In addition to paying higher state taxes, taxpayers in many local jurisdictions will find an increasing local tax burden. In various local elections throughout the year, 66 of 99 tax measures were approved. However, attempts to increase local sales taxes found more resistance, with only three (in San Mateo, Gustine and Los Banos) of six ballot measures winning voter approval. Local governments placed many misleading utility tax measures on the ballot, describing them as "modernizing" the tax, when what they were really doing was extending the tax to cell phone service.

It Could Have Been Worse

Several legislative attempts to impose new tax burdens on taxpayers failed in 2009 after hard-fought battles. A poison pill amendment was added to a much-needed income tax conformity bill ([AB 1580](#), Calderon) to impose a new 20 percent penalty relating to overpaid refunds on some, but not all, business taxpayers, in addition to existing penalties. CalTax and others urged the governor to veto the bill, which he did. There

were a number of bills, all unsuccessful, to raise taxes above the increased levels established in February. [SB 96](#) (Ducheny) would have added new 10 percent and 11 percent income tax brackets; [AB 462](#) (Price) would have imposed an additional 1 percent tax on gross receipts in excess of \$1 million; [AB 656](#) (Torrico) would have imposed a severance tax on oil companies, and indirectly on motorists and other consumers of oil-based products; [SB 558](#) (DeSaulnier) and [AB 1019](#) (Beall) would have imposed a nickel-per-drink tax on alcohol beverages; [AB 639](#) (Torlakson) would have imposed an additional 25-cent telephone tax; [AB 1141](#) (Calderon), [AB 68](#) (Brownley) and [AB 87](#) (Davis) would have imposed taxes on bags that stores give to shoppers to hold products they buy; [AB 1139](#) (John Perez) would have increased taxes on some businesses operating in enterprising zones by mandating additional costs on employers in order to qualify for a hiring tax credit; and [ACA 22](#) (Torlakson), [AB 89](#) (Torlakson) and [SB 600](#) (Padilla) proposed to increase cigarette and tobacco taxes substantially.

Several bills sought to make it easier to raise taxes by lowering the two-thirds vote requirement. [SCA 9](#) (Ducheny) would have lowered the two-thirds vote threshold to 55 percent for tax increase trailer bills, [SCA 15](#) (Calderon) would have lowered the vote for certain budget bills to a majority vote; and [ACA 10](#) (Torlakson) would have lowered the voter-approval threshold to a majority for taxes imposed by educational finance districts. [AB 267](#) (Torlakson), which would have established such educational finance districts, was vetoed by the governor. The scheme was to gerrymander school districts so that voters in one district who didn't want to raise taxes could be outvoted by voters in another to force a tax increase in the entire area. [ACA 9](#) (Huffman) also proposed to reduce the vote requirement for local bonds and special taxes to 55 percent.

There were also other punitive measures aimed at taxpayers. [AB 484](#) (Eng), sponsored by the Franchise Tax Board, sought to punish people who didn't pay their tax bills, by suspending their professional licenses. CalTax pointed out that this would prevent these people from earning a living and earning money to pay off the unpaid bill, and smacked of the outrageous debtors' prisons of Charles Dickens' time.

A proposal was introduced to include income from a tax haven country, as determined by a non-elected European body (the OECD), to be included in a water's-edge combined report ([AB 1178](#), Block). The bill did not advance, but is alive as 2010 begins.

Tax Commission Report Meets With Opposition

A prestigious commission appointed by the governor and legislative leaders to study the tax structure and make recommendations for improvements spent most of the year on the task. The commission's final product met with widespread opposition from all sides. Five of the 14 commissioners did not sign the final report, and several others made it clear that they were just signing it to place the report before the Legislature, but did not agree with everything in it.

While the report had a few supporters – most notably Governor Arnold Schwarzenegger – representatives of both business and labor voiced opposition at legislative committee meetings. Several university professors also dumped on the plan. The heart of the commission's recommendation was to repeal the corporate tax and sales tax in favor of a new 4 percent business net receipts tax (similar to a value added tax). The report also suggested flattening out the income tax.

The governor called a special legislative session to consider the tax commission's recommendations, but there was no action in the Legislature. The governor remains supportive of the commission's recommendations, but legislators appear likely to put the commission's report on the famous dusty shelf.

The commission spent \$652,683 to develop the report, and additional funds were spent on the commission's work by the Department of Finance, Franchise Tax Board, Board of Equalization, Governor's Office and Office of the Legislative Counsel.

A New Member on the State Board of Equalization

Membership of the State Board of Equalization changed this year, as Dr. Judy Chu was elected to Congress in a special election. To replace her, the governor appointed Jerome Horton, a former Democratic Assemblyman from Los Angeles. He was confirmed by the Legislature and took office in October. Steve Shea, who was Dr. Chu's top deputy, served as an interim member prior to Mr. Horton's confirmation, and now serves as a special advisor to Mr. Horton.

BOE members face a number of problems this year, most notably how to get the board out of its dreadful headquarters building at 450 N Street in Sacramento. The building suffered more water damage this year, and mold was found on interior walls and in the elevator shaft. At an October board meeting, staff said the cost of renovating the building would be \$65 million, not including lost staff time due to various moves.

An effort by the board to increase alcoholic beverage taxes on flavored malt beverages was a flop. Although the board voted in 2008 to reclassify such beverages from beer to distilled spirits (to which a higher tax rate applies), the malt beverage industry reformulated its product to avoid the reclassification. In 2009, revenue from the BOE's change fell far short of predictions made by the supporters of the reclassification. If the effort had succeeded, the board would have been hit with a suit by the industry on the basis that the state constitution vests regulation of alcoholic beverages with the Department of Alcoholic Beverage Control.

Legal Developments

The California Taxpayers' Association filed suit to invalidate the imposition in 2008 of a 20 percent levy on the amount of an understatement by law-abiding taxpayers. Sacramento County Superior Court Judge Timothy Frawley gave CalTax standing to bring the suit, but then ruled in May in favor of the Franchise Tax Board on all points of contention. The major thrust of CalTax's arguments is that the proposal is really a tax, as it was passed for the purpose of "raising revenue," but that it failed to pass by a two-thirds vote. CalTax also noted that the proposal fails to provide due process, because it does not allow appeals of the impositions. The case is now on appeal at the appellate level.

Other important decisions included a ruling by the California Supreme Court that cut back the broad authority of local government to use taxpayer dollars to campaign in favor of tax increases or opposition to tax decreases (*Angelina Morfin Vargas v. City of Salinas*).

Also of interest was a decision of the First District Court of Appeal allowing taxpayers to request a jury trial in tax refund disputes (*Franchise Tax Board v. the Superior Court of the City and County of San Francisco*). In the Sixth District Court of Appeal, judges ruled that a senior's transfer of Proposition 13 base-year value must be computed with current values (*Kenneth Wunderlich v. County of Santa Cruz*), and the First District Court of Appeal ruled that the full price of commodity futures sales that are made to hedge against price fluctuations should be included in the sales factor of the corporate tax apportionment formula (*General Mills v. FTB*).

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