

CALTAX YEAR IN REVIEW: 2010 – TAXPAYERS SEND MESSAGE OF 'NO NEW TAXES' TO CAPITOL AS GIMMICK-FILLED STATE BUDGET UNRAVELS

Perhaps 2010 will be best remembered as the year that taxpayers sent an unmistakable message of "no new taxes" to the denizens of the state Capitol after Californians watched in horror as the Legislature adopted a record-late budget based on phantom revenues, phantom budget cuts and a gaggle of gimmicks. To the surprise of no one, the budget unraveled shortly after passage, and when outgoing Governor Arnold Schwarzenegger called a special session in December to address the damage, he found no takers.

In November, voters approved expanding the two-thirds vote requirement to include tax- like fees and extending the two-thirds vote requirement to include "revenue-neutral" bills that raise taxes on some people while lowering taxes on others (Proposition 26). They also defeated – by a large margin – a car tax increase to fund parks, even though proponents outspent the opposition by an overwhelming amount (Proposition 21), and defeated an attempt to raise taxes on corporations (Proposition 24). They also rejected a gimmicky gas tax swap adopted by the Legislature as part of its budget-balancing attempt (Proposition 22) and told legislators to pass the budget (by a majority vote) on time or lose their pay (Proposition 25).

The Legislature was expected to be hostile toward taxpayers in 2010, but despite the efforts of a few tax enthusiasts, the effort largely fizzled. Most tax increase bills failed to clear the Legislature, and the one that did pass (a bill to postpone net operating loss provisions for two years) was somewhat offset by provisions that established a safe harbor in the anti-taxpayer "understatement penalty" and revised the rule for sourcing sales in the corporate apportionment formula for taxpayers who do not elect the "single sales factor."

There was no dearth of examples of waste, fraud and mismanagement in government in 2010, with a scandal in the City of Bell serving as the poster child of what can go wrong in government finance. The state also had its share of examples, such as the withdrawal of welfare benefits from ATMs at strip clubs, casinos, cruise ships and from locations in vacation spots such as Hawaii and the Virgin Islands.

At the local level, assessed values of property dropped 1.8 percent statewide – the first drop in modern memory. Factors causing the decline were a drop in the consumer cost-of- living index used to index Proposition 13 assessments and the vast increase in decline-in- value assessments as a result of the recession.

In the courts, assessors and the State Board of Equalization won two significant property tax cases, but are losing in three others. And as a result of local elections, there will be new assessors valuing more than half of all properties in California.

Voters Send Message by Opposing Tax Increases

In the November election, Californians sent a loud message of "no new taxes" and also approved a major change to facilitate the approval of the state budget.

In a major victory for taxpayers, voters approved Proposition 26, which protects taxpayers by specifying that tax-like "fees" require the same vote as taxes. The measure, approved with 52.5 percent of the vote, also puts an end to the Legislature's ability to pass majority-vote "revenue-neutral" bills that raise taxes on some people while decreasing taxes on others. It covers all bills enacted after January 1, 2010.

Voters rejected two measures that directly called for tax hikes: Proposition 24, which would have repealed recent tax incentives designed to create jobs (opposed by 58.1 percent of the voters), and Proposition 21, which would have imposed a new \$18 car tax to raise funds for the state parks system (opposed by 57.3 percent of the voters).

On the flip side was Proposition 25 (supported by 55.1 percent of the voters), which lowers the vote threshold from two-thirds to a simple majority for the Legislature to approve the state budget, and docks the pay of legislators if a budget bill is not passed on time. The latter provision was emphasized in the avalanche of commercials urging voter approval, so it appears that voters' primary motive in approving the measure was to punish the Legislature for a delay in passing the budget.

Under the current composition of the Legislature, passage of Proposition 25 gives the Democrats ownership of the budget. The measure also provides that budget trailer bills may be approved by a majority vote of the Legislature and may go into effect immediately. However, a published decision of the Third District Court of Appeal held that bills with tax increases still require a two-thirds vote for approval.

California voters also rejected a tax increase on the June 8 ballot – Proposition 15, which would have imposed a tax on legislative advocates and their employers, with revenue to be used on political campaigns. The measure was handily defeated, with 57.5 percent of the voters in opposition.

Also in the June primary election, 84.6 percent of the voters approved Proposition 13, creating a permanent property tax exclusion for construction or reconstruction of seismic retrofitting components of an existing structure. The measure was placed on the ballot by the Legislature.

Worst Budget of All Time?

While the issue is open to debate, many would argue that the 2010-11 state budget, adopted in October, is the worst state budget ever enacted. It was balanced with phantom revenues, phantom budget cuts and a variety of Enron-type gimmicks. By November, the legislative analyst said the budget was out of balance by \$6 billion. Governor Arnold Schwarzenegger called a special session in December to attempt to re-balance the budget, but the Legislature decided to take the month off and went home.

It was evident at the beginning of 2010 that the governor and Legislature would have trouble agreeing to a spending plan. The year opened with the presentation of yet another budget proposal by Governor Arnold Schwarzenegger, who ended up presenting more budget plans and mid-year revisions than any California governor in modern history.

On January 8, he released his budget proposal for the 2010-11 fiscal year – a plan that included \$8.5 billion in spending reductions, \$4.5 billion in funding shifts and \$6.9 billion in anticipated federal funds. The proposal did not include any major tax increases, but proposed a delay in implementation of the business incentives approved in previous budgets. Immediately after its release, the proposal was panned by the Democratic leaders of both houses. The legislative analyst added to the criticism a few days later, opining that the state's chances of getting billions from the federal government were "almost nonexistent."

In a half-hearted attempt to reduce the size of the budget deficit, the Legislature approved a gas-tax/sales-tax swap ([ABX8 6](#), Assembly Budget Committee). The idea was to exempt gasoline from the sales tax and to increase the excise tax on gasoline by a like amount, so motorists would pay roughly the same amount but the state would be able to use the revenue for general fund purposes (whereas the sales tax on gasoline can be used only for transportation programs, under a voter-approved initiative). While the proposal qualified for a majority vote as a "revenue-neutral" bill, it decreased taxes on motorists who buy premium gasoline and increased taxes on motorists who purchase regular gasoline.

The swap was passed by Democrats early in March, and the governor threatened to veto it unless additional legislation was sent to his desk. The Legislature responded March 22 by approving a three-bill package that was more acceptable to the governor.

Included in the package, which was signed into law, was a fix of drafting errors in the original gas-tax/sales-tax swap that would have increased taxes on off-road diesel fuel users and aircraft fuel. The drafting errors were a result of the highly criticized gut-and-amend process used to pass the bills without proper vetting through committees, and without input from taxpayers who would be affected. These errors were fixed by a clean-up bill, [SB 70](#) (Senate Budget and Fiscal Review Committee). Rounding out the package were bills to re-establish a housing tax credit ([AB 183](#), Caballero) and to allow taxpayers to apply for a

sales tax exemption for machinery and equipment purchased for alternative energy-related activities or development of advanced transportation technologies ([SB 71](#), Padilla).

Even with the corrections, the tax swap was repealed in November by passage of Proposition 22, a League of California Cities-sponsored initiative that prohibits the Legislature from borrowing or otherwise reallocating gas tax, property tax and car tax revenue that is intended for local government purposes, and also prohibits the Legislature from shifting property tax to schools.

From June to October, there was delay after delay, as Democrats refused to bring budget bills to the floor for a vote. Finally, after significant arm-twisting – and a floor session that lasted more than 20 hours – the Legislature approved a 2010-11 budget ([SB 870](#), Ducheny) on October 8, a record-setting 100 days past the start of the fiscal year.

The legislative analyst reported that under the new budget, general fund spending for 2010-11 would be \$86.5 billion – a 0.2 percent increase over the prior year.

The budget agreement included two reforms long sought by Governor Schwarzenegger: pension reform to reduce the taxpayers' cost of providing retirement benefits to former government employees, and budget reform in the form of a constitutional amendment to create a stronger "rainy day" fund for the state.

Commenting on the "rainy day" fund and the pension reforms, the governor said he had been fighting for those reforms for six years. "At times it's been hard and downright ugly," he added.

The rainy day measure is scheduled to go before the voters in November 2012. The proposal ([ACA 4](#), Gatto and Niello), approved by a vote of 29-7 in the Senate and 65-8 in the Assembly, strengthens current constitutional provisions on the "rainy day fund" by: increasing the size of the fund from 5 percent to 10 percent; requiring the state to always make 3 percent payments into the fund except in years when withdrawals are made; providing that rainy day funds can be used only to cover spending no higher than the previous year's, adjusted for inflation and population growth; providing that not all money in the fund can be used in one year; and capturing "unanticipated revenue" into the rainy day fund.

Before signing the 2010-11 state budget, Governor Schwarzenegger used his line-item veto authority to remove \$963 million in general fund spending – a move that Democratic Assembly and Senate leaders immediately said they would seek to overturn. A spokesman for the governor said the vetoes were needed because the reserve in the budget approved by the Legislature was "unacceptably low."

One month after passage of the budget, the legislative analyst projected that the state's general fund spending would be \$92.5 billion in the 2010-11 fiscal year – up significantly from the \$86.5 billion approved in the late budget – and would climb to \$102.7 billion in 2011-12. Legislative Analyst Mac Taylor said this spending growth is required under current law if no changes are made by the Legislature and governor.

Of the \$25.5 billion budget gap projected by the analyst in November, approximately \$22.5 billion (almost 90 percent) is attributable to revised spending in 2010-11 and proposed spending in 2011-12 that exceeds the \$86.5 billion amount adopted in October.

Budget Trailer Bills

Tax provisions were lodged in several budget trailer bills adopted in October (with no hearings and little time for review):

- **NOL Suspension.** Net operating loss carryovers and carrybacks were suspended for the 2010 and 2011 tax years ([SB 858](#), Senate Budget and Fiscal Review Committee).
- **Exemption From 2008-09 NOL Suspension.** Taxpayers who meet certain criteria were exempted from the 2008-09 NOL suspension ([SB 858](#)).
- **Corporate "Understatement Penalty" Safe Harbor.** A safe harbor from the corporate strict liability 20 percent "understatement penalty" was created if the taxpayer's understatement is less than 20 percent of total liability, even if the understatement exceeds \$1 million. This provision is effective for original tax returns filed on or after January 1, 2010 ([SB 858](#)).
- **"Cost of Performance" Standard for Determining Sales Factor for Corporations Not Electing Single Sales Factor.** For taxpayers that do not elect to use a single sales factor corporate apportionment formula, intangible sales will be sourced based on "cost of performance" for determining the sales factor ([SB 858](#)).
- **Collection Cost Recovery Fee.** The Board of Equalization was told to impose a collection cost recovery fee for past-due accounts related to sales and use tax, as well as numerous special taxes and fees ([SB 858](#)).
- **Sales Tax on Support Services.** A sales tax was imposed on services provided by nursing homes and other In-Home Supportive Services providers. Supporters said that a tax, as opposed to a "quality assurance fee," was necessary to comply with federal requirements, and that the tax would be paid by the state and not private retailers ([AB 1612](#), Assembly

Budget Committee).

- **Use Tax Reporting Extended.** The provisions allowing taxpayers to report use tax on their personal income tax return were made permanent (**SB 858**).
- **On-Sale Liquor License Fee Increase.** Applicants for on-sale liquor licenses now will pay \$13,800, rather than \$12,000, for the license (**SB 856**, Ducheny).
- **Restrictions on Tax Agencies.** Both the Board of Equalization and Franchise Tax Board were prohibited from redirecting funds for audits and collections without Department of Finance approval. In addition, the Legislature directed the FTB to resolve tax cases without litigation on a basis that is fair to both taxpayers and the state (**SB 870**, Ducheny).

Other Legislative Attempts to Raise Taxes Fail

Except for the budget trailer bills, all other legislative attempts to raise taxes or otherwise stick it to taxpayers were turned back, often in what was akin to hand-to-hand combat.

Taxpayers were apprehensive going into 2010, fearing passage of an avalanche of new taxes, tax-like fees and bills imposing other burdens on taxpayers. This apprehension escalated as a number of Democratic legislators launched new tax increase proposals and other measures imposing egregious burdens on taxpayers.

There were dozens of bills that sought to penalize and burden taxpayers in a variety of ways. These included efforts to impose more draconian penalties on taxpayers, to extend unreimbursed tax collection duties to taxpayers not doing business in California, to expose confidential tax returns, to revoke tax incentives retroactively, to lower voter approval requirements for local taxes, and to give tax agencies more power over taxpayers.

Another problem was the practice of "gut-and-amends," where brand new proposals were amended into existing bills, replacing the previous language entirely. This practice violates the spirit of the state constitution, which requires newly introduced bills to sit for 30 days to allow time for public review. A "gut and amend" proposal is the equivalent of a new bill, but the 30-day rule is not honored.

Tax Commission Report a Flop

A tax commission appointed by Governor Schwarzenegger spent more than \$652,000 in 2009 for hearings and expenses, and produced a report that even many of its members did not like. With only the chair, Gerald Parsky, and the governor active in pushing the recommendations, the Legislature held several

hearings early in 2010 to allow members of the Commission on the 21st Century Economy to speak out about the report, and the hearings became a forum for presenting tax increase ideas that had been rejected by the commission.

Richard Pomp, a professor of tax law from the University of Connecticut Law School, said he opposes the commission's suggested business net receipts tax, and offered extensive testimony on his support for expanding the sales tax to services.

Fred Keeley, a former state lawmaker who now serves as Santa Cruz County's treasurer- tax collector, returned to the Capitol several times to criticize Mr. Parsky's leadership of the commission, and to argue that the commission should have spent more time examining his proposal for a massive fuel tax.

New Faces: Changes in Leadership

As a result of developments in 2010, two of the three branches of state government will see changes at the top. In November, voters elected Democrat Jerry Brown to again serve as governor (he was sworn in on January 3, 2011). Mr. Brown, who defeated Republican businesswoman Meg Whitman in an expensive campaign, promised during the campaign that any new taxes will require voter approval.

In the judicial branch, Chief Justice Ron George resigned and Governor Schwarzenegger appointed Tani Cantil-Sakauye as the new chief. She had been serving as a justice on the Third District Court of Appeal. She was sworn in on December 3.

In the legislative branch, there was no change in the position of Senate president pro tempore, as Senator Darrell Steinberg served in that post throughout the year and was re-elected as leader in December when the Legislature's new two-year session began. In the lower house, Assemblyman John Pérez took the Assembly speaker's gavel from Assemblywoman Karen Bass on March 1, and became the first openly gay leader of the Assembly. Mr. Pérez, who was re-elected in December as speaker for the 2011-12 session, appointed two Republicans to chair committees.

On the Republican side of the aisle, Assemblyman Martin Garrick of Carlsbad, once part of the Reagan White House team, was elected January 19 to serve as the new Assembly Republican leader. In December, after the GOP lost an Assembly seat in the November election, the Republican Caucus selected Assemblywoman Connie Conway as their leader for the 2011-12 session. In the upper house, Senator Bob Dutton replaced Senator Dennis Hollingsworth, who was "termed-out," as Senate Republican leader.

The leaders will be working with many new members in both houses of the Legislature. There were 30 new Assembly members elected in 2010, and 14 new senators (most of whom have previous experience in the Assembly).

There also were some changes at the State Board of Equalization. Two-term Board of Equalization Member Bill Leonard resigned his seat March 9 in order to take a higher-paying position with the Schwarzenegger administration as secretary of the State and Consumer Services Agency. Barbara Alby, a former legislator who had served as Mr. Leonard's chief deputy for several years, was sworn in as an acting member of the BOE. She retired December 30, and was succeeded briefly by Acting Member Sean Wallentine, chief deputy for BOE Member-elect George Runner. Mr. Wallentine was sworn in December 31 and served until Mr. Runner's term began three days later. Mr. Runner was elected to the post in November after serving for many years in the Legislature.

BOE Executive Director Ray Hirsig announced his retirement in September, and former Chief Counsel Kristine Kazadd is serving as interim executive director while the board works to select a permanent replacement.

Property Tax Developments

In 2010, for the first time in modern memory, property tax values dropped. Assessed values fell 1.8 percent to \$4.37 trillion, with only 10 counties reporting a net increase in the assessment roll. The drop was due primarily to the recession, with values of many properties dropping below their Proposition 13 base-year values.

Assessors in California's 58 counties were up for election in 2010, and competitive races were held in several counties as incumbents retired or faced serious challenges. As a result, most properties in California will be valued by a new assessor in 2011.

The biggest change was in Los Angeles County, where Assessor Rick Auerbach retired in March after a career of nearly four decades as an appraiser, manager, assistant assessor and finally as the county's assessor for 10 years. In November, Deputy Assessor John Noguez was elected to the top post by a 20 percent margin over Assessment Appeals Board Member John Wong.

In San Diego County, former Board of Equalization Member Ernie Dronenburg was elected, knocking off appointed incumbent Assessor David Butler.

Other large counties with new leadership are: Sacramento (where Kathleen Kelleher replaced the retiring Ken Steiger); Fresno (where Paul Dictos replaced the retiring Robert Warner); El Dorado (where Karl Weiland replaced the retiring Tim Holcomb); Humboldt (where Mari Wilson replaced the retiring Linda Hill); Marin (where Richard Benson replaced the retiring Joan Thayer); Nevada (where Sue Horne replaced retiring James Dal Bon); San Mateo (where Mark Church replaced the retiring Warren Slocum); Stanislaus (where Dave Cogdill replaced the retiring Doug Harms); Sutter (where Todd Retzloff defeated incumbent Michael Strong); Tulare (where Roland Hill replaced the retiring Greg

Hardcastle); and Yuba (where Bruce Stottlemeyer replaced the retiring Dave Brown).

In five significant court decisions this year involving the property tax, taxpayers won three and assessors won two.

In December, the Orange County Superior Court held that the Legislature's fractional aircraft assessment scheme was unconstitutional (*Netjets Aviation Inc. v. Guillory*), and in August, a Third District Court of Appeal opinion written by the incoming chief justice held that the Nevada County Assessment Appeals Board failed to apply the statutory burden of proof in favor of the homeowner (*John M. Farr v. County of Nevada*). In April, Los Angeles Superior Court Judge Robert Hess ruled that State Board of Equalization Rule 474, which attempts to include refinery fixtures in the appraisal unit, is not valid (*Western States Petroleum Association v. California State Board of Equalization*). CalTax had strongly urged the BOE not to adopt the rule several years ago.

In February, the California Supreme Court held that the transfer of a life estate to one party and the balance of rights to another is a change of ownership (*Lorraine Steinhart v. County of Los Angeles*), and also in February, the First District Court of Appeal held that common use space and limited common use space at San Francisco International Airport's car rental facility created a possessory interest subject to property tax (*Vanguard Car Rental USA, Inc v. County of San Mateo*).

Waste, Fraud and Mismanagement

There is plenty of room for improvement in the way government spends tax dollars. The newspapers of this state were rife this year with stories about excessive government salaries, lavish government employee pensions and fringe benefits, wasted money and lack of controls on how money is spent.

The event that forcefully brought the issue to the attention of taxpayers and public officials was a scandal in the City of Bell. The *Los Angeles Times* broke the story that the small Southern California city was paying its city administrator, Robert Rizzo, a salary and benefits package amounting to more than \$1.5 million a year. In addition, the city had loaned \$900,000 to key officials, including City Council members. The city also levied an illegal property tax, which State Controller John Chiang ordered refunded to taxpayers. As a result, the city administrator and several councilmen resigned and law enforcement is looking into the matter.

At the same time, a Sacramento-area television station revealed that the head of the California School Boards Association (funded by school districts that in turn are funded by taxpayer dollars) was paid more than \$540,000 in 2007-08 and withdrew money at a casino using the association's credit card. He resigned after this disclosure.

A few more of a great many examples of waste at the local level: school districts

were spending millions on error-filled math books; local administrators in Ventura County received extra retirement benefits on top of the lavish CalPERS retirement benefits; some retired public employees are also drawing unemployment checks; Tulare County misspent \$1 million of federal stimulus funds; the Los Angeles Flood Control District was fined \$75 million for allegedly polluting the harbor; the small Monterey Peninsula Park District paid its top administrator (now retired) \$349,00 to supervise 16 employees. There were examples at the state level, as well: the state controller found that dead people were receiving In-Home Supportive Services benefits, and a Sacramento County investigation found 19 cases of IHSS fraud in just four months; mismanagement by technology staff at the state Employment Development Department resulted in \$53 million in cost overruns; CalTrans spent \$4 million for vehicles that sat unused – some for months and even years; welfare recipients were withdrawing payments using ATM cards at strip clubs, casinos, on cruise ships, and in vacation spots such as Hawaii and the Virgin Islands; a woman in Mendocino County used her ATM welfare card to withdraw \$79,000, even though she was the owner of 12 cars and two houses; the state spent \$2.5 million renting a vacant building for two years; the state inspector general found \$13 million in waste in the prison drug program; the University of California has close to the same numbers of senior administrators as it has faculty (8,470 senior managers and 8,851 faculty).

Other Significant Developments

Many other developments in 2010 will have a significant long-range impact on taxpayers. One major action was the adoption by the California Air Resources Board of a "cap and trade" system of regulation of carbon dioxide emissions – estimated to impose significant costs on some taxpayers in the future.

Another big development was the expansion of the scope of the voter-approved independent redistricting commission. The redistricting changes were accomplished by voters, who in November decided to place congressional redistricting under the commission (Proposition 20) and rejected an attempt to abolish the commission (Proposition 27). In December, the members of the redistricting commission were picked, and they will work in 2011 to redraw electoral districts using new population figures from the U.S. Census Bureau.

What Lies Ahead?

As the Golden State enters its 162nd year, it faces an uncertain – and possibly grim – future.

What can be done to reduce California's unemployment rate, which is well above the national average (more than 2.2 million Californians currently are out of work)? Will the significant regulatory burdens placed on California business stifle economic growth? Will voters who turned down major state tax increases in 2009 and 2010 approve a massive tax increase in 2011? Will public employee unions, with virtually unlimited war chests and with their endorsed candidates in charge

of the executive and legislative branches, be able to scuttle significant spending reforms? Will shifting major statewide programs to local government lead to higher taxes and significant regional disparities in government services? Will constitutional changes in budgeting and other fiscal matters make things better or worse (or will they even be approved if they are not to the liking of public employee unions)? Can the state take on even more debt?

Many of these questions will be answered in the 12 months ahead.