

CALTAX YEAR IN REVIEW: 2011 A BETTER YEAR THAN EXPECTED FOR TAXPAYERS

Coming into 2011, taxpayers feared that the year would result in tax hikes and adoption of special-interest agendas. While there was uncertainty regarding a new governor's administration and Democratic legislators' new power to pass a majority-vote budget, taxpayers ended the year on a strong note, without any major tax increases being enacted and many bills – including job killers – that never saw the light of day.

Throughout 2011, taxpayers were protected from hidden taxes thanks to Proposition 26. Other legislative threats that would have imposed burdensome taxes or worsened an already bleak business climate were vetoed by Governor Jerry Brown.

Shortly after Governor Brown was sworn in to office January 3, 2011, he kept his campaign promise by proposing a tax increase requiring a vote of the people during a June special election. The governor sought to ask voters to approve increases in the sales, income and vehicle taxes, but the plan never received the needed support from two-thirds of the Legislature, even after several Republicans indicated they would support higher taxes coupled with serious public employee pension reform. While this proposal failed to garner support in the Legislature, the governor tried again with two other tax proposals.

(One notable tax was approved: A tax on property owners in rural areas passed the Legislature with a majority vote, as it was described as a "fee" to cover fire protection services. This tax is expected to be challenged in court.)

A second tax plan, proposed by the governor in the waning hours of the legislative session and approved by one house of the Legislature, was labeled a "jobs plan," and included provisions disliked by organizations on both ends of the political spectrum.

The final plan was unveiled in December as an initiative aimed for the November 2012 ballot. This proposal did not include the vehicle tax hike, but proposed temporary increases in sales and income taxes. As 2012 began, the governor was raising funds for the signature-gathering and campaign needed to pass this tax measure.

While the governor was pushing his proposals, several other tax increase measures were put on the table by public employee unions and others, all targeted for the November 2012 ballot. CalTax and others also filed an initiative – one that would put a cap on excessive state spending growth.

The New Administration

Unlike his predecessor, Governor Brown was inaugurated in low-key fashion. After a 17- minute address in Memorial Auditorium, the governor made a brief appearance at a party on the steps of the Capitol, where he ate a hot dog and then left without making any remarks.

During his inaugural address, Governor Brown reiterated his campaign promise of "no new taxes unless the people vote for them," and pledged that there would be "no more smoke and mirrors on the budget."

One of the governor's first actions was to appoint his wife, former Gap Inc. Chief Administrative Officer Anne Gust Brown, to the unpaid position of special counsel to the governor. He also made headlines by adopting a dog, Sutter, that frequents the Governor's Office and has his own Twitter account and Facebook page.

The new governor attempted to set an example of frugality by ordering the state's vehicle fleet reduced (with a goal of halving the fleet); imposing a limited hiring freeze; banning state spending on key chains and other trinkets; banning travel by state employees unless it is "mission critical" or there is no cost to the state; canceling the construction of new cells for condemned prisoners; and ordering state agencies to identify annual reports that should be eliminated.

First Budget Under Proposition 25 – No Major Taxes

Soon after taking office, the governor proposed that a special election be held in June to let voters decide whether to raise taxes by \$14 billion. The increases would include: a

five-year extension of the 1 percent sales tax increase that was set to expire at the end of June, a car tax rate increase from 0.65 percent to 1.15 percent that also was set to expire, an across-the-board 0.25 percent increase in personal income tax rates and the Alternative Minimum Tax rate, and a revision to corporate income tax apportionment to change the "single sales factor" from elective to mandatory.

The idea was to have the election prior to the July 1 start of the state's fiscal year so budget-writers could base revenue estimates on the results of the election, and so proponents could frame the issue as extensions of existing taxes, rather than tax increases.

The governor's January budget proposal also included a major reorganization of government – a "realignment" plan that shifted responsibility for many state services to the counties. This resulted in roughly \$6 billion in state spending being eliminated without any programs being cut, as the spending was simply shifted to local governments.

The governor also proposed to repeal California's enterprise zone program – which would retroactively increase taxes on many employers – and to eliminate redevelopment agencies, to free up property tax revenue for local government. The latter idea was approved by the Legislature and signed into law, triggering litigation that ended with a December 29 opinion from the California Supreme Court, upholding the governor's plan.

Democrats in the Legislature announced that they would use a "truncated budget process" to finish most budget proceedings by March, so there would be time for a June election.

But the Legislature did not meet the March 10 deadline set by the governor to pass a budget.

Seven days after the deadline, both houses approved a budget bill and more than a dozen trailer bills. Governor Brown signed trailer bills to make several billion dollars' worth of spending cuts to Medi-Cal and other programs, and also signed [SB 86](#) (Senate Budget and Fiscal Review Committee), a trailer bill that, among other things, imposes new tax penalties on taxpayers who do not participate in the Franchise Tax Board's "Voluntary Compliance Initiative 2" and establishes a Financial Institutions Record Match program.

The governor characterized the actions as representing \$8.2 billion in expenditure reductions, \$300 million in revenue and \$2.6 billion in other changes. Republicans said at least \$2.8 billion of the "cuts" should be classified as fund shifts.

Governor Brown later signed a trailer bill transferring criminals from state prisons to county jails, to shift financial responsibility from the state to local governments. Within weeks, drafting errors were discovered in several of the hastily prepared trailer bills, and the Legislature approved new bills to correct the mistakes.

However, the main budget bill ([SB 69](#), Leno) was not signed along with the trailer bills – it was not even sent to the governor. The budget bill was approved by the Legislature March 17, but was held in the Legislature as negotiations over the tax increase component of the budget continued.

Under Proposition 25, the budget could be passed with a simple majority vote, but tax increases continued to require a two-thirds vote. Thus, the governor met several times with a group of five Republican senators to negotiate a budget deal. In early March, however, the "GOP Five" announced that negotiations had deadlocked because Democrats would not agree to a spending cap, pension reforms, economic stimulus plans and other issues.

By the end of the month, Governor Brown also had concluded that negotiations were officially over (he later would liken the partisan divide to the Civil War). The governor specifically criticized the GOP for opposing a mandatory single sales factor apportionment formula for corporate taxpayers.

Still, some Republicans continued discussing budget options with the governor, and even in late June, the governor said negotiations were not dead.

As the on-and-off negotiations continued, the governor considered putting the tax measures on the ballot in November, and there were rumors that the Legislature would try to pass taxes with a majority vote.

As the governor continued pushing for a tax election, he and the legislative leaders hurriedly passed a law ([SB 94](#), Senate Budget and Fiscal Review Committee) delaying the mailing of vehicle registration notices at the 0.65 percent rate, hoping they still would have a chance to keep the tax at the 1.15 percent rate.

Senate President Pro Tem Darrell Steinberg also proposed legislation ([SB 653](#) and [SBX1](#)

[23](#)) to expand local taxing authority for counties, school districts and other local entities. The legislation would have resulted in major tax increases at the local level, and taxpayer groups noted that under Proposition 26, such legislation requires a two-thirds vote. However, the bills were keyed by legislative counsel as majority-vote bills. CalTax led the opposition to the legislation, and was successful in stopping the measures from being enacted. After April 15, there was a change in the tenor of the budget negotiations, fueled by higher-than-expected tax collections. At first, Democratic legislators downplayed the improved personal income tax collections and continued lobbying for taxes, but they later began voting for bills to restore some of the budget cuts made in March.

Assembly Republicans reacted to the revenue surge by proposing a no-tax budget that they said would protect education from further budget cuts.

When the governor released his revised budget on May 16, he urged the Legislature to enact some of his tax proposals effective July 1, but to forego a public vote until the fall. He said the idea for a "bridge period" would "keep the spirit" of his campaign pledge. The new budget proposal predicted that general fund revenue would be \$6.3 billion higher than predicted in January.

The May revision called for higher personal income tax rates for 2012 and the three following tax years (his January proposal included 2011 as well), along with the vehicle tax extension, sales tax extension and mandatory single sales factor. In all, the budget called for total spending of \$132 billion, up from \$127 billion proposed in January.

During the press conference where he unveiled the revision, the governor repeatedly referred to a "wall of debt" facing the state. He also said, "We need a spending limit – we definitely should put a cap in."

As the calendar moved closer to the Legislature's June 15 deadline for passing a budget, the Legislature still had not sent its March budget bill to the governor, and

State Controller John Chiang announced that under Proposition 25, legislators' salaries would be permanently withheld for the period after June 15 until a balanced budget is sent to the governor.

On the deadline day, the Legislature approved a budget revision bill ([AB 98](#), Assembly Budget Committee) and several trailer bills – with tax increases that were smaller than those proposed by the governor – and finally sent [SB 69](#) to the governor's desk. Governor Brown vetoed the main budget bills almost immediately, and said he would continue pushing for higher taxes.

The veto appeared to catch Democratic leaders by surprise, and Assembly Speaker John Pérez and Senator Steinberg held a joint press conference where they took turns criticizing the governor for being "very unsuccessful at getting Republican votes" and Republican lawmakers for refusing to go along with their plans. In response to the veto, Senator Steinberg also halted all Senate action on gubernatorial appointments.

The veto set off a storm over whether lawmakers' pay would be docked, or whether they had complied with Proposition 25 simply by sending a budget bill to the governor.

Controller Chiang announced June 21 that lawmakers would not be paid. He said a review of the budget bills sent to the governor "found components that were miscalculated, miscounted or unfinished." He added, "The numbers simply did not add up."

Shortly before the start of the 2011-12 fiscal year, Governor Brown agreed to shelve his tax hike plan, and signed a budget that was rushed through the Legislature on June 28 ([SB 87](#), Leno), along with seven new trailer bills. The budget, signed on the last day of the expiring fiscal year, was based on optimistic revenue assumptions.

Before signing the budget, the governor used his line-item veto power to reduce spending by \$23.8 million. At the urging of CalTax, he also struck a provision allowing the Franchise Tax Board to contract out on a contingency fee basis for transfer-pricing audits.

The budget included "triggers" that would lead to spending reductions if finance officials determined in December that revenues were not materializing as expected. In December, with revenue not keeping pace with the budget's rosy expectations, one of the triggers indeed was pulled, reducing budget expenditures by \$980 million.

One of the trailer bills ([AB 114](#), Assembly Budget Committee) included controversial provisions making it virtually impossible for school districts to terminate employees in response to budget problems, and limiting the ability of county offices of education to provide fiscal oversight of school district budgets.

On the revenue side, the budget included a tax (labeled as a fire prevention "fee") on owners of structures in state responsibility areas ([ABX1 29](#), Blumenfield); a vehicle registration "fee" increase of \$12 per vehicle, per year; and an expansion of sales and use tax nexus (see section on taxation of online sales, below).

Last-Minute Tax Proposal Fails

On September 8, one day before the end of the 2011 legislative session, Governor Brown held a press conference with several Democratic lawmakers and two Republicans (Assemblymen Nathan Fletcher and Cameron Smyth) to announce Assembly agreement on a tax package – dubbed a "jobs bill" – that included mandatory single sales factor apportionment, a minute reduction in the corporate tax rate (\$250 maximum), a very limited sales and use tax exemption for manufacturing and research-and-development equipment, and other changes.

The proposal was shoved into [AB X1 40](#) (Fuentes), and was voted on by the Assembly before the language was available to the public, and without any hearings to vet possible problems. With the two Republicans supporting the bill, it cleared the Assembly.

Late September 9 – the last day of session – the same language was transferred to another bill ([SB 116](#), de Leon), which was rushed to the Senate floor. The bill required a two-thirds vote, but fell five short. Senator Sam Blakeslee called the plan a "slap-dash collection of ideas."

New Law Addresses Taxation of Online Sales

The shopping habits of Californians were under the microscope in 2011, as Democratic lawmakers pushed hard to expand sales and use tax nexus to require out-of-state online retailers to collect the tax from California customers. Assemblyman Charles Calderon, one of the most vocal advocates of expanding nexus, said the state had been losing approximately \$1 billion a year due to unreported use taxes.

Lawmakers and supporters – including many retailers with operations in California – called their plan the "Amazon tax," and criticized the company for not collecting sales tax on behalf of the state. After first pushing [AB 155](#) (Calderon), supporters of nexus expansion got behind [ABX1 28](#) (Blumenfield), which was approved by the Legislature the day after the substantive language was amended into the bill. Amazon immediately cut ties with California-based businesses in its Associates Program, as it had promised to do if [ABX1 28](#) passed. The company began a referendum of the bill.

The referendum effort was dropped in September, when Amazon backed a revised version of [AB 155](#) that temporarily reverts California's use tax nexus laws to the way they read prior to enactment of [ABX1 28](#), to allow time to pursue federal legislation

authorizing states to compel remote vendors to collect use taxes.

Conformity Legislation Is Highlight of Legislative Year

One of CalTax's top legislative priorities was to simplify tax administration by increasing the state's conformity to federal tax laws. And, while there was no omnibus conformity bill, there were three targeted conformity bills signed into law in 2011.

The new laws address conformity relating to the tax implications for certain employer-provided health insurance ([AB 36](#), Perea); modified conformity to a few of the rules relating to the federal health care acts enacted in 2010, including to simple cafeteria plans for small businesses ([AB 242](#), Perea); and a conformity measure relating to the federal Regulated Investment Company Modernization Act ([AB 1423](#), Perea), which updated laws with respect to mutual funds and their shareholders.

Initiative Wars

As is typically the case in the year before a presidential election, backers of ballot initiatives – including several major tax proposals – were busy in 2011.

The major activity kicked off in April, when a "paycheck protection" measure was filed to prohibit unions and corporations from deducting employee wages for political purposes.

As proponents were gathering signatures to qualify the measure for the ballot, union leaders persuaded the governor and Democratic legislative leaders to pass a law ([SB 202](#), Hancock) providing that all pending measures would be placed on the November ballot rather than the June ballot. The union leaders hope the November electorate will be less supportive of the anti-deduction initiative. (**SB 202** does not affect the measures already on the June ballot, so voters still will go to polls then to decide the fate of a cigarette tax increase and a legislative term-limit modification measure.)

In December, CalTax, along with the Howard Jarvis Taxpayers Association and the Small Business Action Committee, filed an initiative to put a cap on excessive state spending growth.

Other major initiatives filed late in the year:

- Governor Brown's proposal to raise \$7 billion through a sales and use tax increase and income tax rate increases on income over \$250,000.
- A split roll initiative filed by the law firm of Remcho, Johansen & Purcell.
- An income tax surcharge on all Californians who earn more than \$7,316 a year, sponsored by wealthy civil rights lawyer Mollie Munger.

- An income tax increase on income over \$1 million, filed by the California Federation of Teachers.
- An oil tax filed by John Burton, chair of the California Democratic Party.
- California Forward's initiative that would make several changes to the state budget process, and would effectively prohibit legislation with a tax reduction of \$25 million or more, unless another tax is increased or funding for an existing program is reduced or eliminated.
- An initiative mandating use of the single sales factor apportionment formula, supported by hedge fund manager Tom Steyer.
- An initiative to repeal certain provisions of Proposition 26 and allow the Legislature to impose hidden taxes by a majority vote.

The Think Long Committee for California announced plans for two initiatives that include a wide range of reforms, coupled with a major expansion of the sales tax to services, but did not file the initiatives in 2011.

Pension Reform – Or Lack Thereof

Public employee pension reform was a hot topic throughout the year, but more in word than deed. Governor Brown released a 12-point pension reform plan on the last day of March, urging the Legislature to make changes including banning retroactive pension increases, eliminating the ability of employees to purchase additional retirement service credits ("air time"), basing pensions for new employees on a three-year average of compensation rather than the highest single year, and defining compensation as regular, non-recurring pay only.

Leaders of California Pension Reform, a group pursuing a pension reform initiative, said the governor's plan didn't go far enough, and did not address pension costs of existing employees. Public employee unions and their supporters in the Legislature disagreed, saying the plan went too far and should have been proposed when the governor was at the bargaining table with union leaders.

A group of four Republican senators released a 20-point pension reform plan in June, and Senator Steinberg said at the time that the Senate would pass "comprehensive pension reform" before the legislative session is over.

In late October, Governor Brown released another 12-point pension reform plan, and said he would take some form of pension reform to the voters.

Former Republican Assemblyman Roger Niello filed a pension reform initiative and then decided in late May not to pursue the idea, but came back six months later with a new plan, in partnership with California Pension Reform President Dan Pellissier.

Proposition 26 Takes Effect

Proposition 26, the 2010 initiative to stop hidden taxes, began to have an impact in 2011.

CalTax released a policy paper, "Understanding Proposition 26: A Sponsor's Guide to California's New Tax Structure," in August to help ensure that the initiative is implemented correctly.

Several bills that carried charges described as "fees" were keyed to require a two-thirds legislative vote because of Proposition 26, and local governments acknowledged that the measure could limit their ability to pass new charges without a public vote.

The Franchise Tax Board said in January that Proposition 26 would not impact the omnibus conformity bill ([SB 401](#), Wolk), because the state constitution requires the FTB to apply the law until an appellate court has made a determination that some or all of **SB 401** is "void" pursuant to Proposition 26.

The first major litigation over Proposition 26 was filed in Los Angeles County, where the county's mandated "charge" on consumers who use paper bags at grocery stores was challenged as an illegal tax. The case, *Lee Schmeer, et al. v. County of Los Angeles*, is in the early stages of legal proceedings as 2012 begins.

Property Taxes

Several proposals for a split roll property tax were made, but none succeeded. Los Angeles Mayor Antonio Villaraigosa prompted much of the chatter about a split roll in August, when he called for higher taxes on business property and called Proposition 13 a "corporate tax giveaway." The mayor said the change could be coupled with lowering or eliminating the corporate income and franchise taxes.

Cap-and-Trade Program Adopted

The California Air Resources Board (CARB) on October 20 gave the green light to move forward with a cap-and-trade program that will require certain businesses to purchase and trade allowances that will determine the level of greenhouse gases the businesses are allowed to emit. The effect that the additional financial burden will have on California's economy remains to be seen, but affected businesses already have spent tens of millions of dollars on implementation.

Job Losses Continue to Plague California

The migration of jobs from California to other states continued to be a major problem in 2011. As the year began, Californians read the news that Nordic Windpower USA,

a Berkeley-based manufacturer of wind turbines, was moving to Missouri, where it planned to provide jobs for 200 workers. The year ended with news that Waste Connections Inc., a trash-hauling company headquartered in Folsom, is moving its headquarters and approximately 130 employees to The Woodlands, Texas. Many other companies left the state during the year.

In March, the U.S. Chamber of Commerce issued a report that ranked California as one of the worst states in terms of its climate for business investments. Adding to the bad news, more than 500 chief executive officers in American businesses said California is the worst state in which to conduct business.