

CALTAX YEAR IN REVIEW: GOVERNOR'S TAX INITIATIVE DOMINATED 2012

The year 2012 opened with Governor Jerry Brown saying the fate of the state depended on voters approving personal income tax hikes on California's top earners, and increasing the sales and use tax rate. He crafted a budget proposal that assumed passage of the increases, and his political machine went to work raising funds and crafting a campaign to sell an initiative to the voters.

Early on, things didn't look good for the initiative, which faced criticism even from the governor's political allies. Public opinion polls indicated that it was unpopular, before an opposition campaign had started. Pundits said the appearance of rival tax measures on the ballot would split the vote and cause all to fail. Even the governor's supporters questioned whether he could develop a winning campaign message and stick to it during public appearances.

The governor pressed on. He introduced a revised initiative in a deal to get a powerful union to drop a rival measure. When he couldn't clear the field entirely, he signed legislation to put his measure in the most advantageous position on the ballot. He made speeches at schools and used the specter of education cuts to prompt education officials to campaign strongly for his measure. And he convinced financial supporters to contribute significant sums to the campaign.

While other major action took place throughout the year – including big wins for taxpayers in several court cases, action at the state tax agencies, and passage of a state budget that was shrouded in secrecy – the big story all year was the governor's tax initiative.

When the November election was over, Governor Brown's Proposition 30 had narrowly passed, and the year closed with the governor and legislative leaders saying revenue from the tax increases will save the state budget. Skeptics, meanwhile, questioned whether the temporary tax increases will keep up with policymakers' appetite for more spending.

The November election also saw Democrats winning more than two-thirds of the seats in the Senate and Assembly, giving them the ability to raise taxes and override vetoes without any Republican support.

Was 2012 a watershed year, signaling that Californians are open to paying higher taxes? Was it a one-time decision, based on lopsided campaign funding and circumstances that won't be repeated? Will the new Legislature interpret the vote as a mandate to pass more taxes or weaken Proposition 13?

As the state enters 2013, many questions are in the air.

Battling Tax Initiatives

The governor's first tax initiative proposed increasing personal income tax rates for high-income Californians from 2012 through 2016, and increasing the sale and use tax rate

0.5 percent from 2013 through 2016. He campaigned for this measure in his January 18 State of the State Address, saying, "It's fair, it's temporary, and it's half of what people were paying in 2010."

In mid-January, Governor Brown submitted a new version of his initiative, saying the original version had a typographical error. Attorney General Kamala Harris and Secretary of State Debra Bowen wasted no time getting the new initiative ready for signature-gathering.

As supporters of several tax-related initiatives collected signatures, pollsters monitored shifts in public opinion, and the media reported on the polls at least as often as on the actual policy provisions in the initiatives.

After months of advocating for his tax initiative, Governor Brown introduced yet another version, described as a compromise with the California Federation of Teachers, which had been collecting signatures for a soak-the-rich initiative of its own.

The compromise measure, proposing a top personal income tax rate of 13.3 percent – by far the highest in the nation – for seven years, retroactive to January 1, 2012, and a sales and use tax increase of 0.25 percent for four years, qualified for the November ballot and was labeled Proposition 30.

Governor Brown initially referred to his proposed tax increase on taxpayers with taxable income of more than \$250,000 as a "millionaire's tax," but the campaign eventually settled on a message that did not mention the word "tax" at all.

Throughout the state, there were reports of school officials campaigning for Proposition 30 using school resources, and in one instance, the California State University admitted that staff had used taxpayer-funded resources to urge students to vote for Proposition 30.

Even as the governor and others prepared for the November election, another tax measure appeared on the June ballot. Proposition 29, proposing to increase tobacco taxes by \$1 per pack of cigarettes and to earmark the revenue for a new spending program related to cancer research, was bankrolled by millions from cyclist Lance Armstrong and his foundation. Proposition 29 narrowly failed, finishing with 49.8 percent of the vote, leading some pundits to believe the governor's initiative had no chance of passing.

As the summer went on, the governor's attempt to clear the field of other initiatives met with mixed success. In January, the California State Association of Counties backed off a ballot-box budgeting initiative that would have enshrined realignment funding in the state constitution, and the Think Long Committee for California decided to think longer about its plan to pursue two initiatives, including one that would reduce income taxes and put a new tax on services. (Think Long and its sponsor, billionaire Nicolas Berggruen, later backed an unsuccessful initiative sponsored by California Forward that effectively would have prohibited legislation that reduces taxes by \$25 million or more, unless another tax was increased or funding for an existing program was reduced or eliminated.)

However, wealthy civil rights attorney Molly Munger rejected the governor's request to drop her initiative that sought to increase personal income taxes for most Californians, and her measure qualified for the November ballot as Proposition 38.

The battle between the two plans led many prominent Democrats to blast Ms. Munger for not dropping her initiative, arguing that she was hurting the effort to raise taxes. The Legislature and governor addressed this concern by passing legislation ([SB 202](#), Hancock) that rearranged the order of measures on the ballot to ensure that the governor's would appear first, which typically is an advantageous position.

In November, the governor's measure was approved with 54.3 percent of the vote, while Proposition 38 received just 27.7 percent of the vote.

Other key initiatives on the November ballot:

- Proposition 31, the California Forward measure that effectively would ban future tax reductions, failed with 39.3 percent.
- Proposition 32, which sought to put limits on union and business campaign contributions, failed in the wake of a massive union-funded campaign in opposition. The "paycheck protection" initiative received 43.7 percent of the vote.
- Proposition 39, changing the income apportionment formula for multistate businesses, was approved with 60.4 percent of the vote. Under the law, most businesses are now mandated to use the single sales factor formula, while others are required to use the three-factor formula. Since this change cannot be altered without another vote of the people, it essentially is frozen into state law.

Democrats Post Big Gains in November Election

In the first election cycle using the new political districts drawn by the California Citizens Redistricting Commission, Democrats won more than a two-thirds supermajority in both houses of the Legislature – an achievement that will allow them (if they remain unified) to approve tax increases, override the governor's vetoes and put measures on the ballot without any Republican votes.

Incoming lawmakers will have more power than their predecessors, thanks to passage of Proposition 28 in June. The initiative changed legislative term limits to allow lawmakers to serve up to 12 years in either house (the previous limit was six years in the Assembly and eight in the Senate), which has the effect of reducing time in office by two years for some lawmakers, and increasing the time in office by six years for many others.

Secretive State Budget

On January 5, Governor Jerry Brown unveiled a state budget that called for a 7 percent increase in general fund spending (from \$86.5 billion to \$92.5 billion), and included a plan to merge the Franchise Tax Board and the Employment Development Department's tax branch into a new "Department of Revenue."

The budget assumed – accurately, it turned out – that voters would approve tax increases in November, although the tax hikes that ultimately were approved were not the same ones envisioned in the initial budget. The plan also included cuts of approximately \$5.4 billion, mostly to education programs, that would be triggered if voters rejected the tax hikes. Dan Schnur, director of the Jesse Unruh Institute of Politics, labeled the budget the "largest ransom note in California political history."

The budget also assumed revenue from Facebook's initial public offering, and projected that Facebook stock would be \$45 per share within six months of the IPO. The stock didn't come close to reaching that height (in early January 2013, it was hovering around \$29 per share).

Shortly after the budget was unveiled, Legislative Analyst Mac Taylor said its revenue projections for the combined 2011-12 and 2012-13 periods were approximately \$6.5 billion too high. The analyst's projections were less optimistic about income tax revenue from capital gains.

When the governor released the May revision of his budget, he said the state faced a general fund shortfall of \$16 billion based on ongoing spending commitments and projected revenue. The revision called for \$91.4 billion in general fund spending, and again assumed passage of the governor's tax initiative.

The legislative analyst identified \$6.2 billion in fiscal maneuvers used in the budget to make it appear balanced, including internal borrowing, shifts of funds, delayed loan repayments and payment deferrals that would shift spending to future fiscal years.

The Legislature approved a budget bill on June 15 – the budget deadline – but approved only six of the 28 budget trailer bills that make policy changes related to the budget.

On June 27, the Legislature finished voting on most of the trailer bills, and the governor signed the budget and more than two dozen trailer bills. Many of the bills had been unavailable to the public until the day before the Legislature voted.

Governor Brown used his line-item veto to strike \$154 million in budget spending from state funds. General fund spending in the approved budget was projected to be \$91.3 billion – a 4.3 percent increase from the prior fiscal year.

Months later, on the last day of the legislative session, lawmakers still were voting on trailer bills, including one requiring lumber consumers to pay a 1 percent tax on "lumber products" and "engineered wood products" ([AB 1492](#), Assembly Budget Committee). Although the bill did not comply with Governor Brown's pledge that there would be no tax increases unless approved by a vote of the people, the governor signed the bill.

(The Legislature also introduced new proposals during the last days of the two-year legislative session by using the "gut-and-amend" process. In the last seven days of the session, legislators used the process to place 42 brand-new bills before the Legislature – including five that were totally rewritten on the last day of session – thereby avoiding a

public notification waiting period, meaningful committee hearings and other important steps in the legislative process.)

As 2012 came to a close, the state controller reported that through the first five months of the fiscal year, general fund revenue was \$508 million below projections made when the budget was passed, and expenditures were \$2.16 billion above estimates.

Budget-Related Litigation

The state budget got an assist from the California Supreme Court just before 2012 began, with a ruling that legislation enacted in 2011 to abolish redevelopment agencies is constitutional, and legislation allowing such agencies to continue if they pay specified amounts to the state is unconstitutional. Governor Brown said the decision "guarantees more than a billion dollars of ongoing funding for schools and public safety."

In an unrelated case, a major provision of Proposition 25 – language stating that lawmakers would forfeit pay if they miss their budget deadline – was largely ignored by the courts. Assembly Speaker John Pérez and Senate President Pro Tem Darrell Steinberg filed suit against Controller John Chiang in January 2012, challenging the controller's decision to withhold pay in June 2011 due to the failure to pass a balanced budget. On April 25, a Sacramento Superior Court judge ruled that the controller cannot block legislators' pay if they submit a budget they consider to be balanced. Mr. Chiang said the ruling "is an affront to our basic governing principle of checks and balances, and it perpetuates a bait and switch on voters," and he filed an appeal.

Split Roll, Tax on Services and Other Tax Proposals Stopped

A split roll proposal by Assemblyman Tom Ammiano ([AB 448](#)), strongly opposed by taxpayers, was pulled from an early January committee hearing and was not pursued by the author. Shortly after Democrats made large gains in the November elections, however, Mr. Ammiano indicated that he will be back with a new split roll proposal in 2013.

A March report from Pepperdine University indicated that higher property taxes that would result from a split roll would cause \$71.8 billion in lost output to the California economy, and would reduce employment by approximately 400,000 jobs during the first five years alone.

Additionally, two bills proposing to extend sales tax to services were dropped in the face of major opposition from taxpayers: [AB 2540](#) (Gatto), which initially sought to impose sales tax on a list of specific services to raise money for veterans' homes and pest-eradication programs; and [AB 1963](#) (Huber), which initially proposed a 4 percent sales and use tax on services, except those specifically exempted. The latter bill eventually passed the Legislature as a "study bill," but was vetoed by the governor.

The governor also vetoed [AB 2638](#) (Eng), which would have required the state's annual "tax expenditure" report to incorporate a massive amount of new and meaningless data.

Tax-Related Measures Approved by Legislature and Governor

The Legislature and governor approved legislation ([AB 2323](#), Perea) requiring the Board of Equalization to publish written decisions in cases in which the "amount in controversy" is \$500,000 or more. In December, the BOE adopted guidelines for administering the requirement, and determined that the "amount in controversy" will not include interest or penalties, unless interest or penalties are expressly the issue.

Other significant bills signed into law include [SB 1243](#) (Lowenthal), extending for 10 years a partial sales tax exemption on the purchase of marine fuel, to protect California jobs; [SB 1492](#) (Leno), authorizing San Francisco to impose a local car tax; and bills allowing the Legislature to divert cap-and-trade revenue into new funds ([AB 1532](#), John Pérez, and [SB 535](#), de León).

Cap-and-Trade Auction Held

The California Air Resources Board (CARB) launched the state's cap-and-trade auction program November 14. The auction initially was scheduled to be held two months earlier, but was postponed until after the general election.

Throughout the year, the Legislative Analyst's Office (LAO) scrutinized the cap-and-trade program. In an early February report, the analyst said the program is too complex, and urged the Legislature to revise the design or replace the program with an alternative. Later the same month, the LAO suggested that the Brown administration was overstating budget savings from cap-and-trade revenue, and said only certain programs can be funded with cap-and-trade revenue because of nexus issues. In August, the LAO told the Legislature that the auction of allowances is not necessary for the state to achieve the emission-reduction standards set forth in **AB 32** of 2006.

In November, as CARB launched the cap-and-trade auction program, CalChamber filed suit, arguing that regulators exceeded their authority and were imposing an illegal tax in violation of Proposition 13.

Some Pension Changes Approved

In February, Governor Brown sent proposed pension reform language to the Legislature. Within weeks, Republican lawmakers introduced measures mirroring the governor's plan, but the measures ([ACA 22](#), Smyth; [SB 1176](#), Huff; and [SCA 18](#), Huff) were not taken up by the Legislature's Democratic majority.

The governor introduced a new version August 28, just three days before the end of the legislative session, and the plan was approved with almost no opportunity for public input. The legislation ([AB 340](#), Furutani, and [AB 197](#), Buchanan) caps pensionable salaries at \$110,100; establishes equal sharing of pension costs as the standard; increases retirement ages by two years or more for all new public employees; calculates benefits based on the final three years of regular pay; prohibits purchases of service credits for all employees; and makes other changes, most applying only to employees hired after January 1, 2013.

Critics said the pension changes do not do enough to address the pension costs of existing government workforce, and noted that pension costs cannot be brought under control if current employees are not covered by the reforms.

At the local level, voters in San Jose overwhelmingly approved an initiative requiring new employees to pay half the costs of their retirement in a lower-cost plan.

Fire Tax Fires Up Property Owners

Collection of the new state fire tax began in 2012, and property owners were not happy. The tax – labeled a "fire prevention fee" and approved in 2011 with less than a two-thirds vote of the Legislature – calls for owners of habitable structures in "state responsibility areas" to pay \$150 a year, or less if they also pay for local fire services.

The California Board of Forestry and Fire Protection approved implementation regulations in early January, after being criticized by the governor for previously approving regulations calling for a tax rate of \$90 a year.

Several legislators sought to repeal the tax before it took effect, and in late March, a repeal effort cleared an Assembly committee on a 7-2 vote, with bipartisan support ([AB 1506](#), Jeffries). The repeal measure eventually was snuffed, however, as were other similar measures.

The Board of Equalization began sending out fire tax bills in September, and problems with double-billing and erroneous billing quickly became apparent. One month after the bills went out, the BOE said it would be sending out apology letters to 3,970 property owners who received erroneous notices that their property was subject to the fire tax. Additionally, the BOE reported that noncompliance was running from 17 percent to 35 percent – far in excess of the predicted 7 percent.

The Howard Jarvis Taxpayers Association filed a class-action suit in October seeking to overturn the fire tax because it did not receive a two-thirds vote.

High-Speed Rail Is High-Profile Issue

Observers wondered whether the state's budget problems would prompt policymakers to pull the plug on the state's high-speed rail project, especially in light of criticism that ridership is unlikely to be high enough to support the system financially.

Governor Brown took the opposite approach, and gave a ringing endorsement of the high-speed rail proposal during his State of the State Address. He also proposed that revenue from cap-and-trade auctions be used to fund the project.

In late July, Governor Brown signed legislation ([SB 1029](#), Senate Budget and Fiscal Review Committee) committing \$4.7 billion in state funds to the project.

New Executive Director at the Board of Equalization

In late June, the Board of Equalization appointed Cynthia Bridges, former secretary of the Louisiana Department of Revenue, as the agency's new executive director, capping a search that began when Executive Director Ramon Hirsig retired in September 2010. Kristine Cazadd served as the temporary executive director during the search, and retired from a two-decade career at the BOE after Ms. Bridges was appointed.

Changes at the Franchise Tax Board

After five years as chief counsel of the Franchise Tax Board, Geoff Way stepped down from the position in August, and in December the FTB announced that Jozel Brunett will be the new chief counsel. Ms. Brunett has been a lawyer for the FTB since 1994, and previously was in private practice.

Also in 2012, Carl Joseph was promoted to chief counsel for multistate tax affairs, having served for three years as assistant chief counsel for the Multistate Tax Bureau and 12 years in other positions at the tax agency.

Tax Cases in the Courts

A major California tax case in the courts was heard not in the Golden State, but in Nevada. On May 7, the Nevada Supreme Court heard oral arguments in the Franchise Tax Board's appeal of a Nevada jury's decision to award inventor Gilbert Hyatt damages because of the misconduct of FTB auditors during a residency audit in the 1990s. The Silver State's high court heard a second round of oral arguments June 18. During the hearings, justices peppered attorneys with questions, but did not reveal how they will rule when they eventually hand down a decision.

There was an extraordinarily large number of significant tax-related cases acted upon in 2012:

- The First District Court of Appeal ruled in favor of the taxpayer December 18 in a major case involving whether the right to copy computer software is tangible or intangible property for franchise tax purposes (*Microsoft v. Franchise Tax Board*).
- In *Gillette Company, et al. v. Franchise Tax Board*, a major apportionment case, the First District Court of Appeal sided with taxpayers, then ordered a rehearing, and eventually ruled in favor of taxpayers once again. In a unanimous July 24 decision, the court ruled against the FTB, and said taxpayers may elect to use the equally weighted, three-factor apportionment formula contained in the Multistate Tax Compact instead of California's "mandatory" four-factor formula with a double-weighted sales factor. On August 9, the court ordered a rehearing, which vacated the decision, but taxpayers prevailed when an October 2 published decision was issued. The FTB indicated that it will appeal.
- On August 28, the Second District Court of Appeal ruled that California's qualified small business stock provisions are unconstitutional because the tax benefits (gain exclusion and rollover provisions) are limited to those investing in companies that have 80 percent California property and 80 percent California payroll during

substantially all of the stock's holding period (*Frank Cutler v. Franchise Tax Board*). As a result of the decision, FTB staff decided to invalidate the small business stock incentive altogether.

- On January 4, the state Supreme Court rejected a petition from Apple Inc. to review a decision by the First District Court of Appeal requiring taxable foreign dividends to be repatriated before tax-free dividends are issued (*Apple, Inc. v. Franchise Tax Board*).
- The First District Court of Appeal ruled December 6 that a parcel tax levied by a school district may not impose different tax rates on residential and commercial properties. However, this taxpayer-friendly ruling in *George J. Borikas v. Alameda Unified School District* was vacated as 2013 began, and will be reheard by the court.
- On January 19, the Second District Court of Appeal criticized the Board of Equalization's use of the regulatory process to raise property taxes on oil refineries, and upheld a trial court's ruling that BOE's **Rule 64** (which creates a rebuttable presumption that land, improvements and fixtures at a petroleum refinery constitute a single appraisal unit) is not valid. The BOE petitioned the California Supreme Court to review the ruling in *Western States Petroleum Association v. State Board of Equalization*, and the Supreme Court agreed to take the case.
- In March, a Los Angeles County Superior Court judge upheld a county ordinance that bans retailers from handing out plastic bags and requires them to charge 10 cents for every paper bag provided to a consumer. This ruling in *Lee Schmeer v. Los Angeles County* was appealed, and the case is pending in the Court of Appeal. Plaintiffs note that the bag tax was imposed without a vote of the public, in violation of Proposition 26.
- In April, the state Supreme Court injected more uncertainty into the state's tax system by ruling that the FTB has authority to reject enterprise zone hiring tax credit vouchers issued by a local governmental authority. The case is *Dicon Fiberoptics, Inc. v. Franchise Tax Board* (April 26, 2012) Case No. S173860.
- The Third District Court of Appeal ruled April 30 that the BOE did not have the legal authority to increase the state excise tax on flavored malt beverages in 2008 by reclassifying the drinks as distilled spirits rather than beer (*Diageo-Guinness USA v. Board of Equalization*). After the court ruled, the BOE repealed the regulations that reclassified the beverages.
- The Second District Court of Appeal ruled in July that Proposition 13 was a legally approved amendment to the California Constitution, not an illegally enacted constitutional revision (*Charles Young v. Gregory Schmidt*).

Los Angeles Assessor Jailed

In an episode that recalled California's assessor scandals of the 1960s, the *Los Angeles Times* reported in March that some property owners may have received \$56 million worth of unsupported lower assessments from Los Angeles County Assessor John Noguez.

Mr. Noguez took a paid leave of absence in June, and the Board of Supervisors named Santos Kreimann, director of the county's Department of Beach and Harbors, as acting assessor.

In October, Mr. Noguez was arrested on charges that he conspired to improperly reduce property assessments for clients of a campaign contributor, and he pleaded not guilty. As the new year began, he remained in jail awaiting trial, unable to post bail of \$1.6 million. He continues to collect his full salary, including a raise that took effect in 2012.

Local Taxes

At the local level, voters approved more than 200 tax and bond measures in 2012, including increases in parcel taxes, sales taxes, hotel taxes and utility users' taxes.

One of the biggest changes came in San Francisco, where voters overwhelmingly approved a new business gross receipts tax to replace an existing payroll tax, despite questions over how administration of the tax will create new burdens for San Francisco employers.

Local Governments Go Bankrupt

San Bernardino, Stockton and Mammoth Lakes filed for Chapter 9 bankruptcy protection in 2012, signaling ongoing fiscal instability among local governments.

State's Business Climate Still Dismal

Shortly before the year began, the U.S. Bureau of Labor Statistics reported that from 2006 to 2011, California lost approximately 947,000 jobs – more than any other state in the country.

In January, the nonprofit Tax Foundation gave an indication of why these job losses may have occurred, reporting that California has the third-worst business tax climate in the country. Later in the year, *Forbes* released a report ranking California 41st out of the 50 states in terms of business climate, and the California Chamber of Commerce said its 2012 survey of business executives found that business leaders believe it is getting harder to do business in California than it was one year or four years ago.

Chief Executive magazine also found California to be the worst state in the nation in which to conduct business, based on a survey of more than 650 chief executive officers. It was the eighth consecutive year that California had this dubious distinction.

CalTax Marks 86th Anniversary

The California Taxpayers Association marked its 86th anniversary February 24, and held its 86th Annual Meeting in March in Sacramento. Speakers at the Annual Meeting

included State Controller John Chiang; Board of Equalization Members Betty Yee, George Runner and Michelle Steel; Deputy State Controller Marcy Jo Mandel; Franchise Tax Board Executive Officer Selvi Stanislaus; Santa Clara County Assessor Larry Stone; and veteran political columnist Dan Walters.

In April, CalTax released "CalTax Government Cost Savings Report: How State and Local Government Can Increase Efficiency and Become More Effective," identifying more than \$7.3 billion that state and local government can save or obtain from revenue enhancements if proactive steps are taken to address inefficiencies and reform existing programs.

CalTax also released its annual voting record at the conclusion of the legislative session. The 2012 Voting Record showed that of the 120 members of the Legislature, 29 were in 100 percent agreement with CalTax on key policy issues.