

CALTAX YEAR IN REVIEW: 2015 – ECONOMIC REBOUND LEADS TO TAX REVENUE WINDFALL, WITHOUT TAX HIKES

The year 2015 provided ample proof that a growing economy is the best source of new revenue for the government, as state tax revenue grew significantly under existing tax rates thanks to California's economic rebound.

State lawmakers proposed tax and fee increases that would have added more than \$132 billion per year to the California tax burden, but the Legislature adjourned without approving any broad-based tax hikes.

In fact, the biggest tax-related measure to come out of the Capitol in 2015 was a federal conformity measure ([AB 154](#), Ting), advanced by CalTax and supported by other groups, which was signed in September by Governor Jerry Brown.

While taxpayers had a very successful year in Sacramento, they continued to face challenges in the courts, where the men and women in black robes played a major role in shaping California tax policy in 2015.

Many special interests spent 2015 gearing up for efforts to raise taxes via the ballot box, hopeful that this year's presidential election will draw large numbers of pro-tax voters to the voting booths.

As 2016 begins and CalTax enters its 90th year of protecting taxpayers, taxes continue to be at the forefront of discussion, and the lingering question is whether legislators and voters will risk harming the economy with tax hikes at a time when the government already is experiencing a tax revenue windfall.

State Budget

State Controller Betty Yee delivered good news about the state's finances throughout the year, in monthly reports. In December, she reported that the state had collected \$2.77 billion more revenue in the first five months of the 2015-16 fiscal year than during the same period in the prior fiscal year. This revenue, totaling \$37 billion, was \$502.9 million ahead of the state budget's optimistic projections for the first five months of the fiscal year.

In late November, the legislative analyst reported that the state is in good shape financially, with a "rainy day" fund expected to grow to \$7.2 billion by the end of the 2016-17 fiscal year, and a school funding minimum guarantee that will increase \$3.6 billion in 2016-17.

The budget process started January 9, when Governor Jerry Brown introduced his 2015-16 budget proposal, with no new taxes. His plan proposed \$113.3 billion in general fund spending, and total spending of \$158.8 billion (up from \$108 billion and \$152.3 billion in the prior fiscal year), with a rainy day reserve of \$2.8 billion. The governor said the state government would "live within our means."

In May, the governor unveiled a revised budget plan that anticipated revenue would be almost \$10 billion (9.3 percent) over the \$107.1 billion in the 2014-15 budget, and he proclaimed, “The finances of California have stabilized,” he said.

Budget negotiations between the governor and Democratic legislative leaders took place behind closed doors, and a plan emerged for a vote on June 15 – the deadline for the Legislature to approve a budget or face a loss of pay. The budget was approved, but lawmakers made it clear that it was not the actual budget. Democrats continued negotiating with the governor, and continued amending sweeping new provisions into “budget trailer bills” after the June 15 deadline.

The governor signed the 2015-16 budget with little fanfare, announcing in a June 24 press release that he had signed the spending plan, which included \$115.4 billion in general fund spending. Total spending – including special funds – is unknown, because special fund cap-and-trade spending has been deferred, but the total will be more than \$161.5 billion.

Governor Brown also signed [SB 84](#) (Senate Budget and Fiscal Review Committee), a budget trailer bill that, among other things, establishes a schedule of “fees” assessed on the owners of hazardous material at the time the material is transported by rail. CalTax noted that because the “fees” are not true regulatory fees, and that because the bill was not approved by at least a two-thirds majority of the Legislature, it constitutes an illegal tax.

The governor made some minor reductions from the Legislature’s budget by using his line-item veto.

The governor also vetoed a popular mortgage debt forgiveness conformity measure ([AB 99](#), Perea), along with several other bills that would have provided tax relief through exemptions and credits, saying that because of the state’s “financial uncertainties,” he could not “support providing additional tax credits that will make balancing the state’s budget even more difficult.”

Near the end of the budget negotiations, the governor called two special sessions of the Legislature “to fix how California funds roads, highways and other infrastructure and the state’s core health program – Medi-Cal.” The special sessions did not yield such legislation.

As part of the budget, the state authorized a refundable earned income tax credit (EITC) – essentially a welfare program to give a cash influx to low-income Californians. While Democrats from coastal areas were very supportive of the EITC legislation, a map released by the Franchise Tax Board in December showed that the majority of potential EITC claimants live inland. Meanwhile, the U.S. Treasury Inspector General For Tax Administration reported that the federal EITC is replete with fraud, and that nearly 25 percent of the federal credits were paid improperly.

In March, the governor and legislative leaders announced a \$1 billion emergency drought relief plan. It was approved in April in two bills (one approved in what appeared to be an unconstitutional vote). The governor also proposed a \$10,000-per-day fine on businesses and individuals that waste water. In June, the *Associated Press* reported that more than

\$340 million in previously approved “emergency funds” to address the drought remained unused in government bank accounts.

Under the Dome

“Tax reform” was discussed a lot in the Capitol and by the media, and was a major topic at CalTax’s 89th Annual Meeting in March, but the term meant significantly different things to different people.

A positive reform sponsored by CalTax was a broad-based federal tax conformity bill ([AB 154](#), Ting) that was approved by a bipartisan group of lawmakers, and was signed by the governor in September. It was the first omnibus conformity legislation to be enacted in five years.

Among the tax increases proposed as “tax reforms” were a split-roll property tax measure ([SCA 5](#), Hancock and Mitchell) that was introduced in June with great fanfare, but went nowhere, and a sales tax on services ([SB 8](#), Hertzberg) that was promoted heavily by the author but was not brought up for a hearing. In April, the state Board of Equalization estimated that the latter idea would cost taxpayers at least \$122.6 billion per year. These measures could be pursued this year.

In May, a report from the Legislative Analyst’s Office debunked a claim made by some proponents of “tax reform” – a claim that the sales tax is ineffective because of changes in what Californians buy. The report found that since 1970, the sales tax has grown faster than the growth in personal income, and that the growth of sales tax revenue has remained roughly constant over the long run, declining just 0.2 percent per year.

Other significant tax proposals included:

- A “road user fee” proposed by Assembly Speaker Toni Atkins, at an amount she estimated would cost motorists \$1.8 billion per year.
- A corporate tax rate hike on any publicly held corporation that pays its top-earning employees more than 100 times the median salary for all of its workers – a proposal that was never set for a policy hearing.
- A bill ([AB 464](#), Mullin) that would have increased the maximum allowable local sales and use tax rate, paving the way for local tax increases. The governor vetoed the bill, but later signed two other bills that were county-specific versions of [AB 464](#), as well as legislation ([AB 3](#), Williams) allowing a new utility tax to be imposed by the Isla Vista Community Services District, which opponents said could open the door for more such taxes.
- A new state surcharge on prepaid wireless cards and services that was signed into law, and took effect at the beginning of this year.

- A variety of targeted taxes, including measures aimed at smokers, cocktail drinkers, consumers of sweetened beverages, water users, diesel fuel users, and managed care organizations.

In April, Controller Betty Yee appointed a nine-member council to review and comment on tax reform proposals (the council is expected to report the results of its study this year).

Taxes on Motorists a Mixed Bag

There was other good news for taxpayers: In July, the state's gasoline tax was reduced 6 cents per gallon, to 30 cents per gallon. For diesel fuel users, however, the fuel tax was increased 2 cents per gallon, to 13 cents per gallon.

However, California motorists are paying approximately 10 cents more per gallon for motor vehicle fuel because of California's cap-and-trade program, according to an estimate released in 2015 by the California Air Resources Board.

The Road Charge Technical Advisory Committee, a working group formed by the California Transportation Commission, met during the year to work on a pilot project to test a mileage-based tax that would replace the state's existing fuel tax. The change is intended to solidify the state's funding for transportation infrastructure.

Meanwhile, the California Department of Motor Vehicles agreed to start collecting the correct amount of sales and use tax on vehicles, after complaints that it was collecting incorrect amounts in areas where a single ZIP code includes some jurisdictions that charge local sales tax, and other jurisdictions that don't.

Split-Roll Property Tax

At the beginning of the year, Senate President Pro Tem Kevin de León told the Sacramento Press Club that he was ready to have "a vigorous debate" on increasing taxes through a split-roll property tax or targeted taxes.

On May 7, the "Make It Fair" coalition held a rally in Sacramento to promote a split-roll property tax, and a column by one of the group's leaders was published the same day in *The Sacramento Bee*. The group, comprised of public employee unions and others, argued that corporations are not paying their "fair share" of property taxes.

During a July 10 legislative hearing, split-roll supporter Jennifer Bestor, research director for Educate Our State, revealed more about her anti-Proposition 13 views when she voiced support for requiring the reassessment of homes when owners die and leave property to their children, and frequent reassessment of rental properties.

To educate the public and counter misleading claims made by split-roll proponents, CalTax published Proposition 13 fact sheets and gave presentations to local groups in several parts of the state.

Governor Brown took the wind out of the sails of split-roll proponents in October when he announced, “I’m not supporting a split roll.” The governor called the issue a “tar baby,” using the term in its official sense of describing a situation that is best avoided, but drawing criticism from those who said the term has racist overtones.

Polls showed that Proposition 13 remains popular with voters. In June, a poll by the California Business Roundtable found that 65 percent of Democrats and 82 percent of Republicans would support Proposition 13 if it were on the ballot today. Also in June, the Public Policy Institute of California reported that support for a split-roll property tax is at its lowest point among adults since PPIC began asking the split-roll question in January 2012.

Taxes Headed for the Ballot

Proponents of tax increases were not shy about filing initiatives in 2015, but it remains to be seen how many will collect enough signatures to qualify their measures for the November 2016 ballot. Some of the prominent initiatives:

- A new property tax on properties valued at more than \$3 million, introduced by former BOE Member Conway Collis and others. The measure would cost taxpayers an estimated \$6 billion to \$7 billion per year, the legislative analyst estimated.
- An extension of the temporary income tax rate increases that were in Proposition 30 of 2012. The measure is supported by public employee unions, but Governor Brown has not voiced support for the plan.
- A tobacco tax hike of \$2 per pack of 20 cigarettes, filed by the Service Employees International Union, the California Medical Association and the American Lung Association. Wealthy activist Tom Steyer has provided significant funds to the campaign for the cigarette tax hike. Opponents noted that the Washington, D.C.-based Tax Foundation reported in February that 31.5 percent of cigarettes smoked in California in 2013 were smuggled into the state to avoid taxes, and this problem will get worse if the tax goes up.

Senator Hertzberg formed a campaign finance committee to support his proposed sales tax on services, but did not file an initiative in 2015.

Other notable initiative news: Opponents of a new state law banning single-use plastic bags and imposing a tax-like “fee” on paper bags ([SB 270](#) of 2014) gathered enough signatures to put a referendum on the ballot; a \$9 billion school bond, supported by the California Building Industry Association, qualified for the ballot; BOE Vice Chair Runner and Senator Huff filed a measure to redirect high-speed rail bond funds to water projects; government employees’ unions filed a proposal to increase the state’s minimum wage; an oil severance tax was proposed, but Mr. Steyer said in December that he does not expect it to appear on the ballot this year, and that he is focusing his efforts on other measures; and Lieutenant Governor Gavin Newsom, already an announced candidate for the 2018

gubernatorial race, filed a measure to impose more restriction on firearms bought and sold in California.

The most talked-about initiative of 2015, however, was one that never was circulated for signatures and will not appear on the ballot. In February, Huntington Beach lawyer Matt McLaughlin filed a measure that would legalize the killing of any person who engages in same-sex relations in California. The attorney general refused to prepare a title and summary, arguing that it was a waste of time to do so for a patently unconstitutional measure. The courts agreed. Lawmakers responded to the measure with a variety of proposals to limit the public's access to the initiative process, culminating with a new law that increases the filing "fee" from \$200 to \$2,000 (refunded to proponents of initiatives that qualify for the ballot).

A Busy Year for Lawyers and Judges

Many important tax issues were litigated in 2015. In October, the California Supreme Court – which included two new Brown nominees who were sworn in at the beginning of the year, Justices Mariano-Florentino Cuellar and Leandra Kruger – heard oral arguments in *Gillette Company v. Franchise Tax Board*, relating to whether a corporate taxpayer can use the Multistate Tax Commission's three-factor apportionment formula for tax years when California was a member of the commission. On the last day of the year, the court issued its ruling, unanimously siding with the FTB and holding that multistate taxpayers no longer may elect to use the MTC's three-factor formula to apportion net income for California corporation franchise and income tax purposes.

Some notable California Court of Appeal decisions:

- In *Lucent Technologies Inc. v. State Board of Equalization*, involving the taxation of licensing fees to use switching software transferred in storage medium pursuant to technology transfer agreements, the Second District Court of Appeal sided with the taxpayer and blasted the BOE's legal strategy. Despite the harsh rebuke from the court, the BOE asked the state Supreme Court to review the ruling.
- Redding's Payment in Lieu of Taxes (PILOT) system, in which a municipally owned utility sends money to the city's general fund in an amount designed to be equivalent to the ad valorem property tax the utility would have to pay if it was privately owned, was ruled an illegal tax by the Third District Court of Appeal, in *Citizens for Fair REU Rates v. City of Redding*. The Supreme Court granted a petition to review the case, putting the taxpayers' win in jeopardy.
- San Francisco's "payroll expense tax" was upheld by the First District Court of Appeal, which ruled the tax is not an illegal local income tax (*Coblentz, Patch, Duffy & Bass LLP v. City and County of San Francisco*).

- The city of Santa Barbara's 1 percent "surcharge" on electricity bills "is an illegal tax masquerading as a franchise fee," the Second District Court of Appeal ruled February 26 in *Rolland Jacks v. City of Santa Barbara*. CalTax filed an amicus brief in support of the taxpayer.
- *Morning Star Packing Company v. California Air Resources Board*, a key case involving whether the state's cap-and-trade program is an illegal tax, remained pending in the Third District Court of Appeal, with oral arguments yet to be scheduled. CalTax filed an amicus brief supporting the taxpayer.
- In a key case on combined reporting under California's corporate tax, *Harley-Davidson Inc. v. Franchise Tax Board*, the Fourth District Court of Appeal revived part of a constitutional challenge, but sided with the FTB on the question of whether a subsidiary with no physical presence in California was subject to California income tax. The state Supreme Court denied the taxpayer's petition to review the ruling.
- In *Golden Gate Hill Development Company Inc. v. County of Alameda*, the First District Court of Appeal ruled that if the legality of a parcel tax isn't challenged within 60 days of passage, a taxpayer cannot subsequently seek a refund based on the alleged illegality of the tax – even if the tax is, in fact, illegal. CalTax filed an amicus brief supporting the taxpayer, who has asked the California Supreme Court to review the Court of Appeal decision.

Following up on a major case from three years ago, the Los Angeles Superior Court in May ordered the FTB to pay attorney fees to Frank Cutler to cover his cost of litigating *Frank Cutler v. Franchise Tax Board*, in which the Court of Appeal in 2012 found California tax law to be discriminating against interstate commerce.

Additionally, the year would not have been complete without more activity in the ongoing litigation between the FTB and Nevada inventor Gilbert Hyatt. In December, the U.S. Supreme Court heard oral arguments in litigation over whether a Nevada resident has the right to sue a California agency in a Nevada court. In March, a federal judge dismissed a civil rights suit in which Mr. Hyatt alleged that the FTB and BOE are violating his due process and equal protection rights by taking more than 20 years without completing the administrative process in his income tax dispute, and that decision was appealed. In September, a New York trial court judge ruled that the FTB violated court orders by filing certain documents with the BOE, but said the FTB won't face sanctions for the violation.

In two notable cases not directly related to taxes, the U.S. Supreme Court in July upheld the right of Arizona voters to create an independent redistricting commission (a decision that protects a CalTax-supported political reform in California), and the Third District Court of Appeal in June criticized Governor Arnold Schwarzenegger's pardon of a former Assembly speaker's son for a fatal stabbing – issued on the governor's last day in office – but said the pardon did not violate the law.

State Board of Equalization

The State Board of Equalization had a familiar face in a new capacity, as former BOE Member Betty Yee was sworn in as state controller, and thus retained a seat on the tax board. She appointed Yvette Stowers as deputy state controller to represent her on the BOE and Franchise Tax Board.

Joining the board were new BOE Members Diane Harkey and Fiona Ma, both former state legislators.

BOE Member Jerome Horton, who has chaired the board since 2011, was reelected chairman in January, and BOE Member George Runner was chosen as vice chair.

In May, the BOE announced that the value of state-assessed properties topped \$100 billion for the first time in history (the grand total was \$100,066,007,500).

Franchise Tax Board

With the election of Betty Yee as state controller, the Franchise Tax Board got a new chair in January. BOE Chair Jerome Horton and Department of Finance Director Michael Cohen remained on the three-member board.

A main topic of interest at the FTB was interest itself. Responding to concerns raised by CalTax, the FTB said it is working to provide refunds of overcharged interest to as many as 27,000 taxpayers. In November, the FTB began making “interest adjustments” for personal income taxpayers affected by the overcharges, but not for corporate taxpayers – the agency said it will begin making interest adjustments for business entities this year.

In a separate issue relating to interest payments, the FTB’s interest rate for corporate tax overpayments remained at 0 percent in 2015, aggravating taxpayers who maintain that it is inequitable for the FTB to charge 3 percent interest on unpaid taxes, but pay no interest on overpayments. For personal income taxes, the FTB maintained a 3 percent rate for underpayments and overpayments alike.

Responding to another issue raised by CalTax, the FTB said it is attempting to correct problems associated with the FTB’s high compliance inventory of audits, protests, refund claims and appeals.

Assessors

After several years of scandal and controversy involving a handful of county assessors, 2015 was a relatively quiet year.

Assessed property values in California rose 5.9 percent in 2015-16, the BOE reported in December. As a result, most counties will experience significant increases in property tax revenue, without any change in tax rates and without any weakening of Proposition 13’s taxpayer protections.

In a win for taxpayers, the Santa Clara County Board of Supervisors repealed a \$40 fee that had been charged to those who file a property tax appeal in the county – even if the property owner’s opinion of value was found to be accurate. Assessor Larry Stone, who opposed the fee when it was implemented in 2007, praised the repeal.

Local Tax Increases

In local elections, voters approved nine out of 14 bonds (including school bonds), and 34 out of 58 tax measures, and CalTax maintained [a list of all the local tax measures](#) decided in 2015.

Many local governments spent the latter portion of 2015 ramping up efforts to put tax measures on the ballot this year, hoping that the presidential election will bring out more voters who support local tax increases.

Sales tax increases took effect April 1 and July 1 in more than a dozen cities and a number of counties and special districts, while a 0.5 percent sales tax reduction took effect in the city of El Cajon, in San Diego County.

The 2015 elections were the last in which local officials could write ballot questions that did not include the tax rate and other information – a new CalTax-supported law requires that from now on, the ballot questions must include the amount of money to be raised annually, and the rate and duration of the tax.

Unemployment Insurance Fund Woes Continue

In November, the California Employment Development Department released a forecast showing that California’s unemployment insurance fund deficit was \$8.6 billion at the end of 2014, and was forecast to drop to \$6.7 billion by the end of 2015 and \$4.5 billion this year. The system has been propped up with huge loans from the federal government, leading to tax increases on employers (in the form of federal unemployment tax credit reductions) to pay down the loan balance.

California Jobs and the Business Climate

California maintained its position as the third-worst state in the nation in terms of business tax climate, the Washington, D.C.-based Tax Foundation reported. In April, the American Legislative Exchange Council ranked California’s economic competitiveness 44th out of the 50 states.

Later in the year, Kiplinger ranked California as the least tax-friendly state in the nation, and Orange County-based Spectrum Location Solutions reported that 9,000 companies have moved headquarters or diverted projects out of California in the past seven years.

Farmer Brothers Co., a coffee roaster that employed 350 people at its headquarters in Torrance, did just that in 2015. The company, one of the oldest publicly traded firms in Los Angeles County, moved its headquarters to a massive new complex in Fort Worth, Texas,

and estimated that it will save \$12 million to \$15 million per year because of the lower cost of doing business in Texas.

In September, the *Los Angeles Times* reported that Korean business owners were planning an “exodus” from Los Angeles in the wake of a minimum wage increase and costly regulations. Several of the business owners visited El Paso, Texas, where the minimum wage is less than half the minimum wage in Los Angeles, and said they will prepare a report for other members of the large Korean business community.

Government Waste an Ongoing Problem

Governments at all levels continued to waste tax dollars in 2015. Some notable examples:

- The California Department of Finance reported that many state government departments padded their budgets by keeping vacant jobs on their books, and collected state funds for the phantom employees. Auditors found that some departments continually transferred workers into and out of vacant positions to ensure that no position would remain vacant for six consecutive months – a period that would trigger a state law requiring the position to be abolished.
- The city of Sacramento acknowledged that it overpaid hundreds of retired city workers for several years, costing the city’s pension fund approximately \$2.8 million.
- The state auditor reported that misbehavior by state employees wasted \$4.2 million in tax dollars from August 2012 to March 2014. The transgressions included playing golf during work hours, and running side businesses from state offices.

These and many other examples of waste reported by the media are likely to be remembered by voters later this year when they are presented with proposals to increase state and local taxes.