

CalTax Year in Review: **A Year of Major State and Federal Tax Changes**

The year 2017 was marked by historic changes in tax policy and administration at the state and federal levels, leaving California taxpayers with many unknowns as the new year begins.

At the federal level, President Donald Trump and Congress passed the most sweeping changes to the federal tax code in more than 30 years. The tax package includes a significant reduction in the corporate tax rate, changes designed to encourage businesses to stay in the United States, lower rates for personal income tax brackets, and personal income tax deduction limits that mitigate the benefits for some Californians.

The nation's focus on tax reform was reflected in CalTax's 91st annual meeting, where economist Dr. Arthur B. Laffer – the “father of supply-side economics” and creator of the Laffer Curve – gave an entertaining presentation on how taxes affect the economy.

At the state level, Governor Jerry Brown and the Democrat-controlled Legislature approved an overhaul of the State Board of Equalization, shifting most of the 138-year-old, elected board's administrative and appeal functions to two new agencies within the executive branch of government: the Office of Tax Appeals and the California Department of Tax and Fee Administration. The taxpayer community is watching closely as the new agencies take shape, to ensure that taxpayers' rights are protected, and that the appeals system is fair and impartial.

In addition to changing the tax administration structure, the governor and Legislature approved the largest transportation tax since the gasoline tax was established in 1923 – a \$52.4 billion tax increase over 10 years to fund a broad array of transportation projects ([SB 1](#), Beall, and [SB 132](#), Senate Budget and Fiscal Review Committee). Opponents filed two initiatives to repeal the increases, hoping to qualify the measures for this year's ballot.

The state also extended the California Air Resources Board's cap-and-trade auction with more than two-thirds of the Senate and Assembly in support, thus putting an end to years of litigation over the system's legality.

As 2018 begins, a new tax threat faces Californians – a split-roll property tax initiative that would increase unemployment and consumer costs by imposing an estimated \$11.4 billion-per-year tax increase on California businesses. The initiative was introduced by the California League of Women Voters and others as 2017 was coming to a close.

Will the split-roll measure qualify for the November ballot? Will the new year bring more major changes for taxpayers, or will it be calm after the recent storm of activity? How will state and federal elections impact tax policy? The answers to these and other questions will be revealed over the next 12 months.

New Tax Agencies Arise

The reorganization of the State Board of Equalization was supported by some sitting board members, and opposed by others. State Controller Betty Yee proposed that most of the board's duties be shifted to the executive branch, and advocated for the legislation that made this change. The Legislature approved the bill ([AB 102](#), Assembly Budget Committee), and later passed "cleanup" legislation ([AB 131](#), Assembly Budget Committee).

The new California Department of Tax and Fee Administration (CDTFA) is responsible for administration of sales/use and most special taxes, while the other new tax agency, the Office of Tax Appeals (OTA) will decide appeals of income/franchise, sales/use and various special taxes. The scaled-down BOE retains adjudicatory authority and administration of property taxes, insurance taxes and alcoholic beverage taxes.

In July, Governor Brown appointed Maryland lawyer Nicolas Maduros, former chief of staff at the U.S. Small Business Administration, as director of the CDTFA, and appointed Sacramento lawyer Tad Egawa as chief counsel. Most of the BOE's employees transferred to the CDTFA, and kept their offices in the same downtown Sacramento building that is headquarters for the BOE.

The transition was not without hiccups, as BOE members frequently complained about a lack of communication with the CDTFA, and also accused the agency of dragging its feet on tax appeals to avoid having them heard by the BOE. Additionally, CDTFA Communications Director Mark DeSio was let go, and alleged that he was fired in retaliation for cooperating with criminal and financial investigations when he previously worked for the BOE.

In September, an audit reported rampant nepotism at the former BOE, prompting the CDTFA, which inherited most of the BOE's staff, to adopt anti-nepotism policies.

The OTA officially opened when 2018 began, under the direction of Mark Ibele, a former legislative staffer and advisor to the BOE. In addition to appointing Ibele as director, Governor Brown appointed Kristen Kane, a former Franchise Tax Board tax counsel, as chief counsel of the OTA. Formal regulations pertaining to OTA rules and procedures are in the process of being finalized.

As the OTA was hiring administrative law judges to hear appeals, BOE Members Fiona Ma and George Runner argued former tax agency attorneys should not be selected for the jobs. In a letter to the Brown administration, Ma wrote that she has seen the tax agency attorneys' bias, and "if we were to allow these same biased attorneys to serve as Administrative Law Judges on this new panel, I believe we would be doing a grave injustice to taxpayers and be setting the reform effort up for failure." The OTA has not unveiled its selections, so it remains to be seen if Ma's advice was taken into consideration.

Old Tax Agencies Stay Busy

At the State Board of Equalization, Diane Harkey was elected chair in February, becoming the first Republican to serve as BOE chair since 2001. By virtue of her position as BOE chair, she also joined the three-member Franchise Tax Board, and is the first Republican member of that board since 2009.

In addition to the major changes as a result of the reorganization of the state tax agencies, the BOE had a major change in its executive staff. In September, BOE Executive Director David Gau, who had worked for the BOE since 1981, and had been in the top executive position since March of 1996, announced he would retire at the end of 2017. The board appointed Dean Kinnee, the head of the BOE's Property Tax Department, as his successor.

Additionally, Henry Nanjo, a longtime government attorney, was hired as chief counsel after the former top lawyer transferred to the CDTFA, and Brenda Fleming, the board's chief information officer for the past six years, was appointed chief deputy director.

Midway through the year, after the reorganization was signed into law, there was debate during BOE hearings over whether disclosure of private communications with appellants prior to the July 1 effective date of the law change was required. The issue was resolved when the attorney general issued an advice letter saying the new law's ban on ex parte communications didn't apply retroactively.

Perhaps the most notable tax appeal decided by the BOE in 2017 was the dispute between Nevada inventor Gilbert Hyatt and the FTB – a residency and sourcing case that dates back more than two decades. Hyatt prevails on most issues, as the BOE found he did not commit tax fraud, was not a resident of California during most of the period in which the FTB claimed he lived in Southern California, and did not owe tax on California-sourced income for most of the period claimed by the FTB.

The new year brings a new BOE. Reflecting the board's narrower jurisdiction, its regular meetings are scheduled for just one day each, rather than two or three, and the longstanding committee system has been scrapped.

At the Franchise Tax Board, meanwhile, the agency announced in June that for the first time since mid-2009, the state will pay interest on corporation tax refunds – albeit at a much lower interest rate than charged on underpayments. Effective July 1, the state began paying 1 percent interest on corporation tax refunds, while the interest charged on underpayments is 4 percent.

At its last meeting in 2017, the FTB voted to adopt a resolution barring communication between FTB board members and taxpayers regarding Section 25137 alternative apportionment petitions, unless prior notice and opportunity is provided to FTB staff to participate. This change took effect January 1.

The FTB also approved sponsorship of various bills for this year's legislative session, including conformity to the federal election for partnership-level audit and adjustments (the proposal would make the federal election binding for state purposes, and prescribe the method for

reporting and determining California taxes), modified conformity for tentative refunds based on net operating loss carryovers, and statutory affirmation of rules addressing treatment of existing water's-edge elections involving unitary foreign affiliates.

Record-Setting State Budget Approved

Governor Brown introduced a \$179.45 billion budget in January of 2017, and urged spending caution. Roughly five months later, he signed a \$183.2 billion budget that represents the largest annual spending plan in California's history.

The budget, which reflects an \$22.2 billion spending increase from the budget enacted two years prior, included legislation that ended the ongoing debate over the legality of the state's cap-and-trade auctions. The legislation ([AB 398](#), Eduardo Garcia), approved by more than two-thirds of the Legislature, extended the cap-and-trade auction through 2030, and also included CalTax-sponsored provisions to expand the partial sales and use tax exemption for manufacturing equipment and extend the sunset date.

Early in the year, a report from the Legislative Analyst's Office prompted discussion that the Gann Limit, the state spending limit approved by voters in 1979, would be a factor in budget negotiations for the first time in recent history. Ultimately, the spending approved by the Legislature and governor did not reach the limit.

One of the most controversial provisions of the budget was a bill ([SB 96](#), Senate Budget and Finance Committee) that was only tangentially related to state spending. The bill delays the legislative recall process, in an apparent attempt to protect state Senator Josh Newman from a recall that was filed in response to his vote for the transportation tax legislation.

During the budget negotiations, taxpayers benefitted from the new transparency required by Proposition 54 – the voter-approved 2016 initiative, supported by the CalTax, that requires bills to be in print at least 72 hours prior to the final vote in either house. This year, another important provision of Proposition 54 takes effect, requiring the Legislature to make audiovisual recordings of all floor sessions and committee hearings, to post them online within 24 hours of the conclusion of the event, and to maintain archives of these recordings dating back at least 20 years.

While revenue collections tracked closely with budget projections the entire year, state officials issued warnings about the future. As 2017 began, the state controller noted that the state's liability for retiree health benefits was \$76.7 billion, and was "one of the state's largest long-term debts." The legislative analyst later reported that the state ended the 2015-16 fiscal year with \$97 billion in unfunded teacher pension liabilities, which is \$21 billion higher than the prior year.

In June, taxpayers had reason for concern when Dan Walters, perhaps the most effective budget watchdog in the Capitol press corps, announced his retirement from *The Sacramento Bee*, after 33 years with the newspaper, and more than 40 years of writing about state

government. But Walters immediately moved to the *CALmatters* online news site, and continued his column on California politics and government.

Legislators Propose \$373.4 Billion in Taxes and Fees

In October, the California Tax Foundation, a nonprofit research foundation formed by CalTax in 1980, released the annual “[Tax Watch](#)” report, showing that state lawmakers in 2017 proposed \$373.4 billion in higher annual taxes and fees, and \$8.75 billion in annual taxes and fees were signed into law.

The proposed increases included:

- A single-payer health care plan that would cost an estimated \$106 billion to \$200 billion per year in new taxes ([SB 562](#), Lara). The bill was held in the Assembly Rules Committee, prompting outrage from the California Nurses Association and others, but could be revived this year.
- Elimination of the water’s-edge election for corporate income tax ([SB 567](#), Lara).
- Authorization for local governments to impose income taxes. San Francisco supervisors adopted a resolution urging the Legislature to give local governments this authority, and Assembly Member Phil Ting said he would carry legislation to do so.
- A large tax increase on liquor, to raise revenue to offset the impact of a proposed tax exemption for feminine hygiene products ([AB 479](#), Gonzalez Fletcher).
- A proposed tax on snacks ([AB 274](#) and [ACA 2](#), Cristina Garcia), tax on pain-killing opioid medications ([AB 1512](#), McCarty), an income tax increase in the form of eliminating the mortgage interest deduction for second homes ([AB 71](#), Chiu), and many more.

Several tax proposals were described by sponsors as responses to actions by the Trump administration. Indeed, the beginning of 2017 was marked by vocal anti-Trump sentiments being voiced by state lawmakers. Even before the president was inaugurated, Democratic leaders hired former U.S. Attorney General Eric Holder and a team of lawyers to serve as outside counsel “to advise on potential legal challenges with the incoming Trump Administration.”

The pro-tax viewpoint of many in the Capitol also was on display June 7, the day after the 39th anniversary of Proposition 13’s passage, when Democrats on the Senate Governance and Finance Committee rejected a resolution commemorating the property tax reform initiative.

Changes in the Legislature

The national conversation about sexual harassment had a significant impact on the Legislature, leading to the resignation of two sitting lawmakers (who both were members of the Assembly Revenue and Taxation Committee), investigations into the behavior of three others (including

one who went on paid leave just days into 2018), and new procedures designed to keep lawmakers from sweeping harassment claims under the rug.

The action in the Capitol was prompted by a letter spearheaded by Adama Iwu, a government affairs manager for Visa, and signed by BOE Member Fiona Ma and more than 140 other women who said they have been impacted by inappropriate behavior in state politics. Iwu was pictured on the cover of TIME as part of the magazine's "Person of the Year" tribute to those who broke the silence on harassment.

The resignations leave Democrats without a two-thirds supermajority in either house, although they may be able to regain that status as vacancies are filled in special elections later this year.

In other activity, Senate Democrats chose Senator Toni Atkins to succeed Senator Kevin de León as Senate president pro tem, effective later this year. Atkins will be the first woman and first openly gay Senate president.

Assemblyman Adam Gray was elected as the new leader of the Legislature's moderate Democratic caucus, while elsewhere on the political spectrum, 22 Assembly Democrats formed a new "Progressive Caucus," chaired by Assemblyman Reginald Jones-Sawyer.

The Senate Republican Caucus elected Senator Patricia Bates of Laguna Niguel as the Senate Republican leader, while the Assembly Republican Caucus elected Assembly Member Brian Dahle as leader. Dahle took over when Assembly Member Chad Mayes was ousted from the leadership post after voting for a cap-and-trade bill that was opposed by most legislative Republicans.

In other legislative activity:

- Assembly Member Sebastian Ridley-Thomas, chair of the Assembly Revenue and Taxation Committee, announced December 27 that he was resigning due to undisclosed "persistent health issues" that required five surgeries in 2017. The Assembly speaker appointed Assembly Member Autumn Burke as the new chair of the tax committee.
- Assembly Member Jimmy Gomez left his Los Angeles district to take a seat in Congress, filling a vacancy left when Representative Xavier Becerra was appointed as California's attorney general (to fill the two years left in the term of Kamala Harris, who left to serve as a U.S. senator). Democrat Wendy Carrillo, a former Service Employees International Union employee, was elected in December to fill the vacancy left by Gomez.
- Senator Steve Glazer was forced out of a committee chairmanship after he opposed the transportation tax measure, and Assembly Member Rudy Salas was removed from a committee post for the same reason.
- Senator Mike McGuire, a Democrat from Healdsburg, took the gavel for the Senate Governance and Finance Committee.

- In an event that made national news, State Senator Janet Nguyen was physically removed from the Senate chamber in February after ignoring an order from the presiding officer to stop giving a speech about former Senator Tom Hayden's activities in Vietnam.

Legislators and other state officials also received pay raises of 3 percent, bringing the salary for rank-and-file legislators to \$107,240 plus tax-free per diem payments when the Legislature is in session.

Elections on the Horizon

At the end of 2017, campaigns for statewide ballot measures already were in high gear, with signature-gathering under way for some proposed initiatives. The California Association of Realtors filed an initiative to expand the ability of homeowners age 55 years or older to blend their Proposition 13 base-year value when moving to a new residence anywhere in California, regardless of the new property's value. Meanwhile, the California Business Roundtable filed a statewide ballot measure to address concerns regarding Proposition 26 implementation. Proposition 26, cosponsored by CalTax, was approved in 2010 to stop hidden taxes, but recent court decisions have left taxpayers vulnerable. The proponents of both measures hope to qualify their initiatives for the November ballot.

With California's term-limits law making Jerry Brown ineligible to run for reelection, the voters will elect a new governor in 2018. The frontrunners, based on polling results and campaign finances, appear to be Lieutenant Governor Gavin Newsom and former Los Angeles Mayor Antonio Villaraigosa.

Other Democratic candidates include Treasurer John Chiang and former Superintendent of Public Instruction Delaine Eastin. On the Republican side, Assembly Member Travis Allen and businessman John Cox are in the race. The top two finishers in the June primary will advance to the November election.

Early in 2017, it appeared that the state might have a celebrity candidate for governor: football legend Rosie Grier, part of the Los Angeles Rams' "Fearsome Foursome" defensive line in the 1960s, also known for helping restrain Sirhan Sirhan after the assassin killed Senator Robert Kennedy in 1968. But shortly after announcing he would run for governor as a Republican, Grier dropped the idea.

California's U.S. Senate race got more exciting in October, when Senate President Pro Tem Kevin de León challenged U.S. Senator Dianne Feinstein, positioning himself as a more liberal alternative to the Democratic incumbent.

Meanwhile, wealthy hedge-fund manager Tom Steyer launched an anti-Trump media campaign that fueled speculation he might run for governor or senator, but has not entered either race. Democrat Eric Garcetti also was considered a possible candidate for governor, but announced

late in the year that he will not run. He was reelected as mayor of Los Angeles in March, and now is being mentioned as a possible presidential candidate in 2020.

The November elections also will fill three open seats on the State Board of Equalization, as Jerome Horton and George Runner are termed out of office, and Fiona Ma is running for state treasurer. Harkey and State Controller Betty Yee are expected to retain their seats on the BOE, as both are running for reelection with no significant challengers.

Property Value Gains and Losses

When county assessors submitted their assessment rolls in the summer, major gains in value were reported throughout the state. Assessed values increased an average of approximately 5.5 percent, amounting to billions of dollars in additional property tax revenue for local schools, libraries, fire and police departments, parks and recreation programs, public health programs, streets and transit.

Additionally, the state set the annual Proposition 13 inflation factor at 2 percent (the maximum allowed) for the 2018 assessment roll, which also will have a positive impact on local tax revenue. According to [BOE data](#), the inflation adjustment has reached the maximum level in 34 of the 43 years that it has been in effect, providing predictable property tax revenue growth for local government while protecting homeowners and business owners from large year-to-year tax increases that otherwise might threaten their ability to keep their homes and businesses.

The good news was tempered, however, by realization that the fires that consumed California in 2017 will take their toll not only on the lives and homes of victims, but on the assessment rolls of Napa, Sonoma, Orange, Los Angeles, Ventura and other impacted counties.

Mostly Bad News From the Courts

Taxpayers celebrated a big victory in January when the Fifth District Court of Appeal rejected a sweeping definition of “doing business in California” used by the FTB to seek taxes from out-of-state businesses. In *Swart Enterprises Inc. v. Franchise Tax Board*, the court stated that the FTB’s position “defies a commonsense understanding of what it means to be ‘doing business.’” In February, the FTB announced it would not ask the state Supreme Court to review the case, and will follow the decision “in situations with the same facts.”

In other cases, however, the judicial branch was not kind to taxpayers in 2017. Key cases included:

- The Third District Court of Appeal ruled that the cap-and-trade auction does not constitute an illegal tax (*California Chamber of Commerce, et al. v California Air Resources Board*).
- The California Supreme Court denied a petition from taxpayers to hear their appeal claiming that the state’s cap-and-trade auction constitutes an illegal tax, leaving in place

a Court of Appeal ruling that the auction is not a tax (*CalChamber and Morning Star Packing Company v. California Air Resources Board*).

- In *Upland v. California Cannabis Coalition*, the California Supreme Court ruled that local tax measures placed on the ballot through the local initiative process are not governed by the same constitutional restrictions as local tax measures placed on the ballot by a city council or other government body.
- The state Supreme Court ruled that Los Angeles County can impose a documentary transfer tax on a written instrument that transfers ownership of real property as long as the document reflects an actual transfer of legal beneficial ownership made for consideration (*926 Ardmere Avenue LLC v. County of Los Angeles*).
- The state Supreme Court ruled that a franchise fee passed on to ratepayers' electricity bills does not constitute an illegal tax, as long as the fee truly is related to the value of the franchise (*Jacks v. City of Santa Barbara*).
- The Sacramento Superior Court dismissed a class-action suit challenging California's "fire prevention fee" as an illegal tax (*Howard Jarvis Taxpayers Association v. California Department of Forestry and Fire Protection*).
- The Ninth U.S. Circuit Court of Appeals ruled against Nevada inventor Gilbert Hyatt in his suit alleging civil rights violations by California's tax agencies. (In a separate case, the Nevada Supreme Court upheld a jury's finding that the FTB committed fraud during audits of Hyatt, and intentionally inflicted emotional distress upon him, but lowered the amount of damages the FTB must pay.)

California Supreme Court Justice Kathryn Mickle Werdegar retired in August, 23 years after being nominated by Governor Pete Wilson. This gives Governor Brown, who nominated three of the seven-member panel's existing members, a major opportunity to shape the court. The governor is taking time to fill the vacancy, however. In December, Chief Justice Tani Cantil-Sakauye said the lack of a seventh justice is making it "difficult to operate," and said she thinks the length of the vacancy is record-setting.

Voters Approve 53 Local Taxes

In local elections, voters approved 53 of the 87 tax and bond measures that appeared on their ballots in 2017. Observers noted that the local governments that put the measures on the ballot also wrote the ballot arguments, and typically skewed the language to favor a "yes" vote.

Although the problem was evident in many areas, the city of Carson was particularly blatant in its use of taxpayer dollars to campaign for a tax measure. After declaring a "fiscal emergency" to make it possible to place Measure C – a tax on oil and gas industries – on a special-election

ballot, the city found ample money to pay for campaign-style pamphlets touting the tax, mailed to voters shortly before the November 7 election. The city also posted a campaign-style video on YouTube, with a narrator lavishing praise on the measure, with statements including, “If approved, Measure C will go a long way toward stabilizing Carson’s city budget.” Voters approved the measure.

New Assessors

Citing health issues, Sacramento County Assessor Kathleen Kelleher resigned in May – shortly after an investigation was launched into whether her office gave favorable assessments to her and her staff. Christina Wynn, a longtime employee of the Assessor’s Office, was appointed interim assessor.

Mariposa County Assessor Becky Crafts died in May, and the Board of Supervisors appointed her deputy, Brent Joseph, to fill out the remainder of her term.

Good News on Unemployment Insurance

California’s Unemployment Insurance Fund is projected to have a positive balance by the end of this year, marking the first time since 2008 that the employer-funded account will end in the black, the Employment Development Department reported. This will result in tax relief for employers, as their Federal Unemployment Tax Act (FUTA) credit will be increased.

State’s Business Climate Remains Poor

In 2017, the Washington, D.C.-based Tax Foundation found that California remains ranked 48th out of the 50 states in terms of business tax climate, ahead of only New York and New Jersey.

California’s business climate problem was illustrated in news headlines throughout the year: Nestle announced it is moving its headquarters from Glendale to Virginia, impacting approximately 1,050 California workers; Xero, which makes accounting software for small businesses, moved its U.S. headquarters from San Francisco to Denver, with the chief executive stating that “it’s difficult to grow this business in San Francisco”; Amgen reassigned, relocated or laid off approximately 500 employees of its Thousand Oaks office and opened a new facility in Florida, a state that does not have an income tax; Toyota completed the process of moving approximately 3,000 workers from Torrance to Plano, Texas, and put its 110-acre campus up for sale; and Aerojet Rocketdyne Inc. announced it is shutting down all manufacturing activity in California and moving operations and employees to Alabama.

There were many more business relocations and closures, and from June through August, approximately 10,700 Californians’ lost their jobs, according to state data.

In one of the more well-publicized moves, the Oakland Raiders were cleared by the National Football League to move to Las Vegas, where highly compensated players and coaches will not

face a state income tax. When the move is completed, California also will lose tax revenue from the economic activity at home games, and stadium workers will be left without jobs.

There was some good news, however. The California Film Commission reported in late September that California's expanded film and television tax credit attracted 12 out-of-state television series to relocate to California, generating \$891 million in direct state spending.

In Memoriam

Several people who played prominent roles in California's political and tax arenas passed away in 2017: former BOE Executive Director Burt Oliver; Paul Frankel, a tax lawyer with the law firm of Morrison & Foerster; former California Attorney General John Van de Kamp; Vance Hansen, consultant to the Senate Revenue and Taxation Committee from 1970 through 1984; San Francisco Mayor Ed Lee; former state lawmakers Dave Cogdill, Jim Ellis, Ross Johnson and John Knox; and former five-term Secretary of State March Fong Eu, who had the distinction of being the first woman governor of California, by virtue of her brief service as acting governor while Governor Jerry Brown was out of the state in 1976 (Eu was the mother of former BOE Member and State Treasurer Matthew Fong, who died in 2011).