

CalTax Year in Review: **California Goes Its Own Way**

During the final year of the historic governorship of Jerry Brown, California chartered its own course. State lawmakers introduced legislation to resist federal changes on multiple policy fronts, including tax policies, and California began a new era of state tax administration with the creation of new agencies. The year culminated with the election of a new governor and lawmakers who exemplified California's shift to a more progressive philosophy.

Beyond the politics of resistance, California continued its unprecedented economic expansion, with Governor Brown signing a record \$199.6 billion budget and the Legislature creating two new surplus accounts that allowed California to set aside \$19 billion for future economic declines -- a legacy achievement long championed by the outgoing governor and supported by taxpayers. Despite the economic prosperity, record surpluses and a 66 percent increase in K-14 education spending since 2012, California taxpayers still faced significant tax threats both statewide and locally.

In 2018, the California Legislature proposed taxes and fees that would have cumulatively cost taxpayers \$273 billion, according to the Tax Watch report released by the nonpartisan California Tax Foundation. The two largest proposals -- one to fund a single-payer style healthcare system and another to tax services used by businesses -- were defeated by CalTax but remain prominent threats moving ahead.

The biggest threat facing taxpayers is a split-roll property tax measure that qualified for the 2020 ballot in September and would cost taxpayers billions of dollars annually while eroding Proposition 13 protections.

On the 40th anniversary of Proposition 13's passage, the California Tax Foundation released a report detailing the benefits of this historic tax relief measure by researching property tax data from counties. The report dispels common myths spread by split-roll activists.

Additionally, CalTax engaged coalition partners and built a public education website to inform the electorate of the substantial negative consequences of a split-roll system.

Taxpayers from around the country gathered at the Sacramento Convention Center on March 20 for CalTax's 92nd Annual Meeting and participated in discussions revolving around the theme of "A Year of Major Change."

"While this is a year of major change, one constant is that CalTax is always on the front lines, fighting for taxpayers," CalTax President and CEO Teresa Casazza said in what would be her final address to members, as later in the year she announced her retirement. As the new year began, Casazza was succeeded by President Robert Gutierrez, who had been serving as CalTax's director of state and local finance.

At the beginning of 2018, a state senator was recalled following his vote for the gas tax, a gas tax repeal initiative qualified for the ballot and proponents of strengthening Propositions 13 and 26 submitted more than 1 million signatures to qualify the Taxpayer Transparency and Fairness Initiative for the ballot to strengthen the definition of a tax for state and local governments.

However, the Taxpayer Transparency and Fairness Initiative was pulled off the ballot by its sponsors following a legislative deal, the gas tax repeal was resoundingly defeated by voters in November, and voters approved 408 of the 516 local tax and bond measures placed before them during the year. In the Legislature, the recall of one Democratic senator was overshadowed after voters gave the Democrats significant supermajorities in both houses in the November elections.

*In June, the U.S. Supreme Court injected uncertainty into the sales tax structure when it overturned a longtime precedent in its ruling in *South Dakota v. Wayfair Inc.**

In November, voters elected Lieutenant Governor Gavin Newsom to become California's 40th governor. Newsom campaigned on a platform of healthcare for all, "cradle to college" services for the next generation, the construction of affordable housing and an expansion of anti-poverty programs. He pledged to deliver on the promises through bold and innovative strategies, but details of the plans have yet to be revealed.

As we begin 2019, many questions remain. What will be Governor Newsom's top priority? How will expansive programs be financed? How will tax agencies continue to establish themselves moving forward? Will moderate Democrats maintain a significant voice in the Legislature?

The answers to these questions and many more will be revealed in the year ahead.

Governor Signs Record \$199.6 Billion Budget

Governor Brown signed the 2018-19 state budget ([SB 840](#), Mitchell) June 27 at a ceremony in Los Angeles, joined by the Democratic legislative leaders that participated in developing the spending plan. The governor did not use his line-item veto power to remove any spending.

"When I took office back in 2011 with the state facing a \$27 billion deficit, I pledged to work with the Legislature to fix California's financial mess," Brown said. "Today, the final budget I sign delivers on that pledge and prepares us for the future."

The budget included an \$11.6 billion increase in general spending over the prior year's enacted budget. It did not include any major broad-based tax or fee increases, or major changes to the state tax structure.

Key provisions of the budget:

- The state's rainy day fund, established by a vote of the people in 2014, will be funded to its constitutional maximum of \$13.8 billion, the highest it has ever been. In total with

California's other reserve funds, California has approximately \$19 billion in surplus revenues.

- Education spending increases more than \$4,600 per student over 2011-12 levels, with \$78.4 billion for K-14 schools. The governor noted that this is a 66 percent increase in annual funding from seven years ago.
- Provides full year of funding under last year's transportation package, with \$4.6 billion in new transportation funding in 2018-19.

Governor Brown's vetoes of legislation to create or expand tax exemptions earned acclaim from the Washington, D.C.-based Tax Foundation, which gave the governor an "Outstanding Achievement in State Tax Reform" award.

The foundation said Brown's "colorful vetoes of targeted tax breaks ... have helped California maintain some semblance of a broad tax base and improved its fiscal position."

Social Justice Advocates Qualify Split-Roll Initiative for November 2020 Ballot

During the year of Proposition 13's 40th anniversary, a split-roll property tax initiative filed in late 2017 officially qualified for the November 2020 ballot.

[Initiative 17-0055](#), which will be assigned a proposition number in 2020, would impose a split-roll business property tax increase by requiring frequent market-value reassessment of commercial and industrial property.

The measure is supported by the California League of Women Voters and a coalition of other special interests under the banner of [Schools and Communities First](#).

The property tax hike is being pursued even as property tax revenue is growing steadily under the existing tax structure. In 2018, property tax revenue grew an average of 5.42 percent in each county. Statewide, the assessed value of property grew more than \$374 billion this year, on top of significant growth in prior years.

"That increase, three times the rate of inflation, translates into \$4-plus billion more in revenue for cities, counties and other local governments," *CALmatters* columnist Dan Walters [noted October 17](#).

To educate voters about the importance of preserving Proposition 13, the California Tax Foundation released a chart book titled "[The Evolution and Impact of Proposition 13](#)," which provides voters and members of the media with easy to understand graphics that illustrate the important tenets of Proposition 13.

New Tax Agencies Take Shape

The turn of the calendar year brought major changes and uncertainty to the administration of state taxes in 2018, as duties were transferred from the State Board of Equalization (BOE) to California's two new tax agencies. The BOE no longer decided appeals of income/franchise, sales/use and various special taxes – instead, these appeals were transferred to the jurisdiction of the new Office of Tax Appeals (OTA).

The BOE retained its adjudicatory authority and administration of property taxes, insurance taxes and alcoholic beverage taxes.

These changes were brought about by 2017's [AB 102](#) (Assembly Budget Committee) and [AB 131](#) (Assembly Budget Committee), which also transferred administration of sales/use and specified special taxes from the BOE to another new agency, the California Department of Tax and Fee Administration (CDTFA).

CalTax worked with the OTA to draft and revise emergency regulations that would bring certainty and fairness to taxpayers.

CalTax was able to negotiate terms relating to precedence of BOE and OTA decisions, the process for changing a precedence designation, CDTFA's authority to petition for rehearing, taxpayer confidentiality and testimony under oath.

The OTA held its first round of appeals in January, and established a schedule of a handful of hearings each month, primarily in Sacramento and Van Nuys.

OTA hearings were more formal than previous BOE hearings, but less formal than traditional court proceedings. The OTA's decisions are posted on the OTA's website in monthly batches, often many months after the opinions were signed and presumably sent to the parties in the case.

The OTA decided 162 appeals in 2018, mostly relating to routine personal income tax matters. Taxpayers prevailed wholly or partially in just five cases. At the beginning of November, the OTA issued an opinion in which a panel of three ALJs took issue with the Franchise Tax Board's narrow interpretation of the Court of Appeal ruling in *Swart Enterprises Inc. v. Franchise Tax Board*, in which the court rejected the FTB's broad definition of "doing business" within California for tax purposes.

At the end of 2018, the OTA had 17 ALJs, including 15 who previously worked for a California tax agency.

California Department of Tax and Fee Administration

The California Department of Tax and Fee Administration drew criticism from the Legislature during an informational hearing after the agency's Centralized Revenue Opportunity System (CROS) computer system crashed, causing filing problems for retailers remitting sales tax, and sending confidential information to the wrong taxpayers.

At the informational hearing on sales tax in October, CDTFA Director Nicolas Maduros told lawmakers his agency does not need a change to existing statutes to move forward with regulations to implement the U.S. Supreme Court's ruling in *South Dakota v. Wayfair*, which expanded the definition of a retailer required to collect and remit sales tax.

Maduros, appointed by Brown in 2017 and confirmed by the Senate in April 2018, said the CDTFA would send taxpayers notices to comply with California's "long-arm statute," effective within the first half of 2019. In December, the CDTFA issued a special notice regarding *Wayfair* implementation that would require remote sellers to collect sales and use tax if they made \$100,000 in sales to the state or 200 or more transactions in the preceding calendar year.

Shortly after the CDTFA issued the notice, Assembly Member Autumn Burke and Senator Mike McGuire, chairs of the Legislature's tax policy committees, introduced *Wayfair* implementation language in [AB 147](#) that would raise the threshold to \$500,000 in sales and expand the definition of retailers to include marketplaces that list or advertise tangible goods for sale by third-party sellers.

The legislation contains an urgency clause, so it will require a two-thirds vote and will take effect immediately if enacted.

Franchise Tax Board

The FTB released its final [report](#) on federal income tax changes on April 19 after releasing two preliminary reports in February and March.

The 453-page report includes the FTB's estimates of the likely impact on state revenue from the federal changes, based on static modeling.

State Controller Betty Yee won her reelection bid and continued serving as chair of the FTB. The remaining two seats on the tax board will be filled by the new BOE chair, who will be elected later this month, and Governor Newsom's finance director, Keely Bosler.

State Board of Equalization

The BOE began the year with limited duties and responsibilities after the Legislature transferred administration and adjudication of several taxes and fees not constitutionally required to the BOE to the OTA and CDTFA.

The board voted 4-0 in February to adopt a CalTax-supported proposal to establish constitutional and related statutory matters as a standing agenda item for future BOE meetings.

BOE Member Jerome Horton said the proposal will create a "more methodical process" for addressing property assessment issues, and likened the process to the Legislature's use of informational hearings to gather public input.

When newly elected BOE members are sworn in later this month, the board will feature all new members and a new executive director. George Runner and Jerome Horton were termed out in 2018, Diane Harkey made an unsuccessful run for Congress, and Fiona Ma successfully ran for State Treasurer.

The board will now consist of: Ted Gaines (R) in District 1, Malia Cohen (D) in District 2, Tony Vazquez (D) in District 3 and Mike Schaefer (D) in District 4. Schaefer is the first Democrat in four decades to serve in District 4, and at the age of 81 will be the oldest California constitutional officer in state history.

At the final meeting of the year, on December 12, Executive Director Dean Kinnee announced his retirement after 33 years with the BOE, including eight months as executive director. The board appointed Chief Deputy Director Brenda Fleming as the interim executive director. Fleming has worked with the agency since 2011.

The new board will no longer meet at the BOE's traditional headquarters at 450 N Street, but will be moved to Natomas, where the agency will share a building with a CDTFA call center.

During the one-day reconvening of the Legislature in December, a constitutional amendment was proposed to dissolve the BOE and transfer powers to the CDTFA and OTA.

Legislature: Taxpayers Faced \$273 Billion in Additional Taxes

Despite record state budget spending and a record surplus, California taxpayers still faced targeted tax threats that would have cumulatively cost taxpayers \$273 billion per year in additional taxes and fees, the nonpartisan California Tax Foundation reported October 9 in a report.

Proposals included a sales tax on services used by businesses and a corporate income tax surtax on top of existing corporate taxes that would have given California the highest rate in the United States.

The costliest measure was an ambiguous proposal to implement a single-payer style healthcare system in California. According to a Senate Appropriations Committee analysis of [SB 562](#) (Lara and Atkins), the proposal would cost taxpayers \$200 billion in the first year. CalTax was a part of a coalition that successfully stopped the proposal from advancing.

The next costliest proposal [SB 993](#) (Hertzberg) would have imposed an incremental 3 percent excise tax on services used by California businesses and lowered the state's sales and use tax by 2 percent. Senator Robert Hertzberg said his bill would mitigate volatility of tax revenue and "modernize" the system. CalTax led a robust coalition of 113 businesses, taxpayer groups and trade associations to defeat the measure.

In response to the federal corporate tax reductions, lawmakers introduced [ACA 22](#) (McCarty and Ting), which would have imposed a 10 percent add-on rate on all businesses with net income of \$1 million or more to fund schools, housing and other social programs.

Other targeted tax increases included: a measure to disallow tax deductions for punitive damages, a new tax based upon a chief executive officer's pay, a millionaire surcharge, opioid taxes and carried interest taxes. All proposals were successfully opposed by CalTax.

The Legislature additionally introduced several proposals as attempted workarounds to the federal cap on the state and local taxes (SALT) deduction – most notably a proposal to allow taxpayers to “donate” taxes to educational programs and receive a credit in return.

After such proposals in California and several other states, the Internal Revenue Service and the U.S. Department of Treasury announced in May that taxpayers “should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.”

Overseeing the IRS implementation of regulations will be Charles Rettig, a California tax lawyer appointed as IRS commissioner by President Donald Trump and confirmed in 2018 by a 64-33 vote of the U.S. Senate.

As the year ended, the California Public Utilities Commission proposed a tax on text messaging to fund a program designed to increase access to cell phones for low-income Californians. The proposal was short-lived, however, as the Federal Communications Commission defined text messaging as an information service, which the state commission cannot constitutionally tax.

Legislative Changes: New Senate Leader Elected, Lawmaker Resigns

In a March 21 ceremony in the state Capitol, Senator Toni Atkins was sworn in as the 48th President Pro Tempore of the California Senate, replacing Senator Kevin de León in the leadership position.

Atkins, a Democrat from San Diego, became the first woman and the first openly LGBTQ legislator to lead the Senate. She also is the first person in 146 years to have served as Assembly speaker and Senate president pro tem.

The nationwide focus on workplace harassment had an impact in Sacramento, as Senator Tony Mendoza resigned after being accused of improper behavior toward staff and interns. This, coupled with the recall of Senator Josh Newman (in response to Newman's support for a gas tax increase in 2017) caused the Democrats to lose their two-thirds supermajority in the Senate early in the year.

Mendoza's vacancy was filled in an August 7 special election won by Democrat Vanessa Delgado, who served until the Legislature adjourned August 31. Delgado was not a candidate in November, as she did not finish in the top two in the June primary.

Senator Newman ultimately was replaced by his November 2016 challenger, Republican Ling Ling Chang.

At the end of 2018, Assembly Republican Leader Brian Dahle stepped down from his post to prepare for a Senate run. Republicans voted for Assembly Member Marie Waldron as their new leader.

In the November elections, Republicans around the state were handily defeated by Democratic challengers.

In December, Assembly Democrats outnumbered their Republican colleagues by a 3-to-1 margin, with a 60-20 advantage after picking up five seats. In the Senate, Democrats picked up three seats to hold a 29-11 advantage. Democrats have a six-vote margin above the two-thirds threshold in the Assembly and a two-vote margin in the Senate.

Voters Approve Hundreds of Local Tax Measures

In 2018, voters faced 516 local tax and bond measures, and approved 408, a 79 percent passage rate.

In June, voters in San Francisco approved Proposition C, a 1 percent gross receipts tax for warehouses and 3.5 percent for other commercial uses (with revenue earmarked to fund early child care and early education) and Proposition G, a \$298 parcel tax for 20 years to pay for teacher and staff salary increases at the San Francisco Unified School District.

Propositions C and G were placed on the ballot via the local initiative process, and the city claimed that under the California Supreme Court's 2017 ruling in *California Cannabis Coalition v. City of Upland* decision, both measures could be approved by a majority vote.

Litigation is pending against both measures, with taxpayers arguing the *Upland* decision did not apply to vote thresholds for taxes, and both measures needed to be approved by the constitutional minimum two-thirds vote requirement for special taxes.

In November San Francisco voters approved yet another tax: Proposition C, a 1.5 percent gross receipts tax on any businesses with receipts of \$50 million or more annually in the city of San Francisco, to fund homelessness services. The measure, approved with 60 percent of the vote, was placed on the ballot via the local initiative process and did not receive the two-thirds vote needed for special taxes.

Los Angeles County voters approved November's Measure W, a parcel tax increase based upon a property's square footage of impermeable space, to fund stormwater runoff and other water-related projects.

Citing a county budget of \$11.2 million for "educational outreach," CalTax filed a complaint with the Fair Political Practices Commission at the end of the October, asking the state's political campaign watchdog to conduct an immediate investigation into Los Angeles County's use of tax dollars to fund campaign-style activities in favor of Measure W, including focus group polling to test messaging, mailers to households, and social media advertisements. The FPPC has not yet announced any action related to the complaint.

Earlier in the year, however, the FPPC found probable cause to pursue the Los Angeles County Board of Supervisors and individual members of the board on 15 counts of failing to disclose

(unlawful) political expenditures by the county in favor of Measure H, a tax that appeared on the 2017 ballot.

In the Legislature, lawmakers passed AB 1184 (Ting), authorizing San Francisco to impose a new rideshare tax based upon a percentage of net rider fares for 30 years if approved by local voters.

Additionally, the Legislature allowed Sonoma County, any city within Sonoma County, the city of Berkeley, and the North Lake Tahoe Transportation Authority to exceed the state's 2 percent cap on local sales taxes.

U.S. Supreme Court Issues Two Landmark Rulings

In a 5-4 decision, the U.S. Supreme Court ruled June 21 in [*South Dakota v. Wayfair Inc.*](#) that physical nexus rules may no longer be the sole standard to determine if a retailer must collect and remit sales tax to a state – overturning the 1992 ruling in [*Quill Corp v. North Dakota*, 504 U.S. 298 \(1992\)](#) that used the dormant commerce clause to limit state sales tax collection to retailers with property or employees within the state.

The court's decision also overturns [*National Bellas Hess Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 \(1967\)](#), in which the court ruled that a mail order retailer is not required to collect sales tax if it does not have physical nexus with a state.

To educate policymakers about the *Wayfair* decision and to promote good tax policy for implementation, CalTax put together a policy brief titled "*Taxation of Online Commerce in a Wayfair World*" which provides seven guiding policy principles to follow when implementing *Wayfair* and other factors to consider when crafting implementation policy.

Six days following the *Wayfair* ruling, the U.S. Supreme Court overturned a 41-year-old precedent (*Abood v. Detroit Board of Education*) that said employees must pay "agency fees" to cover union expenditures attributable to activities germane to the union's collective-bargaining activities, but may not be forced to pay for political and ideological projects. The 5-4 ruling in [*Janus v. American Federation of State, County and Municipal Employees*](#) is widely expected to have a dramatic effect on the public employee unions' political spending in California.

Several tax cases were decided in the state courts, as well. In [*Bunzl Distribution USA Inc. v. Franchise Tax Board*](#), the First District Court of Appeal ruled in late September that the FTB properly included income from an out-of-state taxpayer's limited liability companies when calculating the company's California tax liability under the Uniform Division of Income for Tax Purposes Act (UDITPA).

In an amicus brief, CalTax argued that the owners of the single-member LLCs "do not have nexus with California" and therefore are beyond the state's taxing power under *Swart Enterprises Inc. v. Franchise Tax Board* (2017) 7 Cal.App.5th 497.

Also in September, the First District Court of Appeal sided with the California Department of Tax and Fee Administration over communications companies that challenged the state's taxation of pre-installation component parts of telephone lines. On October 24, the court issued a publication order for one of the opinions, [*MCI Communications Services Inc. v. California Department of Tax and Fee Administration*](#).

The court held that Revenue and Taxation Code Section 6016.5 "excludes only fully installed and completed telephone and telegraph lines from sales and use taxation, not the pre-installation component parts of such lines."

A fee imposed by California on hazardous materials transported by rail violates federal law, the U.S. Ninth Circuit Court of Appeals [ruled September 13](#), agreeing with a trial court that came to a similar conclusion. In 2015, the Legislature passed [SB 84](#) (Senate Budget and Fiscal Review Committee), requiring railroads to collect fees from customers shipping any one of 25 specified substances, including diesel fuel, chlorine and ethanol. The legislation was intended to raise funds to mitigate the potential for train derailment through emergency response and planning activities, despite existing public and private response capabilities. The court ruled it was unfair to single out railroads, when other modes of transportation also can necessitate an emergency response.

In a key case on combined reporting under California's corporate tax, the Fourth District Court of Appeal on August 22 sided with the Franchise Tax Board and upheld a trial court ruling that denied Harley-Davidson Inc.'s motion to file on a separate return basis rather than on a combined group basis.

In its published decision in [*Harley-Davidson, Inc. & Subsidiaries v. Franchise Tax Board*](#), the court agreed with the San Diego County Superior Court that "there is a legitimate state interest to require combined reporting of taxable income of interstate unitary businesses, to accurately measure and tax all income attributable to California, that outweighs any possible discriminatory effect."

In December, the California State Supreme Court heard oral arguments in *Cal Fire Local 2881 et. al v. California Public Employees' Retirement System et. al*, a case that could have a major impact on California's pension system and the "California Rule." The case revolves around "air time," where state employees were able to purchase additional years of service to increase pension retirement benefits. Governor Brown and the Legislature eliminated the benefit in 2013, and unions argued that California cannot modify vested benefits.

In one of his final actions as governor, Jerry Brown filled the longest vacancy in California Supreme Court history by nominating his senior legal advisor, Joshua Groban. The new justice was quickly confirmed by the Commission on Judicial Appointments, and was sworn in this week. He is the fourth sitting Supreme Court justice appointed by Brown.

With California Ranked 49th in Business Tax Climate, Employers Leave

California's poor business tax climate – ranked 49th out of the 50 states by the Washington, D.C.-based Tax Foundation and ranked worst according to *Chief Executive Magazine* – prompted many businesses to move facilities and jobs to lower-cost states.

Departing companies included Weatherby, Inc., a high-end rifle maker that left for Wyoming; Bechtel, a San Francisco engineering firm that moved to Virginia; VF Corp., which includes the popular outdoor clothing company North Face and Jansport, and moved to Colorado; and McKesson, a pharmaceutical distribution company that moved its San Francisco headquarters and approximately 1,300 jobs to Texas.

San Francisco-based Core-Mark Holding Co. Inc., a Fortune 500 company, is moving its headquarters to Texas next year. President and Chief Executive Officer Scott McPherson said the central location, favorable operating costs and lower taxes in Dallas were big draws.

Despite the unfavorable business climate and common employee complaints regarding the high cost of living in California, the state's population grew by 309,000 residents, reaching 39.81 million, according to May estimates by the Department of Finance.

California Tax Foundation Tracks Spending Inefficiencies

In May, the California Tax Foundation launched the [Revenue Accountability Project](#) to track government misuse of taxpayer dollars by state and local governments.

Since the report's launch, the project identified \$50.8 billion in misuse by state agencies and \$896 million by local agencies.

The largest misuse of taxpayer dollars was identified by the California state auditor in the California High-Speed Rail Program. The auditor found that poor decision-making and contract management led to escalating prices and cost overruns totaling billions of dollars.