

October 2006

Prepared by the
Legislative and
Research Division
Staff

Emerging Issues: Tax Legislation

California State Board of Equalization

- **Cooperative Partnering**
- **Change in Ownership Discovery**
- **Property Tax Revenue Allocation**
- **Streamlined Sales Tax Project**
- **Internet Cigarette Sales**
- **Cigarette Tax Increase**
- **Tax Gap**
- **New and Increased Fees**
- **Alternative Fuels**
- **More Cities and Counties Seek Voter Approval of Local Taxes**

- **Cooperative Partnering of Government and Industry to Resolve Issues For Mutual Benefit**

This year the Board of Equalization sought and received funding through the budget process for a proposed market value study of the personal property used in the biopharmaceutical and semiconductor industries, as well as, a market value study of non-production computers. In addition, the Board sponsored AB 2182 (Mullin, Ch. 417, Stats. 2006), which establishes a rebuttable presumption of correctness with respect to assessed values for specified business personal property that are determined by using the newly developed valuation factors that will be issued after the study is complete.

The new study will allow the Board to develop, in conjunction with assessors and the affected industries, objective and defensible valuation factors. The measure received overwhelming bipartisan support in the Legislature. The final language of the bill was the result of a collaborative effort by industry and assessors. This joint effort will ensure the development of unbiased valuation factors that will result in more accurate assessments, as well as, promote uniformity in the assessment of these property types. This bill is intended to resolve ongoing disputes in California concerning the proper assessment of these types of properties by establishing a presumption of correctness, when the resulting valuation factors are used.

Similar issues related to the assessment of other specific property types that have been highly controversial have been resolved in the past through specific legislative direction, such as AB 2182 provides. For instance, last year, AB 964 (J. Horton, Ch. 699, Stats. 2005), related to the taxation of commercial air carriers, provided that if a particular assessment methodology is followed, the resulting value is reflective of fair market value. In prior years, legislation was enacted to establish a rebuttable presumption of correctness when a particular methodology is used for various types of property, specifically: cable TV assessments (AB 3234, Ch. 1630, Stats. 1988); inter-county pipeline land assessments (SB 2106, Ch. 801, Stats. 1996); airport assessments (AB 2318, Ch. 85, Stats. 1998); and commercial air carrier assessments (AB 1807, Ch. 86, Stats. 1998).

The Board is looking for more opportunities in the future to work cooperatively with taxpayers in order to improve the efficiencies of our tax and fee programs.

- **Change in Ownership Discovery**

A movement to require more frequent reassessment of property owned by legal entities to current fair market values, which is often referred to as creating a "split roll" has been active in the last few years.

Legislation has been introduced in each of the last four legislative years to modify change in ownership statutes for legal entities. In 2005-06, SB 17 (Escutia) was introduced, proceeded in 2003-04 by SB 17 (Esuctia) and ACA 16 (Hancock). In 2002, statement of intent language was passed by the Senate in SB 1662 (Peace). In 2001, AB 1013 (Leonard) was introduced and in 2000, AB 2288 (Dutra). The issue had not been actively pursued in the Legislature since 1991 in SB 82 (Kopp, et al). Additionally, in 1992, Proposition 167 was placed on the ballot which

addressed a number of tax related items, and included a provision to modify the change in ownership definitions related to legal entities. Proposition 167 was not approved by voters. In 2005, multiple constitutional initiatives on the split roll issue were approved for circulation but none were ultimately placed on the ballot.

This year, given all of the attention to split roll property tax proposals in recent years and the potential for missed reassessments of properties due to the complexities of legal entity change in ownerships, two bills, with the goal of improving discovery of changes in ownership, AB 1029 (J. Horton) and AB 926 (Chu) were approved by the Legislature. However, both were vetoed by the Governor. In his veto messages, the Governor encouraged proponents of these measures and property owners to develop procedures to ensure that change in ownership information requests are delivered and received by the proper parties.

AB 1029, sponsored by the California Assessors' Association, specifically related to legal entity change in ownerships. It sought to improve the annual change in ownership question asked on corporate income tax returns by deleting from statute the specific detail of the question, as requested by industry. In addition, it sought to improve the penalty abatement process for failure to respond to change in ownership inquiries sent by the Board of Equalization and improve the informational notice.

AB 926, sponsored by the San Francisco County Assessor, was intended, in part, to improve the Preliminary Change In Ownership Report by removing the specific detail from statute so that the form can be improved for taxpayer ease and efficiency. In addition, it would have increased from \$2,500 to \$10,000 the penalty cap for failure to respond to a written request to file a change in ownership statement with the local county assessor, except for owner occupied homes. The purpose of this provision was to attempt to improve taxpayer reporting, given the difficulties that the city and county of San Francisco stated it has experienced in obtaining information.

- **Property Tax Revenue Allocation**

Under current law incremental growth in property tax revenues from state assessed property, except railroads, occurring post-1987 is shared on a "countywide" basis. These additional revenues can be the result of increased property values, new construction, or acquisitions of property. Post-1987 incremental growth revenues are distributed to nearly all governmental agencies and school entities in the county in proportion to each entity's share of the county's total ad valorem property tax revenues in the prior year. Under the countywide system, all entities receive a share in the revenues, regardless of whether any of the value growth actually occurred within its jurisdictional boundaries.

An emerging trend is a return to local tax rate area (situs) allocation for certain new major projects undertaken by state assesses.

In 2002 after electrical deregulation, AB 81 (Migden, Ch. 57, Stats. 2002) was enacted to change the revenue allocation of power plants divested by public utilities and sold to private operators, as well as those newly constructed by merchant power plant owners, to provide for situs based revenue allocation. The situs issue was brought forward again in 2004, when San Diego Gas and Electric sought and received special revenue allocations for a proposed new power plant to be constructed in the City of Escondido (AB 2558).

This year two more bills were enacted, SB 1317 (Torlakson, Ch. 872, Stats. 2006) and AB 2670 (Aghazarian, Ch. 791, Stats. 2006) which provide that state assessee revenues shall be allocated in a manner so that a greater share goes to affected local governments, rather than distributing the revenues countywide, so as to garner their support for the proposed new projects.

- Southern California Edison sponsored SB 1317 to provide a financial incentive for cities to support the construction of certain electrical generation facilities and substations within their boundaries by ensuring a greater share of the resulting property tax revenues.
- The California Railroad Industry sponsored AB 2670, which is a mixed bag of revenue allocation procedures. While it seeks to place railroad property in the countywide system for the first time for administrative convenience and simplicity, it also seeks to provide a special revenue allocation procedure for a proposed major new stand alone project. It would provide that 20 percent of the value of a railroad loading facility to be newly constructed at the cost of more than \$100 million would be allocated exclusively to the specific tax rate where the property is located and require the county

auditor to make special allocations of the resulting revenues so that a greater share of the resulting revenue would be dedicated to the governmental entities providing services to the property.

- **Streamlined Sales Tax Project**

The Streamlined Sales Tax Project (SSTP) is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The Streamlined Sales and Use Tax Agreement, a multi-state agreement providing for simplification of the nation's varying sales tax laws, went into effect on October 1, 2005.

Before October 1, 2005, the implementing states, including California, were responsible for the agreement, including amendments and interpretation. As an "implementing state," California had a vote on all agreement-related matters. However, on October 1, 2005, those responsibilities were transferred to a Governing Board comprising states certified to be in substantial compliance with the agreement. Only states on the board can vote on issues related to the agreement. States can join the board by coming into compliance before January 1, 2008. Because California is not on the board, the state no longer has a vote on the final disposition of issues relating to the agreement and now can only participate in an advisory capacity. And while a budget change proposal was sought by the Board to address the increased workload generated by California's participation in the SSTP, the Governor's 2006-07 budget did not include any additional funding.

Consequently, in an April 2006 Legislative Committee meeting, Legislative Committee Chair, suggested that one or more Board Members might be willing to talk to the appointing authorities of the Senate and the Assembly to the Board of Governance to gauge their level of interest in the SSTP. The Members of the Board agreed with that suggestion. As a result, meetings with Board Members and SSTP Board of Governance appointing authorities and the Director of the Department of Finance were held and resulted in a general consensus that the Legislature and the Administration will review the role of the Board of Governance in January 2007, and that effective July 1, 2006, the Multistate Tax Commission, rather than the Board of Governance, will monitor SSTP and State and Local Advisory Council meetings and report discussions and actions to California.

We anticipate that there will be legislation introduced in 2007 that would essentially withdraw California's participation in the SSTP. BOE will continue to review the SSTP developments and analyze whether the provisions would be appropriate and workable for California's sales tax law.

- **Internet Cigarette Sales**

Many California consumers have turned to the Internet as a way to buy cigarettes from out-of-state sellers and avoid paying California taxes. The Board has estimated that cigarette excise tax revenues lost to out-of-state purchases total \$21.5 million per year, which includes out-of-state purchases made by California consumers from the Internet and mail order. Use tax revenues related to these Internet and mail order sales account for additional revenues of \$7.9 million.

To help collect taxes due on purchases of cigarettes from out-of-state sellers, the Board has implemented the Cigarette and Tobacco Product Internet Program to collect the California state excise taxes and use taxes from California consumers purchasing untaxed cigarettes and/or tobacco products from out-of-state Internet retailers, and/or by way of mail or telephone, for self-consumption in California. The Board uses purchaser information provided by sellers who comply with the federal Jenkins Act, which requires sellers to provide purchasers' names and addresses. The Board has also subpoenaed common carrier records for deliveries of cigarettes or tobacco products to individual consumers in California to increase excise tax compliance.

To address the problems posed by out-of-state cigarette purchases, SB 1208 (Ortiz) was introduced to prohibit, with certain exceptions, shipping or transporting cigarettes to persons in California, and to establish criminal and civil penalties for violating this prohibition. The exceptions included, but were not limited to, the shipment of products to a person licensed under the Cigarette and Tobacco Products Licensing Act of 2003. This measure, which did not address out-of-state purchases of other tobacco products, was vetoed by the Governor. In his veto messages, the Governor indicates that existing law has in place rules for youth access to cigarettes over the Internet. He also states that the Board currently uses

the federal Jenkins Act to recover excise taxes from Californians that have purchased cigarettes via out-of-state Internet websites.

SB 1208 is similar to a New York law that prohibits, with certain exceptions, shipping or transporting cigarettes to people and businesses in New York. We expect legislation similar to SB 1208 to be introduced during the 2007 Legislative Session.

Other cigarette and tobacco products tax enforcement related legislation includes AB 1749 (J. Horton, Ch. 501, Stats. 2006) which increases fines and penalties related to cigarette and tobacco products tax evasion.

- **Cigarette Tax Increase**

Proposition 86, which qualified for the November 7, 2006, ballot, would impose an additional excise tax on cigarettes of thirteen cents (\$0.13) per cigarette, or two dollars and sixty cents (\$2.60) per package of 20. The initiative would indirectly increase tax on other tobacco products. The revenue from the cigarette tax increase would be allocated to specified purposes, including private hospital and physician emergency services, indigent healthcare, breast cancer research, tobacco use prevention, tobacco smuggling prevention, and nursing education.

If approved by voters, California's cigarette tax rate would be the highest in the nation at \$3.47 per package of 20, followed by New York City (\$3.00 per pack), Rhode Island (\$2.46 per pack) and New Jersey (\$2.40 per pack).

- **Tax Gap**

In the early part of 2005, considerable attention was given by legislative leaders in addressing California's tax gap in our effort to generate more revenues for the state without raising taxes. Although numerous ideas surfaced in legislation during that year, such as enhancing penalties for failing to report use tax liabilities, imposing additional continuing education requirements for tax preparers relative to use tax laws, and using county assessor business property statements to alert business owners of their use tax reporting requirements, none were enacted into law, with one exception – Assembly Bill 1418.

AB 1418 (J. Horton, Ch. 716, Stats. 2006) will take effect on January 1, 2007. This measure is intended to reduce the state's accounts receivable balances by requiring the Board of Equalization to make available as a matter of public record each quarter, a list of the 250 largest sales and use tax delinquencies in excess of \$100,000. The bill also imposes a similar requirement on the Franchise Tax Board with respect to personal and corporation income tax delinquencies. Prior to making a tax delinquency a matter of public record, however, both agencies are required to provide a preliminary written notice by certified mail, return receipt requested, to the persons liable for the tax. If within 30 days of issuance of that written notice, the person or persons do not either pay the amount due, or otherwise make arrangements for payment of the amount due, the tax delinquency will be included on the list.

Another measure, which was introduced in 2006 and was recently signed into law is also expected to increase compliance with the tax laws, and thereby increase revenues to the state and local governments. This measure (Senate Bill 1449, Migden, Ch. 252, Stats. 2006,) created a new 40% penalty for a person's failure to timely report sales tax reimbursement or use tax collected. The bill provides that any person who knowingly collects sales tax reimbursement, or use tax, and who fails to timely pay that tax collected to the Board, shall be liable for a penalty of 40 percent of the amount not timely remitted. The penalty will not apply to any person whose liability for the unpaid tax averages \$1,000 or less per month, or does not exceed 5 percent of the total amount of tax liability, for which the tax was collected for the period in which the tax was due, whichever is greater. The bill further provides relief from the proposed penalty if the Board finds that the person's failure to timely remit the tax was due to reasonable cause or circumstances beyond the person's control.

- **New and Increased Fees**

In 1978, voters passed Proposition 13, which imposed a two-thirds supermajority vote requirement for legislative approval of new or increased state taxes. Over the years, this has led to a proliferation of legislation proposing new fee programs, which need only a majority vote in the Legislature.

During the 2006 Legislative year, the Legislature introduced measures imposing a number of new fees to be collected by (or contracted to be collected by) the Board, including a drug manufacturer fee, pseudoephedrine fee, brake mitigation fee, and water resources connection fee. A Clean Vehicle Discount Program was also considered which would have provided a surcharge or discount for all vehicles based on the amount of greenhouse gases and air pollutants generated. None of these measures were passed by the Legislature.

Successfully signed into law were measures that repealed the sunset date related to the marine invasive species fee (SB 497, Simitian, Ch. 292, Stats. 2006), and expanded the environmental fee to include, in addition to corporations, other business organizations, and maintained the California tire fee rate at \$1.75 per tire until January 1, 2015 (AB 1803, Committee on Budget, Ch. 77, Stats. 2006).

- **Alternative Fuels and Taxes**

California consumers saw the average weekly retail price for gasoline top out at \$3.332 per gallon in May 2006. Previous highs occurred after hurricanes affected oil and gas production in August and September 2005. The increase in fuel prices led to several bills to provide some relief from fuel price increases and encourage alternatives to reduce the use of gasoline and diesel fuels. However, none of these measures were ultimately enacted in 2006.

The Legislature considered providing relief to both consumers and local governments through different tax exemptions. AB 2621 (Strickland) was introduced to provide a sales and use tax exemption for sales of gasoline. SB 1522 (Aanestad) would have provided an excise tax exemption for diesel fuel used in a police, sheriff, or fire department vehicle. Additionally, to reduce demand for gasoline and diesel fuels, AB 1631 (Klehs) would have provided a sales and use tax exemption for sales of public transit buses running on a fuel cell system. Those measures failed to make it to the Governor.

The Legislature also considered the environmental impacts of vehicles and encouraged the use of alternative fuel vehicles through the tools of both new fees and financial incentives. Assembly Bill 2325 (Nation) would have increased the excise tax on gasoline to fund, among other things, a rebate program to encourage the purchase of alternative fuel vehicles. A Clean Vehicle Discount Program was considered in AB 2791 (Ruskin), which would have provided a surcharge or discount for all vehicles based on the amount of greenhouse gases and air pollutants generated. The higher a vehicle polluted, the higher the surcharge up to a specified maximum. In exchange, lower polluting vehicles would have received a discount funded by the surcharge. Neither of these measures were sent to the Governor.

Additionally, with respect to encouraging and developing alternative energy sources, Proposition 87, an oil severance tax initiative will be on the November ballot. Proposition 87, if approved by voters, would impose a severance tax on oil production in California to generate revenues to fund \$4 billion in various alternative energy programs.

- **More Cities and Counties Seeking Voter Approval of Local Taxes**

California cities and counties provide services such as fire and police protection, road maintenance, water, libraries, hospitals, and parks and recreation programs. These programs are funded through local sales taxes. In an effort to raise revenues to support these projects, local governments are asking voters to approve local sales tax hikes.

These local sales taxes include both general purpose taxes and special purpose taxes. General purpose taxes are imposed for general government purposes and require a simple majority vote of the local electorate. Special purpose taxes are imposed for specific purposes, even though the revenues may be deposited into general funds. Special purpose taxes require a two-thirds vote of the local electorate.

For the June 2006 Primary Election, there were a total of ten measures—five city measures and five county measures. Of the ten measures, only two city measures passed both of which were general purpose taxes. The failing measures included two general purpose taxes and six special purpose taxes. Thirty-six measures are currently slated for the November 2006 General Election—22 city measures and 14 county measures. Of the 22 proposed city measures, 14 are general purpose taxes and eight are special purpose taxes. Of the 14 proposed county measures, four are extensions of existing taxes and one is an extension with an increase. Of the nine new proposed county measures, one is a general purpose tax and eight are special purpose taxes.

Local voter-approved sales tax rate increases have resulted in variations in sales tax rates throughout California. Effective October 1, 2006, there will be a total of 72 local voter-approved sales taxes: 38 citywide and 36 countywide, with rates ranging from 0.10 percent to 1 percent.

The total combined state and local sales and use tax rates in areas with voter-approved local taxes range from 7.375 percent to 8.75 percent. A cap on locally imposed sales taxes prevents the combined state and local sales tax rate from exceeding 9.25 percent.