

October 2008

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# Emerging Issues: Tax Legislation

California State Board of Equalization

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## • Revenue Raising Options

The \$15+ billion budget deficit became a major legislative priority this year. Many proposals that would have raised taxes, eliminated exemptions, or provided amnesty to increase state General Fund revenues were discussed this session to address the shortfall. Some proposals, such as amnesty for certain sales and use penalties and taxing selected services, such as pay-per-view, car washes, admissions to amusement parks, movie theaters, sporting events, repair services, and towing, to name a few, while discussed with legislative committee consultants, were never introduced in bill form. Also, the Legislative Analyst's Office (LAO) proposed an alternative budget that included specific tax expenditure changes that the LAO recommended be considered to help the budget problem. In addition to various income tax changes, the LAO suggested that consideration be given to repealing several sales and use tax exemptions, including those attributable to sales and purchases of farming equipment, timber harvesting equipment, equipment used in post-production services (such as editing, subtitling, and special effects) for television and films, and custom computer programming.

The LAO recommended these changes, stating that general tax policy suggests that all industries be treated similarly for tax purposes, and that it is not evident why these particular industries are more deserving of a tax exemption than many other industries in the state.

While this alternative budget proposal was not adopted in 2008, we may expect more interest in 2009 considering the fact that the state will again be faced with serious budget shortfalls.

Out of all the revenue raising ideas and proposals discussed in 2008, the following proposals were actually introduced in bill form for the primary purpose of addressing the budget deficit. These include:

- **AB 23xxx (Calderon)** would have included digital property within the definition of tangible personal property under provisions of the Sales and Use Tax Law, thereby imposing the sales or use tax on charges for digital downloads. This bill was never heard in committee. Another measure on this issue introduced by Assembly Member **Calderon (AB 1956)**, would

have required the Board of Equalization (BOE) to submit a report to the Legislature on transactions involving digital property within this state that includes, among other things, a proposed regulation that would provide that sales of digital property are subject to tax for purposes of the Sales and Use Tax Law. This would have essentially placed the responsibility on the BOE to administratively include digitally downloaded items within the sales and use tax base and avoid the requisite 2/3 vote needed through the legislative process. More than 130 companies and organizations registered their formal opposition to this bill, and the bill failed passage in the Assembly Revenue and Taxation Committee.

- **AB 25xxx (Calderon)** would have doubled all penalties imposed in the Revenue and Taxation Code with respect to both BOE and Franchise Tax Board (FTB) tax programs, generating \$148 million in General Fund revenue, and over \$4 million in local and special tax revenues for fiscal year 2008/09. The bill was not heard in committee, however.
- **AB 28xxx (Calderon)** would have eliminated the sales tax exemption for sales of goods delivered out-of-state. Therefore, any sales of tangible goods by California retailers delivered by mail, common carrier, or otherwise would have been subject to California sales tax. This bill was also not heard in committee.
- **AB 1452 (Assembly Budget Committee)** would have increased the state sales and use tax rate by one percent. However, that provision was amended out on September 15, 2008, before the Legislature and the Governor reached their budget deal. As sent to the Governor, the bill contains numerous revenue raising provisions primarily falling under the purview of the FTB. With respect to the BOE's programs, the bill reinstates the 12-month rebuttable presumption for purchases of vehicles, vessels and aircraft outside California.
- **AB 1xxx and AB 1839 (Calderon)** would have deleted the provisions that allow certain lenders, under certain conditions, to claim a refund for sales or use tax reported and paid by a retailer on transactions on accounts held by a lender that are determined to be uncollectible. Industry groups strongly opposed the bill, arguing that it would inhibit retailers' ability to sell accounts receivable, which could lead to a tightening of credit and reduced liquidity for retailers (the BOE estimated that this bill would have increased state and local revenues by over \$41 million annually). The bill failed on the Assembly Floor.

- **Use Tax Compliance**

Unreported use tax, which accounts for approximately \$1.2 billion in state and local revenues annually, continues to be the largest area of noncompliance among the tax and fee programs administered by the BOE. In 2008, the Legislature continued to seek ways to enhance collections. Use tax liabilities are primarily a result of a California-based business or individual making a taxable purchase from an out-of-state retailer without paying California sales or use tax. Because many California purchasers are either not aware of their use tax reporting obligation, or because they believe that the tax is not strictly enforced, voluntary compliance in reporting the use tax is low. And, since the onset of the Internet shopping format, e-commerce sales have soared, further contributing to the problem of noncompliance. The Legislature has, therefore, given considerable attention in recent years to enhance California purchasers' compliance with the use tax law, and the 2008 legislative session continued this effort with the following measures:

- As a way to further educate California businesses and individuals of their use tax reporting duties, as well as simplify their reporting obligations, Board-sponsored **AB 1957 (Eng)** was introduced to clearly specify that if the use tax due on purchases made during the year was not reported to the BOE, then the use tax *must* be reported on the income tax return. To simplify reporting, AB 1957 also contained an optional “look up” table, where California purchasers could determine their use tax liabilities based on their income, rather than having to calculate the use tax by tracking all their untaxed purchases made during the calendar year. Although the Governor vetoed a similar measure (AB 969, Eng) in the 2007 session due to concerns that the effective date of that measure was too soon for taxpayers to compile adequate records of their taxable purchases for calendar year 2007, AB 1957 addressed the Governor’s veto by delaying the operative date and adding the optional “look up” table. The bill swiftly passed the Assembly, but failed in the Senate Revenue and Taxation Committee.
- Other measures to enhance collections of the use tax that were considered in 2008 include one that would have broadened the limits contained in current law with respect to out-of-state retailers’ use tax reporting obligations. **AB 1840 (Calderon)** would have provided that a “retailer engaged in business in this state” for purposes of having a duty to collect the use tax on sales made to California consumers, includes any out-of-state retailer that has substantial nexus with California for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty. However, a strong coalition of industry groups was formed to defeat the bill. The coalition argued that the bill would lead out-of-state businesses to sell their goods on non-California websites, which in turn would hurt California technology businesses. In addition, industry argued that the bill created uncertainty in the nexus standard for purposes of sales and use tax collection, which could lead to further litigation on this issue, and that the bill would essentially leave the responsibility with the BOE to determine the extent to which nexus would be applied. The bill ultimately failed on the Assembly Floor.
- Another measure, **AB 33xxx (Calderon)** was introduced September 5, 2008, to facilitate collection of the use tax by businesses not already registered with the BOE. The bill would have required businesses that are required to file a business property statement with local assessors, to register with the BOE and to file a return by April 15 showing their taxable purchases made during the preceding calendar year. The bill was never heard in committee.

- **New Fee Programs**

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

During the 2008 Legislative year, the Legislature introduced a handful of measures imposing new fees to be collected by the BOE. While not as abundant as past years, these new fee program measures include:

**AB 2640 (Huffman)** would have imposed upon landfill operators a **green material fee** equal to the existing state tipping fee on all green material used as daily cover at landfills to fund

competitive grants to operators of new or existing green and food material composting facilities.

**AB 2638 (Coto)** would have required the BOE to collect an **air quality and environmental health fee** from motor vehicle dealers on the sale or lease of new passenger motor vehicles, as specified, related to their weight rating, retail price, and fuel economy. The fee revenues would have been used to finance projects and programs that mitigate or prevent the air pollution harm caused by motor vehicles subject to the fee.

**AB 2769 (Levine)** would have prohibited a store from providing a single-use carryout bag, including a green carryout bag, to a customer at the point of sale unless the store charges the customer a **bag pollution cleanup fee** at an amount not to exceed twenty-five cents (\$0.25) per bag. In part, the fee revenues would have been expended to provide financial assistance for projects that encourage and support recycling of single-use carryout bags, grants for local programs that encourage and support recycling of single-use carryout bags, and single-use carryout bag pollution prevention and outreach programs.

**SB 1582 (Simitian and Maldonado)** would have imposed an **ocean ranger fee** of one dollar and fifty cents (\$1.50) on each passenger who embarks on a cruise from a port of call in California and each passenger who ends a cruise and disembarks at a port of call in California. The fee revenues would have been used to fund an ocean ranger program under which an ocean ranger would travel aboard a cruise ship for passenger safety and environmental protections, if allowed by the owner or operator of the ship.

Also revisited again this year in the form of an initiative on the November 4, 2008, General Election ballot (Proposition 10) is a \$5 billion bond measure that would provide rebates as an incentive to purchase alternative fuel vehicles and high fuel economy vehicles. The BOE would be responsible for providing rebates to eligible vehicle purchasers or licensed dealers, as provided. Additionally, the BOE would be authorized to adopt such regulations as deemed necessary to administer the rebate program. Similar legislation was introduced in the 2006 and 2007 legislative years, which proposed to enact a Clean Vehicle Incentive Program to be administered by the BOE. These measures, AB 2791 (Ruskin, 2006) and AB 493 (Ruskin, 2007) were not signed into law.

The proposed BOE-administered fee programs this last year were primarily related to solving specific environmental-related issues. We expect to see this trend continue during the upcoming Legislative session.

- **Disasters – Fires and Budget Constraints**

Raging California wildfires that destroyed thousands of homes, businesses, and agricultural properties in recent years prompted an array of property tax relief measures for property owners and local governments. They also renewed activity in a new fire-related fee proposal for property owners, as follows:

- **Fire Fee.** Widespread wildfires in areas covered by the state Department of Forestry and Fire Protection resulted in skyrocketing expenses at a time of budget deficits. To partially offset the state's cost of providing fire protection services, the Schwarzenegger administration proposed an insurance surcharge to be assessed upon all property insurance premiums statewide, which never became a bill. Also considered was **Senator Kehoe's SB 1617**, which would have charged a \$50 fee for each structure on a parcel that

is subject to property taxes and is within a state responsibility area in order to fund fire prevention activities. That measure was intended to have property owners contribute to fire prevention activities designed to reduce the risk to their properties posed by wildfires. While neither of the proposals was successful, we expect to see similar measures in the upcoming year to address escalating firefighting costs.

- **Property Tax Backfill.** In addition to trying to address the state's exposure to firefighting costs, the state's cost to hold local governments harmless for property tax revenue losses associated with fire damage also became an issue this year.

While the state traditionally backfills property tax revenue losses resulting from assessment reductions for major disaster events, in view of the cumulative impact of recent fires, a bill containing these routine provisions, **AB 1759 (DeVore)**, was amended in the Senate Appropriations Committee to place conditions on receiving backfill revenues. Specifically, backfill would not be provided to a county if it had not taken certain steps, such as stricter fire ignition resistant local building codes or fire risk reduction public education programs, to minimize fire damage in areas where the state had responsibility for fire protection. Rather than accept those amendments, the author dropped the bill since it was duplicative of another measure, SB 1064 (Hollingsworth), which had already gone to the Governor. We expect the issue to resurface in future years if the extent of wildfire damages continues to outpace the general fund monies available.

- **Agriculture.** Mindful that the property tax disaster relief benefits are generally not applicable when a disaster primarily affects agricultural crops (because growing crops are exempt from property tax), a new idea surfaced to provide relief to property owners by offering them the opportunity to defer payment of their property taxes on the basis of an *income* loss. The issue first came to light with the big freeze of January 2007 – when major citrus crop losses occurred. In the last two years, Senator Hollingsworth has carried legislation to offer taxpayers in agricultural industries property tax deferral without interest or penalty for one year (**SB 148** and **SB 1562**), if they suffer a significant income loss. In addition to the freeze, deferral would have been offered to taxpayers that suffered crop losses from other disasters, such as the fires and windstorms. Neither provision was enacted with the deferral provisions.

- **Property Tax Audits**

California assessors sponsored legislation, **AB 550 (Ma)**, to revamp the mandatory audit program and eliminate the requirement that they audit once every four years *every* taxpayer with personal property holdings of \$400,000 or more.

Instead, the assessor would be required to annually audit a specified fixed number of taxpayers in the county. The number will vary by county. Of the total number required, half will be of the top-ranked taxpayers in the county in terms of the size of their personal property holdings and the other half will be selected from the remaining business taxpayers in the county, regardless of size.

As a result, some businesses routinely subject to audit will be relieved of the process, while others that have never been audited will be selected. The Legislature approved AB 550, and if enacted into law, we expect some challenges, questions, and concerns from those taxpayers that will be new to the audit process.

- **Base Year Value Transfers**

Expanding the availability of base year value transfers for persons over the age of 55 was of particular interest this year. Two measures were active but ultimately, neither was successful due to fiscal realities of the times.

One measure, **SCA 24 (Dutton)**, would have proposed a constitutional amendment to allow base year value transfers if a person purchases a home of greater value. The difference in market values between the two homes would be added to the base year value of the original home with the low Proposition 13 protected value.

The other measure, **AB 2579 (Niello)**, related to the once-in-a-lifetime limitation would allow each spouse the ability to make separate claims for a base year value transfer. Currently spouses that are on title together are treated as a single claimant. In practical application, this would mean that married couples could move their base year value twice: from the original family home, for example, to an active adult community and then later to a condo.

The one-time only provision and the equal or less value limitation limit the availability of base year value transfers and we expect both of these provisions to be reintroduced in upcoming sessions.

- **Cities and Counties Continue to Seek Voter Approval of District Taxes**

California cities and counties provide services such as fire and police protection, hospitals, libraries, road maintenance, transit services, and parks and recreation programs. Many of these programs are funded through voter-approved transaction and use taxes, also known as district taxes. These district taxes are levied on a countywide basis and within many incorporated city limits.

The first district tax was approved by voters in the San Francisco Bay Area (includes Alameda, Contra Costa, and San Francisco counties) in 1970 as a means of providing funding support for the Bay Area Rapid Transit District. By 1991, 24 counties had received voter approval to levy district taxes in their areas for various purposes.

Prior to 1991, only counties had authorization to impose district taxes. In 1991, legislation was enacted for the first time to allow a city (Calexico) to impose a district tax. By 2003, an additional 22 cities, through special legislation, gained authorization to impose district taxes. Of those 22 cities, nine received voter approval and actually imposed a tax within their city limits.

Legislation enacted in **2003 (SB 566, Ch. 709)** provided cities with the same authority as counties to impose district taxes for general or special purposes, subject to voter approval. This bill eliminated the need for all of the special “city” legislation. It also increased the maximum combined rate of all district taxes that may be imposed within a county from 1.5 percent to 2 percent.

Since enactment of SB 566 in 2003, the number of voter approved city district taxes has grown rapidly, with **62 city district taxes** now imposed throughout California. With **36 district taxes levied in counties, California currently has 98 voter-approved district taxes.** (See next page for an illustration of the increase in voter approved district taxes.) As local governments continue to seek new revenue sources, we expect the number of city and

county district taxes to continue to be on the rise. For example, for the **November 2008 General Election**, there are currently **25 measures slated**, with three measures still unconfirmed. Of the 25 proposed measures, **17 are city measures** and **8 are county measures**.

Cities and counties may impose these district taxes as long as the combined rate in the county does not exceed 2 percent. The city district taxes count against the 2 percent maximum. Consequently, more counties may be unable to enact new district taxes as cities within the county continue to enact higher district taxes (for example, Los Angeles County currently cannot enact a new district tax, as voters of the City of Southgate recently enacted a one percent district tax increase, which, combined with the county's district taxes, reaches the maximum 2 percent cap). Efforts to get around the 2 percent maximum rate and impose higher rates have already surfaced. **In 2003, SB 314 (Ch. 785, Murray)** authorized the Los Angeles County Metropolitan Transportation Authority to impose a 0.50 percent district tax for specific transportation projects, and excluded that 0.50 percent tax from the 2 percent limitation. Again, during the 2007-2008 Legislative session, **AB 1646 (DeSaulnier)** would have authorized counties to impose a district tax of 0.25 or 0.50 percent for healthcare purposes, and also excluded those taxes from the 2 percent limit. However, AB 1646 did not have the same success as SB 314, and failed passage in the Senate Revenue and Taxation Committee.

With cities and counties pushing for a portion of the 2 percent rate, it is likely that legislation will continue to be introduced that would either bypass or increase the 2 percent limitation.

### City and County District Taxes 1970 - October 1, 2008

