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STATE BUDGET:**State Personal Income Tax Revenue Now \$8.4 Billion Ahead of Last Year**

As April comes to a close, personal income tax revenue continues to come in far above the amount projected in Governor Jerry Brown's January budget proposal, according to State Controller Betty Yee's [daily tracker](#).

As of April 25 (the most recent date with data available), the state had collected \$13.3 billion in April, with five days left in the month. The January budget proposal estimated that \$13.5 billion would be collected this month.

The 2017-18 fiscal year's PIT revenue was \$75.2 billion as of April 25, which is approximately \$8.4 billion higher than at the same point last year.

Revenue collection peaked in the days near the April 17 deadline (which was extended by one day in response to the IRS doing the same because of computer problems). The state collected \$1.5 billion on April 17, \$3.3 billion on April 18, and \$1.7 billion on April 19, up considerably from an average of \$339 million per business day in the first two weeks of the month.

During the last fiscal year, personal income taxes accounted for 67.9 percent of all state general fund revenue, and 15.4 percent of the PIT revenue arrived during the month of April.

OFFICE OF TAX APPEALS:**FTB Legal Team Gets Aggressive in Appeal Over Like-Kind Exchange Involving Out-of-State Property**

An April 24 personal income tax appeal hearing conducted by the Office of Tax Appeals had a tenor distinctly different from past appeals, as a team of three attorneys from the Franchise Tax Board aggressively challenged exhibits submitted by the taxpayer, objected to the qualification of the taxpayer's expert witness and sought to force the taxpayer to provide the FTB with copies of notes she referred to while presenting her case.



The OTA has not yet heard any corporate income tax appeals, but this week's hearing might foreshadow the tone that can be expected from the FTB when those hearings reach the new tax appeals board.

The FTB's protestations garnered mixed results from the three-member panel of OTA administrative law judges, comprised of Teresa Stanley (lead), Alberto Rosas and Michael Geary.

Stanley, the only one of the OTA's 14 original administrative law judges who has not worked as an attorney for any of the state tax agencies, sustained the FTB's objections on some exhibits, but overruled the objection to the expert witness – agreeing only to direct him not to testify about the meaning of various legal precedents that the panel already is expected to be familiar with.

Regarding the FTB's request for copies of the taxpayer's notes, Stanley asked if the FTB would allow the taxpayer to use her notes "since this is an administrative hearing and we like to give leeway." The FTB's legal team would not make this concession, arguing that since the taxpayer had been sworn in as a witness, any document she referred to must be admitted as an exhibit. The taxpayer's attorney responded that the notes contain items protected by attorney-client privilege, and thus would not be turned over. After some back-and-forth, the FTB attorneys said they reserved the right to ask for copies after hearing the taxpayer's testimony, and Geary told the taxpayer she would have to provide the documents to the FTB if she used them during testimony. At that point, the taxpayer resolved the issue by proceeding without her notes, instead referring to official exhibits when she needed to cite an exact date or sum of money. (Official exhibits were plentiful, as nearly 70 were entered into the official record.)

Did the Taxpayer Qualify for a Like-Kind Exchange?

The main issue in the *Appeal of Sharon Mitchell* was whether a Walnut Creek property was sold in 2007 by a partnership as the sole seller, or by the partnership, Mitchell and another tenant in common – and thus whether Mitchell qualified to conduct a like-kind property exchange under Internal Revenue Code 1031, and defer taxes on her capital gain.

The property, which sold for approximately \$6.4 million, had been owned by the partnership since 1969. Mitchell's mother was a key partner, described as a savvy real estate investor and negotiator. Mitchell became a partner in 1991 when she inherited a partnership interest from her aunt.

Shortly before the sale of the property became final, Mitchell and her mother redeemed their partnership interests, and became tenants in common. After the sale, Mitchell deferred tax on her capital gain by purchasing replacement property in Arizona within the 45-day legal deadline.

The 1031 exchange was audited by the FTB, which alleged that the partnership was the true seller of the property, and Mitchell's capital gain was taxable as partnership income.

During the hearing, the FTB lawyers argued that Mitchell redeemed her partnership interest as a tax-avoidance scheme, and that she could not be considered a seller because she did not actively participate in negotiating and finalizing the sale.

The taxpayer argued that she relied on her mother – to whom she had given power of attorney – to negotiate the sale, and added that many sellers use experts to handle the nuts and bolts of selling property, especially when the property is very valuable.

Additionally, the taxpayer said, there were legitimate reasons for the timing of the partnership redemption, including differences between partners over whether to continue investing in property or cash out and retire, and growing lack of desire to remain in the partnership after original members died and willed interests to others who had not earned the same level of familiarity and trust.

Most importantly, the taxpayer's attorney argued, there is no requirement in law that a person hold a property for any specified amount of time before being legally recognized as a seller. There are requirements that in a 1031 exchange both properties must be held for use in a trade or business or

for investment, that they be the same nature, character or class, and that the purchase of the replacement property occur within 45 days of the sale of the relinquished property, but no requirement for how long the seller must have owned the relinquished property, the attorney noted.

Such a time requirement would be “bad tax policy ... and certainly not in the law,” the attorney testified. She said the FTB’s position ignores the law and also puts recent purchasers of property at a disadvantage for exercising their right to a 1031 exchange. “What are taxpayers supposed to do, just guess and hope that the IRS or FTB don’t come and audit you?” she asked.

Additionally, the attorney noted that the taxpayer had engaged in many other 1031 exchanges and the only one that was challenged by the FTB was the one that involved a replacement property in another state. The FTB should not be allowed to strip the taxpayer of her legal right to a 1031 exchange “just because they don’t like the fact that she exchanged this property for property outside California,” the attorney told the OTA panel.

Other Issues

The FTB also disputed the step-up in basis calculation used by the taxpayer, and asserted that assignment of income doctrine should apply, so Mitchell would be required to pay tax on the gain as partnership income, even if the right to income was transferred.

Mitchell’s attorney said the FTB was “grasping at straws” with the assignment claim, and argued that the courts have not allowed the doctrine to be used to keep a taxpayer from being able to defer income. She stressed that Mitchell was “simply deferring gain, not evading tax.”

The expert witness agreed, stating that since a 1031 exchange involves a tax deferral, not tax evasion, the assignment doctrine would not apply.

The FTB’s Legal Tactics

The FTB’s three lawyers – David Gemmingen, Ciro Immordino and Michael Cornez – objected to the admission of exhibits that they argued were irrelevant, including a document by the expert witness that explained existing law, an unsigned document whose origin could not be verified, and a legal opinion that the taxpayer believed to be controlling. Stanley sustained the objection to the expert witness’ memo, accepted the submission of the unsigned document as a “hearsay document” that could be considered if corroborated by other evidence, and accepted the legal opinion after stating that there would be no harm in admitting it as an exhibit, even it wasn’t needed.

After the testimony of expert witness Jeffrey Krajewski, a certified public accountant from Arizona, the FTB asked for copies of his complete files on the case, including his correspondence with the taxpayer’s attorney. Expert witnesses are not protected by attorney/client privilege, the FTB argued, and his files should be open to all parties.

Stanley denied the request for Krajewski’s files, calling it “an attempt at late discovery.” Addressing the FTB’s legal team, she said, “I think that ship has sailed.”

The FTB's opening argument was brief, but the agency spent considerable time cross-examining the two witnesses – Mitchell and Krajewski – and delivered a tag-team closing argument that lasted 80 minutes. The FTB did not call any witnesses of its own.

At one point, an FTB attorney asked the ALJs to ask the taxpayer's attorney a question, and the ALJs rejected the request and reminded the attorney he would have a chance to question the taxpayer himself.

Questions From the Administrative Law Judges

All three ALJs asked numerous questions during the hearing, and almost all were directed to the taxpayer and her expert witness.

When the taxpayer appeared to be getting flustered by cross-examination from the FTB attorneys, the panel repeatedly urged her to take her time answering, and informed her that if she didn't know the answer to a question, she could simply state that she doesn't know.

Rosas, a former FTB and State Board of Equalization attorney, asked Krajewski if he has represented taxpayers in 1031 cases, and whether he would have advised Mitchell to do anything differently than she did. The witness identified a few things, including redeeming the partnership interests earlier in the process.

Geary, a former attorney for the BOE and California Department of Tax and Fee Administration, asked several questions about the short period of time between the redemption of partnership and the sale of the property, and about who prepared the documents that gave Mitchell ownership of the property.

Stanley questioned Mitchell about her mother having power of attorney, and also inquired whether Mitchell still owns the Arizona property (she does). Stanley asked hypothetically whether the FTB would treat this case differently if the partnership redemption had occurred earlier.

Many additional questions were asked about the timeline of events, the advice given to Mitchell, the details of the partnership, and the negotiation of the sale. The expert witness was questioned about what documents he reviewed, and was asked by Geary to retrieve his briefcase from a nearby chair so he could go through his files and cite every document for the record.

The ALJs did not give clear indications of how they intend to vote on the appeal, but Rosas said the FTB's arguments had contradictions regarding Mitchell's role in the partnership, and he also questioned the use of the assignment of income doctrine.

Lengthy Hearing

The hearing, held in the Victim Compensation Board Hearing Room, began at 9 a.m. and ended at 4:30 p.m.

Stanley recessed the hearing for a one-hour lunch break and for several 10-minute breaks to give the parties time to review documents, and to provide breaks for the stenographer. Near the end of the day, she urged the parties to be succinct and to avoid repeating previous testimony.

Although the OTA had indicated that its hearings would be streamed online beginning in April, that was not the case. Agency staff indicated that they are close to being able to stream hearings held in Sacramento, but are not yet equipped to stream those held in Fresno or Los Angeles.

OTA Director Mark Ibele attended the hearing, as did a number of staffers from the state tax agencies. The audience thinned as the hearing dragged into the late afternoon.

Stanley informed the parties that a decision will be rendered in 100 days or less.

COMMENTARY:

The Value of Proposition 13, as Revealed by a Burned-Out House



By Joel Fox, editor and co-publisher of [*Fox and Hounds Daily*](#)

No surprise that Proposition 13 gets some blame for the housing crisis in California – yet like so many attacks on Prop. 13, the truth is opposite what opponents claim. Proposition 13 prevents greater housing woes by helping people keep their homes.

Case in point, the story in the [San Jose Mercury News](#) that reports the shell of a burned-out house in San Jose on the market for \$799,000 sold for at least \$100,000 over the asking price. The 1,066-square-foot house was nearly destroyed by a fire two years ago, yet it fetches close to \$1 million. A burned-out shell!

Yes, the location is excellent, about a mile away from the proposed Google campus, and the value is in the plot of land the house sits on. But the Prop. 13 connection is important to the neighboring homes.

Prior to Proposition 13 rewriting the property tax law, a sale of a house would affect the assessed values of all homes in the immediate area. If a burned-out house was tagged at \$1 million, all the homes around it would be reassessed at considerably more. It didn't matter when the neighboring homes were purchased or the income of the individual homeowners in the nearby houses; those neighboring homes would be faced with paying property taxes based on the new assessed value that was out of the homeowner's control. Likely, many people could not hold on to their homes.

Under Proposition 13, the sale of a burned-out shell does not jack up the assessments throughout the neighborhood. Thus, Prop. 13 doesn't increase the housing crisis, but eases housing concerns for many.

The charge that Prop. 13 adds to the housing crisis is based on the argument that by limiting property taxes, the cost of services for new residents would outweigh the new tax revenue received from those residences. Therefore, it is argued, local governments have little incentive to okay housing projects. Instead, government officials look to establishments that can produce additional revenue through sales taxes.

However, the Legislative Analyst's Office took an indepth look at Proposition 13 a couple of [years ago and concluded](#) that there was little evidence that the fiscal incentives for retail buildings, auto dealers and hotels over housing influenced city zoning and permitting decisions.

Meanwhile, the new owners of that burned-out shell in San Jose know what their taxes will be, and know how much the property tax will increase in the future. They can do their own calculations (even for any new structure they build on the property) without leading to increased taxes on their neighbors.

Such a circumstance is what prompted U.S. Supreme Court Justice Harry Blackmun to write, while declaring Proposition 13 constitutional in the case of *Nordlinger v. Hahn* in 1992, that an existing owner “does not have the option of deciding not to buy his home if taxes become prohibitively high.”

Under Prop. 13, taxpayers enjoy tax certainty that prevents deepening the housing crisis. In a real sense, Proposition 13 was a social movement providing for the taxpayers’ security in their housing.

STATE TAX AGENCIES:

Budget Subcommittee Approves Funding for More FTB Auditors and CDTFA Employees

An Assembly budget subcommittee voted April 24 to approved additional funding for the Franchise Tax Board and California Department of Tax and Fee Administration, as well as the agency that oversees both tax organizations.

Assembly Budget Subcommittee No. 4 on State Administration approved:

- **Franchise Tax Board Auditors.** The committee approved a funding increase of \$7.8 million for additional FTB staff to perform audits. The agency said the auditors are needed because of growing case complexity over the past five years. Additionally, the agency said it has a substantial number of key employees at the maximum salary range in their classifications, so more money will be needed to move them to higher-paying classifications to improve retainment.
- **FTB Information Technology.** The subcommittee approved funding for FTB staff positions to work on the Enterprise Data to Revenue project, a multibillion-dollar information technology project that began in 2011. The FTB said the program is on its way to achieving its \$4.7 billion revenue target. Additionally, the subcommittee approved 23 permanent positions and \$5 million for information technology security enhancement staff positions.
- **California Department of Tax and Fee Administration.** Among the many core functions transferred from the State Board of Equalization to the California Department of Tax and Fee Administration was the Centralized Revenue Opportunity System (CROS), a computer system upgrade designed to provide “innovative customer-centered solutions.” The committee approved CDTFA’s budget request for \$70.1 million dedicated to CROS and additional positions. The committee also approved funding for 29 positions and overtime for department staff.
- **Government Operations Agency.** The committee heard from GovOps, the agency that oversees CDTFA, FTB and the Office of Tax Appeals, among other agencies, on a proposed Civil Service Improvement Initiative. The proposal aims to improve staffing management and to hire/promote candidates based on merit. Budget language still is being reviewed, and no action was taken.

Actions approved by the subcommittee will be advanced in the budget process. The Legislature has a June 15 deadline for sending a budget bill to the governor.

ASSEMBLY REVENUE AND TAXATION COMMITTEE:

Panel Approves CalTax-Supported Bill to Extinguish Taxes and Penalties on Businesses That No Longer Exist

The Assembly Revenue and Taxation Committee voted 10-0 on April 23 to approve [AB 2503](#) (Irwin), a CalTax-supported bill sponsored by the Franchise Tax Board to extinguish annual taxes (and related interest and penalties) that continue to improperly accrue to businesses that no longer exist, because they failed to complete the paperwork necessary for dissolution.

Assembly Member Jacqui Irwin said similar dissolution is allowed for nonprofits, and has been a good tax policy.

CalTax Director of State Fiscal Policy Therese Twomey told the committee AB 2503 is a “common-sense, good government bill.” The bill will result in more accurate revenue predictions, she said, as the FTB will not have to carry uncollectible debts on its books for 20 years. Additionally, the tax agency will be able to redirect its resources to address higher-priority workload.

“This mirrors successful administrative dissolution programs implemented in other states,” Twomey added.

The California Society of Enrolled Agents also testified in support, saying the bill would correct a longstanding problem. No opposition was voiced.

The bill now goes to the Assembly Appropriations Committee.

In other action from the committee:

EITC Measure Advances. [AB 1942](#) (Santiago), requiring the Franchise Tax Board to revise specified forms to promote utilization of the California Earned Income Tax Credit, was approved with a 7-0 vote. The committee’s analysis states that “the FTB estimates that this bill would not impact state income or franchise tax revenue,” indicating that the FTB may not believe that the measure would increase utilization of the refundable credit.

Tax Credit for Water Recycling Systems Flows Through Committee. [AB 2042](#) (Steinorth), allowing a personal income tax credit for a taxpayer who installs a residential graywater reuse system, was approved with a 9-1 vote. The only opposing vote came from Assembly Member Phil Ting, who was appointed to the committee to replace Assembly Member Bill Quirk for one day. The bill sets the credit amount equal to 25 percent of the system cost, with a maximum credit of \$1,000 per residence. Supporting testimony was provided by two high-schoolers who proposed the idea in a “there ought to be a law” contest.

Panels OKs Reduction in Minimum Franchise Tax for Some Small Businesses. [AB 2410](#) (Grayson), reducing the annual tax from \$800 per year to \$400 per year for every limited liability company (LLC) that is a “small business” during its first two taxable years of operation, was approved with a 9-0 vote. The bill defines “small business” as an LLC that reasonably estimates it will have gross receipts, less returns and allowances, of \$250,000 or less.

Tax Exclusion for Education Loans Clears Committee. [AB 2478](#) (Voepel), allowing an employee to exclude from gross income the principal or interest on a qualified education loan that is paid by an employer on the employee’s behalf, was approved with a 9-1 vote, with Ting opposed.

Income Tax Increase on Carried Interest Advances. [AB 2731](#) (Gipson), imposing an additional income tax at the rate of 17 percent on the portion of taxable income derived from an “investment management services interest,” was approved on party-line 7-3 vote, with Democrats in support.

The bill is targeted at hedge fund managers whose carried interest – partnership interests received in exchange for the performance of services related to raising capital or investments related to specified assets – is not taxed as regular income at the federal level.

Assembly Member Mike Gipson said his bill “seeks to close a carried interest loophole until action is taken by the federal government to correct this long-standing injustice.”

Revenue from the tax hike would be earmarked for various social and educational programs, including agriculture technical education.

The bill is supported by a long list of labor unions. One supporter at the hearing testified about the benefits of redistributing wealth.

Opponents noted that taxes on financial services directly increase the cost of financial advice and education for investors who need it most, including Californians who have relatively small amounts to invest and do not have access to sophisticated financial advice. Opponents also testified that it would harm a broad class of employees at financial services firms, and that the bill would apply to assistants and others who could be deemed to be “supporting” the activities, but the author said amendments will clarify that the tax applies to partners, not downstream employees.

The committee staff’s analysis raised concerns about defining “carried interest,” and added: “Even if the correct balance can be struck to apply the tax as intended, there is still the risk that fund managers will simply flee to other states in an effort to minimize the significant tax consequences involved.”

Waiver of Parcel Tax Uniformity Requirement Wins Unanimous Approval. [AB 2954](#) (Bonta), waiving the parcel tax uniformity requirement to allow school districts to impose parcel taxes with a lower rate on unimproved property, was approved unanimously without a formal presentation by the author or proponents. The bill is supported by the Howard Jarvis Taxpayers Association, the Alameda United School District, and unions representing firefighters and school employees.

Tax Cut for Cannabis Businesses Rolls Through Committee. [AB 3157](#) (Lackey and Bonta), reducing the state excise tax rate on cannabis and cannabis products from 15 percent to 11 percent, and suspending the cultivation tax for approximately three years, was approved with an 8-0 vote. The authors – a Republican and a Democrat – said the goal is to help cannabis businesses transition from the black market to a regulated, taxpaying market.

The bill’s findings and declarations state that it would further the purpose and intent of the voter-approved initiative that legalized and taxed cannabis in California, but the committee’s staff questioned that claim. In their analysis, the staff wrote: “It is not clear that suspending the cultivation tax and reducing the excise tax, even for a specified period of time, is in line with the intent of the voters to tax and regulation recreational use of cannabis. As such, the changes made by this bill may be subject to legal challenges.”

Property Tax Exemption for Disabled Veterans Gets Committee’s Salute. [AB 3209](#) (Frazier), exempting from property tax the principal residence of a totally disabled veteran, was approved unanimously. The author agreed to amend the bill, at the committee’s suggestion, to add a similar benefit for the unmarried surviving spouses of totally disabled veterans.

SENATE GOVERNANCE AND FINANCE COMMITTEE:

Committee Approves Change in Local Sales Tax Allocation for Online Sales

After discussing the potential for more sweeping changes to the state tax code, the Senate Governance and Finance Committee approved a bill April 25 that would alter the sales tax allocation under the Bradley-Burns Uniform Local Sales and Use Tax Act.

The committee voted 7-0 to approve [SCA 20](#) by Senator Steve Glazer, a Democrat from Orinda, to change the allocation of local sales tax under Bradley-Burns from origin-based to destination-based for online sales. The measure would place the matter before the voters in the November election. Operative language is included in a companion measure, [SB 1466](#).

Citing a report released by the state auditor relating local sales tax distributions from online sales, Glazer said the report found “online sellers can allocate their sales mostly to two warehouses or distribution centers.”

“Many jurisdictions lose out, since ... sales tax from their residents is transferred to a handful of cities or counties that are home to online fulfillment centers,” Glazer said.

Under Bradley-Burns, 1.25 percent of the total state sales tax is allocated to cities and counties for general operations and one-quarter percent of that is dedicated to county transportation purposes.

Glazer testified that under the current system, local jurisdictions are losing sales tax revenue despite their residents purchasing from their homes, leading to those jurisdictions not being able to spend as much tax revenue on government services.

A representative of the State Auditor’s Office called the proposed change to destination-based allocation “more equitable.”

Senator Robert Hertzberg, a committee member who has long supported extending the sales tax to services, expressed his excitement for the change, and used the bill as a platform to broaden the discussion.

“This thing turns the whole thing on its head and is going to be an interesting chapter in tax policy,” Hertzberg said. “That’s why we need to fix the whole thing. I think it forces the hand of tax reform.”

Immediately following Hertzberg’s comments, Republican Senator John Moorlach agreed, and said, “We’ve got to reevaluate what’s going on, as we have super winners and we have everyone else subsidizing that.”

The bill now heads to the Senate Elections and Constitutional Amendments Committee.

In other action from the committee:

Panel Rejects Plan to Dedicate Repatriation Revenue for Infrastructure. [SB 1384](#) (Bates), which would dedicate future revenue from repatriated income to infrastructure projects, failed on a partisan 4-2 vote, with Hertzberg abstaining. Committee chair Senator Mike McGuire expressed reservations that this bill would bypass the budget process by dedicating general fund revenue, and said the issue should be worked out in the budget committee process. Senate Republican Leader Pat Bates was granted an opportunity to have her bill reconsidered at a future committee hearing.

Authorization for More Local Bonds Passes. [SB 961](#) (Allen), allowing enhanced infrastructure districts to, among other things, issue bonds with voter approval, passed unanimously 7-0.

Bond to Fund Maintenance and Construction of Higher Education Facilities Passes. [SB 1225](#) (Glazer), placing a \$4 general obligation bond on the November ballot to finance several projects related to higher education building needs, passed on a 6-1 vote. Senator Moorlach opposed the measure, citing concerns about adding more state bond debt.

Database of Local Development Fees Passes Unopposed. [SB 1296](#) (Glazer), requiring a planning agency to include in its annual report a list of fees charged to new developments, passed on a 7-0 vote.

FRANCHISE TAX BOARD:

Board Approves Amendments to Proposed Regulation on Sourcing Nonresidents’ Income From Pass-Through Entities

The three-member Franchise Tax Board voted at this month’s meeting in Sacramento to delete a sentence from a proposed regulation on the sourcing of nonresidents’ income from pass-through entities, agreeing with taxpayers’ representatives who said the sentence is at odds with California statutes and case law.

The action was approved unanimously during the board’s 90-minute session. The meeting, chaired by State Controller Betty Yee, was the first with its newest member, BOE Chair George Runner, and also the first with Department of Finance Chief Deputy Director Jacqueline Wong-Hernandez serving as the representative for Finance Director Michael Cohen.

The regulatory action is the latest in a [long process](#) relating to proposed regulation Sections 25137-1 and 17951-4. At issue in this meeting was a sentence in the proposed amendments to Section 17951-4 that read: “Revenue and Taxation Code section 17952 is not applicable in determining the source of income allocated to the nonresident taxpayer by the partnership.”

Jeffrey Vesely, a partner with the law firm of Pillsbury Winthrop Shaw Pittman LLP, testified that the sentence should be deleted because it is directly at odds with Section 17952 and the case law that has interpreted it. Chris Parker, a senior manager at Moss Adams, also testified in support of removing the sentence.

Two representatives of Governmental Advocates Inc. testified against deleting the sentence, arguing that it would reverse two precedential court decisions “by unilateral and arbitrary action that can only be seen as an attempt to act by underground regulation.” They also stated that the FTB staff has changed its position on the issues at hand at least three times during the interested parties process.

A secondary issue was a sentence in the “15-day notice” used by the FTB to let the public know in February that it had proposed deleting the language from the proposed regulation. Vesely asked that a sentence in the notice be stricken because it is contrary to the plain language of Section 17952, and may create confusion for taxpayers and the Office of Tax Appeals.

Bruce Langston, FTB’s counsel, and other FTB legal staff said the statement in the 15-day notice is an expression of staff that doesn’t carry any authority, and that there is no avenue for removing language from a notice that already went out.

Langston said a transcript of the FTB’s discussion of the notice – including the descriptions of the notice having no legal weight – will be part of the regulatory file.

In other action from the meeting:

FTB “Nudging” Taxpayers. The FTB’s staff gave a presentation on “nudging” – adding language to FTB documents to encourage people, in subtle ways, to comply with tax laws. A common example of nudging is found in many hotels, where signs posted near towel racks state: “Seventy percent of our customers choose to reuse their towels to support our green environment.” Hotels report that this “nudge” results in more guests reusing their towels, staff said.

“We know that people generally want to do the right thing,” the staff told the board. “Nudging isn’t telling people what to do, it’s helping them make choices that they normally would make if they had been more mindful in the moment.”

An academic paper offered this explanation of the concept: “Nudges are not mandates. Putting fruit at eye level counts as a nudge. Banning junk food does not.”

Staff said the agency is “just dipping our foot in the water with this nudge concept,” but hopes it will become a low-cost method of increasing compliance. The FTB is conducting a pilot project relating to taxpayers who claim unreimbursed employee business expenses. Staff said research indicates that many people might be claiming too much, so they sent a letter to people with information about

typical misunderstandings, and pointed to resources about the deduction. This led to 60 percent of the recipients reducing their deductions the following year.

A similar informational letter was sent in January to taxpayers who previously claimed high percentages of itemized deductions like medical deductions or contributions to charities.

The agency also is testing a nudge designed to educate low-income taxpayers about the state's earned income tax credit. Three versions of letters including nudges were sent to three groups of 10,000 taxpayers who might qualify for the refundable credit, and a "no-nudge" letter was sent to another 10,000 taxpayers as the control group, staff said. The results will be studied to determine whether those who were nudged were more likely to apply for the credit, and whether some nudges worked better than others.

A jurisdiction in the United Kingdom has successfully used the concept, staff said. The tax collectors there revised a letter sent to remind people that their taxes are late by adding the statement: "Nine out of 10 people in your town paid their taxes on time." This nudge, which staff said was factually correct, reportedly increased the number of people making an on-time payment by 15 percent.

Board Asks for \$2 Million Annual Budget Increase to Give Raises to IT Staff. The FTB is requesting state funding of \$1.76 million in 2018-19 and \$2.33 million in 2019-20 and beyond to cover the costs of transitioning from an old classification for information technology employees to a new classification that would result in pay raises. The State Personnel Board and Department of Human Resources collaborated to create a plan that "modernizes IT classifications to attract and retain competitive and knowledgeable staff."

More Funds Requested to Cover Costs of Collecting Cash From Cannabis Taxpayers. The FTB requested a \$193,000 budget augmentation in 2018-19 and \$247,000 in 2019-20 and beyond to handle an increase of cash payments resulting from the state's new adult-use cannabis law. "Revenue associated with cash payments is anticipated to be \$19 million in 2018-19 and \$23.5 million ongoing," staff stated. "FTB will collaborate with California Department of Tax and Fee Administration (CDTFA) to leverage the infrastructure CDTFA has in place to collect cannabis cash payments from taxpayers. This will minimize costs and provide convenience to taxpayers."

Retiree Honored. The board presented a resolution to Privacy and Disclosure Officer Laurie Rhea, who is retiring after 31 years with the FTB.

STATE BOARD OF EQUALIZATION:

Federal Tax Reform Could Lead to Property Tax Increase on Some State-Assessed Properties

Recent federal tax reform legislation could prompt property tax increases on some state-assessed properties, staff of the State Board of Equalization told board members at their April 24 meeting in Sacramento.

State assesses that are not rate-regulated companies could see property values increase for 2018-19 because the BOE places some weight on the income approach of valuation, said Mike Harris, manager with the State-Assessed Properties Division.

Harris said there will be minimal impact on companies with rates regulated by the state, because the state will adjust rates so that the benefit of federal changes will be realized by ratepayers, not the companies.

Harris said the agency also is making adjustments to the assessment of independent power producers to make sure the assessments account for the effects of renewables on the energy market. The changes include shortening the economic lives of power plants that are in jeopardy of shutting down, and reducing revenue projections for periods subsequent to the expiration of power purchase agreements.

Attorney Peter Michaels, who represents owners of several state-assessed properties, was unable to appear in person, but sent a letter commending BOE staff and saying he hopes his clients' methodological concerns will be worked out with staff as the parties continue working together to address issues that have been raised.

In other action from the meeting, which lasted just 15 minutes:

Auditors Get More Time. The board voted 4-0 to give the assessors of El Dorado, Los Angeles and Trinity counties more time to complete their 2018 assessment rolls (Aye: Chair George Runner, Vice Chair Fiona Ma, Member Diane Harkey and Deputy State Controller Yvette Stowers, representing Controller Betty Yee; Absent: Member Jerome Horton). Each assessor was granted a 30-day extension of the July 1 deadline.

Staff Continuing the Transition to Board's New Role. Executive Director Dean Kinnee updated the board on the staff's work to address issues that have arisen as the agency transitions to its new role in the state's tax structure.

Staff is working on a plan to have all BOE members lease space in one state office building once current leases expire, as required by the state law that reorganized the state tax agencies, Kinnee said. Staff also is developing a plan to redo the BOE's public website, internal network and policies to reflect its current role.

The staff also is working with the California Department of Tax and Fee Administration to retrieve historical files that were taken by the CDTFA, and has submitted a formal state budget request for money and employees to address gaps in several departments that were left when employees and equipment migrated to the new agency.

Retiree Honored. The board adopted a resolution honoring Paula Montez, an associate property auditor appraiser in the County-Assessed Properties Division who is scheduled to retire May 1 after a long career at the BOE. Montez started with the agency in 1979 as stenographer. After a leave of absence, she returned in 1982 as a program technician, and subsequently was promoted several times.

NEW WINE IN OLD BOTTLES: Recently Amended Bills of Interest

Base-Year Value Transfer Expansion. [AB 1748](#) (Steinorth), expanding base-year property value transfers for people who are over the age of 55 or permanently disabled, was amended April 25 to make the bill operative only if a companion measure, [ACA 20](#), is approved by voters. Vote: Majority.

PIT Home Care Service Credit. [AB 2703](#) (Mayes), providing a personal income tax credit for home care services, not to exceed \$10,000, was amended April 25 to lower the cap to \$5,000. Vote: Majority.

Tax-Defaulted Property Sales. [AB 2746](#) (Eduardo Garcia), previously relating to school volunteers, was gutted and amended April 26 to instead deal with tax-defaulted property sales by specifying that property owners lose all rights upon close of the redemption period unless a right of redemption is revived. The bill also states that it is the sole responsibility of the tax collector and the county during the redemption period to sell the tax-defaulted property, and specifies that the tax collector and county are not liable for any injury on the property. Vote: Majority.

Education Bond. [AB 2771](#) (Eggman, Grayson and Weber), placing on the November ballot a \$7 billion general obligation bond for the construction, remodeling or reconstruction of higher education facilities, was amended April 26 to add an urgency clause. Vote: Two-Thirds (Bond).

Film Tax Credit Extension. [SB 832](#) (Portantino, Allen, de León and Stern), extending the film tax credit through fiscal year 2023-24 in an amount equal to 20 percent to 25 percent of qualified expenditures up to \$100 million for five years beginning January 1, 2020, was amended April 25 to authorize a sales and use tax credit in lieu of a personal income tax or corporate tax credit. Vote: Majority.

Film Tax Credit Extension. [SB 951](#) (Mitchell), extending the film tax credit and allowing a credit in an amount equal to 20 percent to 25 percent of qualified expenditures up to \$100 million for five years beginning January 1, 2020, was amended April 25 to authorize a sales and use tax credit in lieu of a personal income tax or corporate tax credit. Vote: Majority.

Child Tax Credit Increase. [SB 1176](#) (Nguyen), previously increasing the child tax credit (which is \$353 for the 2017 taxable year) to \$700 beginning January 1, 2019, with annual adjustments for inflation, was amended April 23 to change the new credit amount to \$389. Vote: Majority.

Renters' Credit Increase. [SB 1182](#) (Glazer), doubling the amount of the renters' credit (from \$120 to \$240 for joint filers and from \$60 to \$120 for individuals) contingent upon a budget appropriation, beginning January 1, 2018, was amended April 26 to remove the budget contingency and to require the Franchise Tax Board to annually adjust the credit for inflation on or after January 1, 2023. Vote: Majority.

Government-Mandated Report on Private Companies' Pay and Personnel. [SB 1284](#) (Jackson), requiring California corporations with 100 or more employees to submit a report to the state with payroll data related to employees by race, ethnicity, sex and several job categories by September 30 of each year or pay a \$500 fine, was amended April 24 to make it unlawful for an employee of the

Department of Fair Employment and Housing to make public any individually identifiable information obtained in a report. Vote: Majority.

WASTE, FRAUD & MISMANAGEMENT:

Your Tax Dollars at Work

Former Superintendent Charged With Felony Misuse of Public Funds Pleads Guilty to Lesser Crime.

Former Poway Unified School District Superintendent John Collins pleaded guilty April 25 to a misdemeanor as part of a deal that resolved criminal and civil cases – including four felony charges for misappropriations of public funds.

Collins pleaded guilty to failing to properly file a state-mandated economic interest form to report consultant income received while working as superintendent.

Collins, who served as superintendent from 2010 to 2016, was sentenced to five years of probation and ordered to comply with the terms of a civil settlement reached simultaneously with the school district. To settle the civil case, he agreed to pay Poway Unified \$185,000 over the next 18 months. If the payments are not made, Collins could face a year in jail and a \$10,000 fine.

The former school leader had been facing up to five to seven years in custody if convicted on all charges, which were tied to his alleged misuse of the district credit card and excessive vacation and leave time.

Collins' guilty plea will not affect his \$296,500 annual pension, since he pleaded to a misdemeanor charge and not a felony.

Poway Unified fired and then sued Collins in 2016 for alleged fraud and breach of fiduciary duty. The district sought to recover \$300,000 to \$400,000 in payments the district alleged Collins took beyond what he was owed in his contract. (Source: *Voice of San Diego*, April 25.)

Riverside Agency Didn't Properly Monitor Overtime, Resulting in Huge Payout. Riverside Public Utilities didn't adequately monitor overtime during a period in which a dispatcher received more than \$257,000 in overtime pay – more than double his six-figure base salary – in a single year, according to an audit presented to the Riverside City Council on April 24.

The audit, conducted by a private firm, looked for possible fraud or abuse related to overtime earnings by 10 utilities employees that may have occurred between 2012, and 2016. It also looked for any lack of internal controls in the authorization of that overtime, a letter from the firm stated.

The review found no evidence that employees collected overtime pay by creating overtime when the work wasn't needed or by submitting timekeeping records for overtime not worked. However, the auditors found that internal review was lacking, and overtime policies were not followed.

The auditor reported that after the dispatcher's pay was reported by the media, changes were made to improve internal controls and adherence to overtime policies. (Source: *Riverside Press-Enterprise*, April 25.)

Los Angeles Police Officer Charged With Workers' Comp Fraud. A Los Angeles Police Department officer assigned to the Van Nuys Station has been charged with felony workers' compensation fraud.

Officer John Bailey, who was taken into custody this week, was investigated over a medical claim he filed earlier this year. He is accused of knowingly committing workers' compensation fraud and receiving benefits under false pretenses, according to the LAPD. (Source: *Los Angeles Daily News*, April 26.)

Milpitas City Manager Who Resigned in Controversy Is Hired for Same Job in Millbrae. Former Milpitas City Manager Tom Williams, who resigned in September after being placed on paid leave during an investigation for allegedly using tax dollars to pay personal attorney fees, has been hired as the interim city manager of Millbrae.

The Millbrae City Council unanimously voted this week to hire Williams, who has lived in Millbrae for more than 20 years.

Williams served as Milpitas' city manager from 2006 until he resigned last year. The investigation was into whether he used public funds to cover attorney fees incurred while exploring a suit against the city and Milpitas Mayor Rich Tran for discrimination and harassment.

Millbrae hired a consultant to conduct background and reference checks on candidates for the job. Millbrae Councilman Reuben Holober said "everything came back very positive" on Williams. (Source: *San Jose Mercury News*, April 25.)

POTPOURRI:

Symposia, Sightings, Salutes & Snafus

FTB Sets Third Interested Parties Meeting on Market Sourcing of Intangibles. The Franchise Tax Board announced April 25 that it has scheduled a third interested parties meeting to gather public input on proposed adoption of California Code of Regulations, Title 18, Section 25136-2, regarding market sourcing of intangibles. The meeting will be held Friday, May 18, at 10 a.m. at the FTB headquarters at 9646 Butterfield Way in Sacramento.

Links to the [draft language](#) that will be considered, as well as other provided documents for the meeting, can be found [here](#). Details about the meeting, including RSVP information and deadlines for submitting written documents, are [here](#).

The previous interested parties meetings on this matter were held last year in January and June.

Former Sanitation Board Member Accused of Name-Calling During Board Meetings. A former member of the South San Luis Obispo County Sanitation Board has been accused of calling a local activist a “fat ass” during this month’s public meeting of the board.

The comment came during a meeting that involved activist Julie Tacker’s allegation that the board recently violated the state’s Open Meetings Act by holding a meeting out of its jurisdiction. *CalCoastNews.com* reported: “As Tacker walked back to her seat, former sanitation district board member Mary Lucey called Tacker a ‘fat ass.’ Tacker then confronted Lucey and alerted District Board Chair Linda Austin to the harassment. Austin banged her gavel down, but took no other action. Lucey has regularly degraded speakers by playing mooing sounds from her phone or calling names as they walk to or from the podium during public comment. Even so, Austin appears to ignore the ongoing harassment.” (Source: *CalCoastNews.com*, April 24.)

TAX TRIVIA:

When Was the 16th Amendment Ratified?

The 16th Amendment to the U.S. Constitution, which states that Congress “shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration,” was ratified in what year?

BLAST FROM THE PAST:

California Gives \$1.1 Billion Tax Rebate While Other States Raise Taxes

“The fact that 34 other states are raising taxes while California is giving money back is a mark of distinction that has drawn more jobs to our state and helps us beat the competition. And with consumer confidence somewhat shaken by the October decline in the stock market, our \$1.1 billion rebate to California consumers provided the perfect tonic for continued prosperity. Tomorrow, I will submit a \$44.3 billion state budget, 6 percent higher than the current year. I’m proud to say that this budget is highlighted by what has become for California a traditional trio: a balanced budget, a prudent reserve and no general tax increases. So, although the high-tax advocates disagree, we choose the common sense wisdom of living within our means, not the pie-in-the-sky vision of expensive dreams. As long as I’m governor, California, unlike the federal government, will never succumb to the fatal attraction of excessive spending.”

— Governor George Deukmejian, in his State of the State Address delivered January 6, 1988

COMING UP:**Legislative Committee Hearings***Monday, April 30*

SENATE APPROPRIATIONS COMMITTEE HEARING

State Capitol, Room 4203, 10 a.m.

Agenda includes:

- [SB 920](#) (Cannella), extending the authorization for people licensed in the practice of engineering, land surveying or architecture to form limited liability partnerships.

ASSEMBLY REVENUE AND TAXATION COMMITTEE HEARING

State Capitol, Room 126, 2:30 p.m.

Agenda includes:

- [AB 2833](#) (Santiago), relating to the renters' personal income tax credit.
- [AB 3009](#) (Quirk), putting a \$1-per-gallon tax on paint sold in California.

Tuesday, May 1

ASSEMBLY BUDGET SUBCOMMITTEE NO. 4 ON STATE ADMINISTRATION HEARING

State Capitol, Room 447, 1:30 p.m.

Agenda includes discussion of open issues from past hearings, including those relating to the state tax agencies.

Wednesday, May 2

ASSEMBLY APPROPRIATIONS COMMITTEE HEARING

State Capitol, Room 4202, 9 a.m.

Agenda includes:

- [AB 2303](#) (Thurmond), imposing a new tax on specified businesses that contract to provide goods and services to prisons.
- [AB 2758](#) (Burke), authorizing an income tax credit for qualified small businesses.
- [AB 2855](#) (Brough), a CalTax-supported bill to expedite tax refund adjustments of net operating loss carrybacks.

SENATE GOVERNANCE AND FINANCE COMMITTEE HEARING

State Capitol, Room 112, 9:30 a.m.

Agenda includes:

- [SB 958](#) (Dodd), allowing local special taxes that exempt teachers and school district employees from having to pay.

- [SB 1237](#) (Bates), changing the definition of what constitutes a change in ownership of properties in transactions involving legal entities.
- [SCA 15](#) (Nguyen), specifying that constitutional vote thresholds for local special taxes apply to taxes put on the ballot via a local initiative.

Thursday, May 3

SENATE BUDGET AND FISCAL REVIEW SUBCOMMITTEE NO. 4 ON STATE ADMINISTRATION AND GENERAL GOVERNMENT HEARING

State Capitol, Room 2040, 9:30 a.m. or upon adjournment of Senate floor session

Agenda includes discussion budgets for the State Controller's Office and the Financial Information System for California.

The next issue of the *CalTaxletter* will be published May 4, 2018.

Tax Trivia Answer: 1913.