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Living by the Initiative and Dying by the Initiative

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by Steve R. Johnson

A significant fiscal development in recent decades in many states has been revision of tax laws and policy not by legislatures but by voters through the initiative process. Initiatives often have been used to restrain the growth of taxes and spending, and to that extent the owners of wealth, property, and income have benefitted from initiatives.[1] Among the many examples of controversial and important state tax and spending initiatives, one may think of the Taxpayer Bill of Rights in Colorado,[2] the supermajority requirement for tax increases in Nevada,[3] and of course Proposition 13 in California.[4]

However, that gate swings both ways; initiatives also can be used to *increase* taxes and spending. This installment of the column discusses one such initiative, California's Proposition 63 and a recent case, *Jensen v. Franchise Tax Board*,[5] rejecting challenges to it.

> ***Two-track tax legislation — tax lawmaking by the legislature versus tax lawmaking directly by voters via initiatives — can engender confusion and tensions.***

The first part below describes the initiative and the case. The second part addresses the equal protection challenges to the initiative. Those challenges were easily rejected by the *Jensen* court, but reviewing them may serve as a doctrinal refresher. The third part considers the separation of powers challenges to the initiative. Although those challenges also were rejected in *Jensen*, they illustrate how two-track tax legislation — tax lawmaking by the legislature versus tax lawmaking directly by voters via initiatives — can engender confusion and tensions. The fourth part depicts *Jensen* in a larger context. The case is a window onto a portion of the panorama of tax politics. Through that window may be glimpsed the pushback by wealthy taxpayers, a phenomenon that may well grow in the years to come.

The Initiative and the Case

California's voters approved Proposition 63 in the 2004 general election.[6] The measure did not amend the California Constitution. Instead, it enacted the Mental Health Services Act. The act augments funding for mental health services in California and prevents future funding for mental health services from dropping below the 2003 level. To pay for

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[1]I use "benefit" in an immediate, not a long-term, sense. Whether citizens are better off with lower taxes or with a greater level of public goods and services financed by higher taxes is a question open to endless debate.

[2]For recent discussion of the fiscal effects of TABOR, see "Maine's TABOR II Endangers Public Services, Business Climate," *State Tax Notes*, Oct. 19, 2009, p. 173, *Doc 2009-21051*, or *2009 STT 199-3*. A box on p. 176 of the report examines Colorado's declining services because of TABOR. Colorado's TABOR has spawned similar initiatives in other states. Such initiatives were recently rejected by voters in Maine and Washington. *See* Nicola M. White, "Antitax Advocates Undaunted by Failure of Spending Limits," *State Tax Notes*, Nov. 9, 2009, p. 396, *Doc 2009-24463*, or *2009 STT 213-2*.

[3]Nev. Constitution Art. 4, section 18(2) (requiring two-thirds approval in both houses of the Legislature in order to approve tax increases); *see generally* Steve R. Johnson, "Supermajority Provisions, *Guinn v. Legislature* and a Flawed Constitutional Structure," 4 *Nev. L.J.* 491 (2004). That article was part of a symposium on *Guinn v. Legislature*, 71 P.3d 1269 (Nev. 2003), *clarified & confirmed*, 76 P.3d 22 (Nev. 2003), *cert. denied sub nom. Angle v. Guinn*, 541 U.S. 957 (2004), *overruled in part*, *Nevadans for Nevada v. Beers*, 142 P.3d 339, 347 (Nev. 2006).

[4]Calif. Constitution Art. XIIA, section 2.

[5]178 Calif. App. 4th 426 (Oct. 14, 2009).

[6]*Codified at* Calif. Revenue and Taxation Code section 17043 and Calif. Welfare and Institutions Code section 5891.

expanded services, Proposition 63 imposed an additional income tax of 1 percent on taxpayers whose incomes exceed $1 million.

Craig and Sally Jensen had such income for the year at issue. They paid the 1 percent increment under protest, and then filed a refund claim for it with the Franchise Tax Board. The FTB failed to act on the claim, so the Jensens filed a refund suit. They argued that Proposition 63 set up wealthy taxpayers as victims of arbitrary discrimination, in violation of both the federal and state constitutions' equal protection clauses.[7] They also argued that in mandating funding levels Proposition 63 effected an unconstitutional suspension of state budgetary powers, which could be legitimately achieved only by amending the state constitution.

The FTB demurred. The trial court sustained the demurrers, and the court of appeal unanimously affirmed.

Equal Protection Challenges

The strength of an equal protection challenge often depends on the standard of review the court finds applicable. The taxpayers swung for the fences, arguing that the most rigorous form of review — strict scrutiny — was warranted. When strict scrutiny applies, differential treatment under state or local law will be upheld only if the government establishes that the classification is necessary to advance a compelling state interest.[8] Those hurdles are high. Thus, statutes subject to strict scrutiny usually are invalidated.

However, strict scrutiny applies only if the classification either infringes on the exercise of a fundamental right or disadvantages a suspect class. Neither of those predicates was present. State and local taxes occasionally can impinge on fundamental rights,[9] but no fundamental right was at stake in *Jensen*.

Thus, the taxpayers argued for strict scrutiny based on suspect classification, namely wealth. The court emphatically — and properly — rejected that contention. It stated:

> We are unaware of any case authority holding that wealthy individuals form a "suspect class" deserving of a heightened degree of scrutiny. Suspect classifications include race, gender, national origin or illegitimacy. Wealth generally confers benefits, and does not require the special protections afforded to suspect classes. Wealth has "none of the traditional indicia of suspectness: the class is not saddled with such disabilities, or subjected to such a history of purposeful unequal treatment, or relegated to such a position of political powerlessness as to command extraordinary protection from the majoritarian political process."[10]

The taxpayers relied on *Serrano v. Priest*, in which the California Supreme Court struck down a system of public school financing based on local property tax assessments because it produced disparate opportunities based on district wealth.[11] However, although *Serrano* was a successful wealth-based equal opportunity challenge, the problem there was disadvantaging the poor, not the wealthy.

'We are unaware of any case authority holding that wealthy individuals form a "suspect class" deserving of a heightened degree of scrutiny,' the court of appeal said.

With the failure of their strict scrutiny argument, the Jensens were relegated to their alternative argument: that Proposition 63 violated equal protection even on rational basis analysis. Under that standard, the classification will be upheld as long as it bears a rational relationship to a legitimate governmental interest.[12] Moreover, the government need not even identify that interest. It suffices if the court can conceive of a plausible policy consideration that the government *may* have considered.[13]

Rational basis is the lowest level of scrutiny. It is highly deferential in all contexts, but it "is especially

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[7]U.S. Constitution Amendment 14; Calif. Constitution Art. 4, section 1. In some instances, cognate state and federal constitutional provisions are interpreted differently. That was not the case in *Jensen*. The appellate court discussed the federal and state equal protection clauses together, without differentiating between them.

[8]*E.g.*, *Loving v. Virginia*, 388 U.S. 1, 11 (1967); *see also Plyler v. Doe*, 457 U.S. 202, 216-217 (1982) (the classification must be "precisely tailored to serve a compelling governmental interest").

[9]For example, the right to travel or migrate interstate is a fundamental right. *Dunn v. Blumstein*, 405 U.S. 330, 338 (1972). Thus, state and local taxes that burden such travel trigger strict scrutiny. *See, e.g.*, *Hooper v. Bernalillo County Assessor*, 472 U.S. 612, 623 (1985) (invalidating property tax exemption that was limited to persons who were residents before a stated date and so discriminated against new residents).

[10]*Jensen*, 178 Calif. App. 4th at *9 (quoting *San Antonio School Dist. v. Rodriguez*, 411 U.S. 1, 28 (1973)). (For the decision in *Jensen*, see *Doc 2009-22735* or *2009 STT 198-4*.)

[11]487 P.2d 1241 (Calif. 1971).

[12]*E.g.*, *Massachusetts Bd. of Retirement v. Murgia*, 427 U.S. 307, 314 (1976) (per curiam).

[13]*E.g.*, *Fitzgerald v. Racing Ass'n of Central Iowa*, 539 U.S. 103, 107, 110 (2003). Indeed, the state "has no obligation to produce evidence to sustain the rationality of a statutory classification." The classification "may be based on rational

(Footnote continued on next page.)

deferential in the context of classifications made by complex tax laws."[14] There are at least four reasons for this: the centrality of revenue to government operations, courts' fears of being inundated with cases, respect for legislative prerogatives, and judicial recognition of the difficult political and policy issues inherent in tax classifications. Accordingly, relatively few rational basis equal protection challenges to state or local tax provisions succeed.[15]

The Jensens attempted to scale that steep peak via two paths: the absence of a rational connection between the group taxed (the wealthy) and the problem addressed by Proposition 63 (mental health services), and the allegedly arbitrary and capricious nature of the classification wrought by the measure. Both of those paths proved to be unclimbable.

The "absence of rational connection" prong of the Jensens' argument proceeded in this way: Individuals with incomes over $1 million do not particularly need or use expanded mental health services funded via Proposition 63; accordingly, no connection exists between the group being taxed and the use of the funds collected.[16] If you are surprised by that argument, you should be. It is flawed both conceptually and historically. Conceptually, accepting that argument would have equated income taxes with fees for services and would have cast a heavy pall on progressivity of tax rates. Historically, the argument comes nearly a century too late. Contentions of that sort were considered — and decisively rejected — in the very early days of modern income taxation. Over 70 years ago, the U.S. Supreme Court said: "Nothing is more familiar in taxation than the imposition of a tax upon a class or upon individuals who enjoy no direct benefit from its expenditure, and who are not responsible for the condition to be remedied."[17] Additional cases cited by the *Jensen* court in rejecting that argument were 1898 and 1916 precedents.[18]

The arbitrary and capricious prong of the taxpayers' no rational basis argument was founded in part on the sharp consequences of potentially tiny income gradations. For example, under Proposition 63, "a person earning $1,000,001 is subject to tax, while a person earning $999,999 is exempt."[19] There is some emotional appeal to that argument. In tax measures enacted by legislatures, such severe disparities usually are avoided through use of phase-ins, phaseouts, or other devices. Perhaps initiatives are instruments too blunt to allow use of such mechanisms, which may be difficult to explain to the electorate.

Whatever emotional appeal the position may have does not translate into legal traction. The drawing of lines is the essence of tax classifications, and it is well recognized that some degree of arbitrariness is inherent in setting numerical limits.[20] Thus, "[a] classification does not fail rational-basis review because it is not made with mathematical nicety or because in practice it results in some inequality."[21]

Separation of Powers Challenge

The Jensens' structural argument had more merit than their equal protection argument, but still not enough. They maintained "that the core functions of the legislative branch include passing laws, levying taxes, and making appropriations. These functions require the Legislature to take into account the needs of the state and its financial resources." Proposition 63, they contended, infringed on those core functions "by totally taking the mental health services budget away from both the Governor and the Legislature."[22]

> ***Because there were escape provisions should it prove too onerous, Proposition 63 presented no constitutional infirmity, in the court's view.***

Although not styled as such by the taxpayers, this is a separation of powers argument. By virtue of their power to make statutes via initiatives, the people themselves are constituted as an independent lawmaking branch of government. The statutes the people made via Proposition 63, the argument went, so encroached on the prerogatives and spheres of action of the executive and legislative branches as to compromise their core powers.

The *Jensen* appellate court began its analysis of that contention with the ritual encomium in favor of direct democracy that one is accustomed to seeing in

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speculation unsupported by evidence or empirical data." *Heller v. Doe*, 509 U.S. 312, 320 (1993).

[14]*Nordlinger v. Hahn*, 501 U.S. 1, 11 (1992).

[15]Examples of successful challenges include *Williams v. Vermont*, 472 U.S. 14 (1985) (sales and use tax); *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1965) (insurance premiums tax).

[16]*Jensen*, 178 Calif. App. 4th at *11.

[17]*Carmichael v. Southern Coal Co.*, 301 U.S. 495, 521-522 (1937).

[18]*Jensen*, 178 Calif. App. 4th at *10-12 (citing *inter alia Thomas v. Gay*, 169 U.S. 264, 279-280 (1898); *Brushaber v. Union Pac. R.R.*, 240 U.S. 1, 21, 25 (1916)).

[19]178 Calif. App. 4th at *12.

[20]*E.g.*, *United States v. Boyle*, 469 U.S. 241, 249 (1985).

[21]*Heller v. Doe*, 509 U.S. 312, 321 (1993) (internal quotation marks and citations omitted).

[22]178 Calif. App. 4th at *13.

state court opinions.[23] Nonetheless, the court did acknowledge that, at some point, the initiative power could be used to "greatly impair or wholly destroy the efficacy of some other governmental power, the practical application of which is essential."[24]

The court concluded, however, that the Jensens had not established that that point was reached as a result of Proposition 63. The court noted that initiative statutes can be amended or repealed by the Legislature with approval of the electorate.[25] Moreover, the terms of Proposition 63 allow amendment by a two-thirds vote of the Legislature if the amendments "are consistent with and further [the measure's] intent," and it allows amendment by majority vote of the Legislature "to clarify procedures and terms."[26] Because there were escape provisions should it prove too onerous, Proposition 63 presented no constitutional infirmity, in the court's view.[27]

Jensen and Tax Politics

The taxpayers' structural contention was fairly arguable, but their equal protection contentions were hopeless, a montage of long and consistently rejected notions. Had the equal protection contentions been the whole of the Jensens' case, a judge could have considered imposing "frivolous argument" sanctions against them.[28]

In the face of a high probability of losing, what motivated the taxpayers to litigate and appeal this case? The answer, I think, is a sense of injustice. I suspect that the taxpayers genuinely believed that they, and rich people generally, were being picked on by California's electorate. The *Jensen* appellate court noted that dynamic, saying: "The Taxpayers perceive themselves as victims of a populist movement to 'soak the rich.'"[29]

No doubt there will be many — particularly among the ranks of those who do not make over $1 million per year — who will see that feeling as silly or selfish. They will deem it a laudable social choice to funnel money out of millionaires' yachts, vacation homes, and the like into mental health services.

But fairness, like beauty, is in the eye of the beholder. I do not doubt that there are more wealthy individuals who believe, along with the Jensens, that there is a movement afoot to "soak" them. That belief is likely to grow. Unless the political constellations realign (and rapidly), wealthy taxpayers are likely soon to face substantially higher federal taxes to accompany whatever state tax burdens they bear.

As *Jensen* shows, the wealthy will not be able to defeat such populism through litigation. The response will have to be either political lobbying or "self-help" measures. That is good news for tax shelter promoters and also for those seeking to lure wealthy taxpayers to lower-tax jurisdictions, whether other American states or foreign countries.[30] In that sense, *Jensen* reflects — and may contribute to — a countercurrent of American tax politics. It will be interesting to see where the current carries us. ☆

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[23] *Id.* (calling the initiative process "one of the most precious rights of our democratic process") (quoting *Kennedy Wholesale, Inc. v. State Bd. of Equalization*, 53 Calif. 3d 245, 250 (1991)).

[24] 178 Calif. App. 4th at *13. The court quoted *Simpson v. Hite*, 36 Calif. 2d 125, 134 (1950), and *Carlson v. Cory*, 139 Calif. App. 3d 724, 729 (1983). *Carlson* had rejected a challenge on similar grounds to the constitutionality of initiative statutes repealing the state's inheritance and gift tax laws.

[25] *See* Calif. Constitution Art. II, section 10(c).

[26] Prop. 63, section 18.

[27] 178 Calif. App. 4th at *14.

[28] *See* Calif. Code Civ. Proc. section 128.7(b) (California's equivalent of Fed. R. Civ. Proc. 11). However, I admit that I am more of a "Rule 11 hawk" than judges tend to be.

[29] 178 Calif. App. 4th at *12.

[30] *See e.g.*, Steve R. Johnson, "Extraterritoral Audits, Tax Competitors, and Narratives: The Hyatt Case," *State Tax Notes*, Dec. 8, 2008, p 283, *Doc 2008-21040*, or *2008 STT 214-8* (discussing litigation involving a wealthy Californian tax émigré to Nevada).