SUBCOMMITTEE NO. 4 Agenda

Senator Richard Roth, Chair
Senator Tom Berryhill
Senator Jerry Hill

Thursday, March 21, 2013
9:30 a.m. or Upon Adjournment of Session
Room 112

Consultant: Mark Ibele

Agenda

State Finance and Administration

Overview of State Fiscal Offices and Functions

Proposed Vote-Only Calendar:

Proposed Discussion / Vote Calendar:

Overview of State Fiscal Offices and Functions

Legislative Analyst's Office

Presentation from the Legislative Analyst's Office on the California's state fiscal offices and their related activities. These departments and offices comprise:

Tax Agencies
Franchise Tax Board
State Board of Equalization
Employment Development Department

Fiscal Control Departments
Department of Finance
State Controller's Office

Banking, Treasury, and Credit Management
State Treasurer's Office

Independent Auditor
California State Auditor

Proposed Vote Only Calendar:

0968 California Tax Credit Allocation Committee

Department Summary: The California Tax Credit Allocation Committee (CTCAC) allocates federal and state tax credits used to create and maintain affordable rental housing for low-income households in the state by forming partnerships with developers, investors and public agencies. CTCAC works with public and private entities to assist with project development and monitors project compliance. CTCAC coordinates its functions with state and local housing fund providers and with private fund investors in the provision and maintenance of affordable housing. CTCAC consists of seven members from state and local governments, with the State Treasurer serving as chair. Other members are the Governor or Director of Finance, State Controller, Director of the Department of Housing and Community Development, Executive Director of the California Housing Finance Agency, and two representatives from local government.

Budget Summary: The CTCAC budget calls for $6.3 million and 40 positions for 2013-14. This represents a slight increase from the 2012-13 funding level of $6.0 million and 39 positions. CTCAC is funded through fees generated by the issuance of debt and reimbursements, with no General Fund support.

Item Proposed for Vote Only:

1. **Budget Proposal (Governor's Budget BCP#1):** The Governor's Budget proposes an augmentation of one position for the allocation unit to carry out core functions and administer federal and state mandates associated with the Low Income Housing Tax Credit Program. The request is in response to an increase in the number of competitive applications for the program. Although applications fluctuate from year to year, prior to 2011, they averaged around 100 whereas as now they approximate 175-200 annually. Project review frequency is established through federal law and regulations.

   Staff Comment: Staff has no concerns with this proposal.

   Staff Recommendation: Approve the request for the additional position.

   <u>Vote:</u>

0971 California Alternative Energy and Advanced Transportation Financing Authority

Department Summary: The California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) was established in 1980 to promote prompt and efficient development of energy sources that are renewable or technologies that more efficiently utilize and conserve scarce energy resources than conventional technologies. The intent of the legislation establishing the Authority was to promote energy sources designed to reduce the degradation of the environment. The Authority later was expanded to include development and commercialization of advanced transportation technologies. More recent legislation added advanced manufacturing to the list of eligible projects. CAEATFA consists of five members and is chaired by the State Treasurer.

Budget Overview: The CAEATFA budget calls for $6.7 million and 9 positions for 2013-14. This represents a slight decrease from the 2012-13 funding level of $7.1 million; the position number will remain constant. CAEATFA is funded through special funds and reimbursements, with no General Fund support.

Item Proposed for Vote Only:

1. **Budget Proposal (Governor's Budget BCP#1):** The Governor's Budget calls for one, three-year, limited-term position to address the workload associated with implementing SB 1128, which expanded the types of eligible projects under CAEATFA's existing authority to provide a sales and use tax exclusion. The legislation allows the sales and use tax exclusion to extend beyond equipment and machinery used to produce advanced transportation and alternative source energy, and include advanced manufacturing. The definition of advanced manufacturing is broad and complex and will further be refined during program development. The proposal also includes a request for budget bill language (BBL) that provides for extending the repayment date of the loan to CAEAFTA from the Renewable Resources Trust Fund to June 30, 2016. The extension of the loan is necessary to allow for the program to establish a fee structure and generate fee revenue to repay the loan. The loan was made in 2011-12 and carries interest equal to the Pooled Money Investment Account (PMIA) rate.

   Staff Comment: Staff has no concerns with the proposal.

   Staff Recommendation: Approve the request for one, three-year, limited-term position and proposed BBL providing for an extension of the existing loan repayment date.

   <u>Vote:</u>

0860 / 7730 Board of Equalization / Franchise Tax Board

Departments and Budgets Overview: Descriptions of Board of Equalization (BOE) and Franchise Tax Board (FTB) and their budgets are provided under Discussion / Vote items.

Item Proposed for Vote Only:

1. **Budget Change (Staff Issue):** Prior to the current budget year, California was a member of the Multistate Tax Commission (MTC), a multistate organization that provides information on state tax issues, facilitates cooperation in compliance and enforcement efforts, provides model legislation, and coordinates litigation efforts affecting states. SB 1015, adopted as part of the 2012 Budget Act, repealed all provisions related to the Multistate Tax Compact (which addressed the apportionment of income of multistate companies), among other provisions. The repeal of the Multistate Tax Compact ended California's participation as a voting member of the executive committee of the MTC. California's dues as a member of the MTC were roughly $540,000, evenly split between BOE and FTB.

   Staff Comment: California's membership (and dues obligations) ended as of the effective date of SB 1015. These funds have been reapplied, according to both tax agencies, to other activities. Given that both agencies reverted significant resources in 2011-12 and the funds freed-up through the deactivation of the state's MTC membership were never redirected by legislative action, the committee may want to consider having resources for this activity removed from the current year budget and in the 2013-14 budget and ongoing. If the state reactivates its membership, the agencies could request an augmentation

   Staff Recommendation: Approve action to reduce current year budgets for BOE and FTB by $270,000 for each agency, and reduce the 2013-14 budget and ongoing by an equivalent amount.

   Vote:

9600 Bond Extinguishment

Item Description: The Constitution authorizes the Legislature, at any time after the approval by the voters of a law authorizing the issuance of bonded indebtedness, to reduce the amount of the indebtedness authorized by the law to an amount not less than the amount contracted at the time of the reduction. Existing law authorizes departments of the state to issue certain securities for facilities in the Capital Area Plan.

Item Proposed for Vote Only:

1. **Bond Extinguishment and Bonding Authority Reduction (Budget Trailer Bill):** The Governor's Budget proposes trailer bill language that would reduce the amount of bonded indebtedness authorized under the Public Education Bond Act of 1996 by $12.9 million. The budget trailer bill would also repeal the authority of the Director of General Services and the Public Works Board to issue up to $391 million in financing securities for facilities in the Capital Area Plan.

   Staff Comment: Staff has no concerns with this proposal.

   Staff Recommendation: Approve placeholder trailer bill language.

   <u>Vote:</u>

Proposed Discussion / Vote Calendar:

9600 General Obligation Bonds and Commercial Paper

Item Overview: Expenditure of bond proceeds is reflected in the budgets of individual departments, with the payment of bond debt service consolidated in Item 9600 in the Governor's Budget. It is the repayment of bond debt that is reflected as a General Fund expense. Some bond costs are offset by special funds or federal funds. Other bonds are 'self-liquidating,' or have their own dedicated revenue source for debt service. For example the Economic Recovery Bonds (ERBs) receive a quarter-cent of the sales tax as a component of the 'triple flip' enacted as part of the 2004 budget package.

Budget Overview: The Governor's Budget includes $5.1 billion in General Fund costs for General Obligation (GO) bond debt service and related costs, or a total of $6.5 billion when the debt service costs of the ERBs are included. In addition to this amount, $1.1 billion in debt costs are scheduled to be funded from special funds. Finally, federal bond subsidies, through the Build America Bonds (BABs) program, will provide $352 million in 2013-14 providing for a reduction in General Fund expenses. The Governor's proposed budget includes $98.5 billion in General Fund available resources (not including carry-over balances), so the net General Fund bond debt service as a percentage of General Fund resources is about 5.0 percent.

Governor's Budget for GO Bond Debt
(Dollars in Millions)

Category	2011-12 Actual Cost	2012-13 Estimated Cost	2013-14 Forecasted Cost
General Fund cost	$4,390	$4,292	$5,071
Other funds cost	894	765	1,082
Federal subsidy (Build America Bond Program)	300	352	352
Total Debt Service	**$5,584**	**$5,409**	**$6,505**
Economic Recovery Bonds (ERBs, not included above because indirect GF cost)	$1,025	$1,399	$1,543

The ERBs are not included directly in General Fund costs for bond debt service. As noted above, repayment of those bonds is financed from a quarter cent sales tax that was temporarily redirected from local government. Local government revenue is backfilled through a diversion of property tax revenues and an increase from the state General Fund in Proposition 98 education funding. The Governor's Budget reflects special fund expenditures of $1.5 billion for ERB debt service in 2013-14, and the Proposition 98 budget reflects increased General Fund expenditures of $1.5 billion.

Background: The state uses GO bonds to borrow funds for spending—primarily for infrastructure and other capital investments. Bonds must be approved by voters and bond proceeds are either continuously appropriated (immediately available for expenditure) or require an appropriation from the Legislature. All bond debt service is continuously appropriated and, therefore, not scheduled in the annual budget bill. According to the State Treasurer's Office, the state has $79.6 billion in outstanding GO bond debt (including self-liquidating bonds such as the ERBs). Another $33.2 billion in bonds is authorized, but remain unissued. In most instances, bonds are sold at different lengths of maturity such that repayment is spread over about 30 years. The chart below indicates the authorized but unissued reservoir of bonds.

General Obligation Bonds Authorized and Not Issued
(Dollars in Millions)

Authorized Bond Program	Unissued Amount
Prop 1B of 2006: Transportation	$10,275
Prop 1A of 2008: High-Speed Rail	9,449
Prop 55 of 2004 & Prop 1D of 2006: Education Facilities	2,442
Prop 84 of 2006: Safe Drinking Water	2,957
Prop 71 of 2004: Stem Cell Research	1,767
Prop 1E of 2006: Disaster Prep and Flood Prevention	1,819
Prop 46 of 2002 & Prop 1C of 2006: Housing	1,259
All other	3,240
Total	**$33,208**

The state generally goes to market to sell GO bonds twice annually—once in the spring and once in the fall. Bond structures are often tailored to meet market demand and investor appetite. This tailoring includes adjusting variables such as fixed and variable rates, call features and premiums, and various security enhancements. Bonds are sold in amounts necessary to meet expenditure needs plus an additional cash cushion to account for flexibility regarding how fast projects will expend funds and uncertainty about the timing of the next bond sale.

Paying GO bond debt is a significant General Fund expense; however, the use of bonds to accelerate capital projects is a commonly-used practice of government entities. State and federal tax exemptions for interest income received by investors ensure that GO bond debt is a low-cost financing alternative. To the extent bond costs do not exceed a government's long-term ability to fund other commitments, bonds allow the public to enjoy the benefits of infrastructure investment more quickly than would otherwise be the case. The LAO indicates that the state's debt service requirements will climb steadily over the next several years to about $7.3 billion in

2017-18. As a percent of General Fund revenues, however, debt service should remain at about the 6.0 percent level.

Voters approved over $40 billion in new bonds on the 2006 ballot, just prior to the national recession. The bonds have allowed the state to invest in infrastructure while the need for economic stimulus is most acute, borrowing costs are low, and construction procurement is favorable. Despite the benefits of bonds, they come with the cost of many years of debt service. A $1.0 billion bond generates annual bond debt costs of about $65 million over a 30-year period. That bond cost crowds out alternative expenditures over the life of the bond. The Legislature can prioritize or limit bond funding through the budget process as overall expenditures are prioritized. This question may be particularly acute as the economy begins to recover and interest costs climb as result of increased demand for capital.

Items Proposed for Discussion / Vote:

1. **Bond Sale and Cash Plan for 2013-14 (Governor's Budget Proposal):** The budget plan includes an assumption that $3.7 billion in GO bonds will be sold in the spring of 2013, and that $2.0 billion more will be sold in the fall of 2013. Among these are the planned sales for transportation and related capital facilities and for various education facility bonds. Subsequent to the Governor's Budget, the spring issuance was reduced to $2.7 billion. The issuances will comprise both bond originations and refinancings.

   Detail: As the state's cash situation deteriorated with the most recent recession, the Administration changed the methodology for managing bond cash. Prior to the recession, reserve cash funded project costs in advance of bond sales, and then bond sales replenished cash reserves. When reserve cash declined, the state had to instead sell bonds in advance of expenditures. Due to project expenditures occurring slower than anticipated at the time of bond sales, large bond cash balances developed—about $9.7 billion as of December 2011. Last year, the Administration implemented a plan to utilize commercial paper to aid cashflow, and reduce the need to carry large bond cash balances. Progress has been made to reduce bond cash, and the cash reserves have dropped to about $6.0 billion currently. At budget hearings, the Administration could be asked to discuss their management of bond proceeds, forecasts of project expenditures and the optimal level of cash balances. Cash balances are shown in the table below.

General Obligation Current Cash Proceeds
(Dollars in Millions)

Authorized Bond Program	Bond Proceed Cash November 2012
Prop 1B of 2006: Transportation	$1,026
Prop 1E of 2006: Disaster Prep and Flood Prevention	1,187
Prop 84 of 2006: Safe Drinking Water	951
Prop 1C of 2006: Housing	633
Prop 1D of 2006: Public Education Facilities	611
Prop 50 of 2002: Water Security	458
Prop 13 of 1996: Clean Water and Watershed	223
All others	916
Total	**$6,005**

Staff Comment and Questions: While funding for bond debt service is continuously appropriated, a broader discussion on GO bonds may be useful to understand the Administration's priorities and help inform future discussion on individual bonds and expenditure plans. The Administration should be prepared to discuss their overall plan for GO bonds in 2013-14. Individual bonds will be discussed in more detail by subject matter in this subcommittee and other subcommittees as hearings progress this spring.

Questions: *(1) Is bond cash sufficient to fund all bond projects appropriated by the Legislature, or are some projects on hold due to insufficient bond cash or other reasons? (2) Are cash expenditure projections for bond projects being met? If not, can planned 2013 bond sales be adjusted to reduce the General Fund debt service cost in 2012-13? (3) Does the Administration support appropriations for unissued bonds, or does the Administration want to curtail any bond programs to preserve General Fund resources? (4) The Treasurer recently indicated that bond refinancings have saved the state $200 million; have these savings been incorporated in the budget?*

Staff Recommendation: Informational item. Bring the issue back at a future time if the Administration substantially revises their bond plan as part of the May Revision.

2. **Infrastructure Financing and Debt Service Capacity (Governor's Budget Proposal):** The Governor's Budget proposes bond sales in the spring and fall of 2013. The issuance of authorized bonds on a consistent basis over the next few years would keep debt service requirements in the range of 6-7 percent of General Fund revenues. Beginning in 2015-16, debt service requirements as a percent of General Fund revenues would begin to drop without additional bond issuances. However, significant infrastructure needs are apparent throughout the

state which must be addressed through additional bond authorizations, on a pay-as-you-go basis, or some alternative means of financing.

Detail: The state's capital needs related to new infrastructure and maintenance are significant, and the state has struggled to keep up with the backlog of projects through the bond program. On the transportation side alone—a significant proportion of the total—the California Transportation Commission (CTC) has identified $538 billion in in total infrastructure needs, including $172 billion in highway and intercity rail needs. A transportation workgroup is expected to explore long-term funding options, including pay-as-you-go, as a means of financing needed projects. Over the last decade, pay-as-you-go provides about one-third of infrastructure spending.

In addition, the Administration will release the 2013 Five-Year Infrastructure Plan later this year. The plan is expected to lay out the Administration's infrastructure priorities for the next five years for major state infrastructure programs, including high-speed rail and other transportation projects, resource programs, higher education, and K-12 education. Given the state's increased debt burden and General Fund constraints, the plan will examine agencies' reported needs assessments, analyze the use of General Fund-backed debt, and explore alternatives to the reliance on voter-authorized GO bonds. The Legislature could balance the various options according to a matrix of considerations including financing costs, ease of implementation, project flexibility and assumed risk.

Staff Comment and Questions: The Administration should be prepared to discuss the affordability of the state GO bond plan and the ability of the state's General Fund to continue at the current level—or any future increased level—of debt service requirements given other demands on the General Fund. This additional debt could include the discussed water bond. It should also discuss the status of the infrastructure plan and the different types of financing options that are being considered. Finally, sequestration has occurred and there will be an impact of federal debt service subsidies through the Build America Bonds (BABs) program, the impact of which should be addressed by the administration or the Treasurer's Office.

> *<u>Questions:</u> (1) What is the status of the infrastructure plan? (2) Can the Administration address the options for funding that might be considered under the plan? (3) What affect, if any, will sequestration—or other upcoming potentially negative federal events—have on the state's debt service plans?*

Staff Recommendation: Informational item.

9620 Cash Management and Budgetary Loans

Item Overview: This budget item appropriates funds to pay interest costs on General Fund borrowing used to overcome cash flow imbalances during the fiscal year. Because receipts and disbursements occur unevenly throughout the fiscal year, the General Fund borrows in most years, even though each budget is balanced when enacted, and funds are repaid within the fiscal year. Interest is paid on both internal borrowing, such as short-term loans from special funds, and for external borrowing, such as Revenue Anticipation Notes (RANs). This item additionally pays interest costs for budgetary borrowing by the General Fund from special funds. Budgetary borrowing is across fiscal years and is scored as a budget solution, whereas cashflow borrowing is not counted as a budget solution, but conducted in order to maintain adequate cash reserves.

Budget Overview: This item appropriates funds for interest costs associated with cashflow and budgetary borrowing. The budget includes $150 million General Fund for the interest costs associated with two cashflow borrowing methods—$100 million for the RAN and $50 million for internal borrowing costs. The proposed amounts are conservative and based on budgeting sufficient funds to cover the uncertainty in interest rates and other factors. In addition, the budget includes $31.5 million in interest costs associated with the repayment of internal budgetary borrowing from special funds.

Items Proposed for Discussion / Vote:

1. **Cashflow Borrowing (Governor's Budget Proposal).** The Governor's Budget proposes both internal and external cashflow borrowing. Generally, internal sources are assessed first, and external borrowing is used to supplement internal sources. In order to supplement the state's internal borrowing within the budget year, the Administration has proposed a RAN initially sized at $7.0 billion. This provides an additional cashflow cushion to the existing availability of internal resources. Without the external borrowing, there would be insufficient cash reserves and other funds during the months of October, November, December and March. In addition, there would be only a narrow 'cushion' during several other months in the fiscal year.

   Background and Detail: Given that the state receives revenues on an uneven basis throughout the year, the state's cash position varies, with the typical low points occurring in July, October and November. Maintaining an adequate cash balance allows the state to pay its bills in a timely fashion. For the current year, the state issued Series A and B RANs in August, sized together at $10 billion. The RANs are payable in May and June and carry an expected interest cost of $48 million. With regard to internal borrowing, last year, an additional eight special funds were made eligible for cash borrowing, which provided about $865 million of new borrowable resources. The state also established a new cashflow tool in the form of the Voluntary Investment Program (VIP). This program provided an additional means to assure cashflow continuity by establishing a new account for voluntary participation by local governments, but it was not required in the current year. Another cash management tool of the state is the State Agency Investment Fund (SAIF) which attracts deposits from entities not otherwise required to deposit funds with the state. During the current year, there were deposits totaling approximately $1.7 billion combined from University of California (UC) and the California State University (CSU) systems.

An additional tool in managing cash is deferrals of payments within the fiscal year to higher education, K-12 education, local governments, and other entities. In recent years, flexible deferrals have been enacted in statutes that allow specified deferrals if necessary to maintain a prudent balance for bond debt and other priority payments. For the current year, there were deferrals allowed for K-12 education, higher education and local government payments. The fiscal impact of these deferrals varies from entity to entity depending upon their own cash positions. Fortunately, given the improvement in the cash status, no new education or other payment deferrals are incorporated in the budget.

Based on the cashflow statements of the Administration, the cash low-points will occur in July, October and November, when unused borrowable cash resources are estimated to be $3.7 billion, $4.3 billion and $4.0 billion respectively. By way of comparison, and reflective of the uneven flow of receipts and disbursements, the cash and borrowable resources in June of this year are estimated to be $11.0 billion.

Staff Comment and Questions: Maintaining an emphasis on cashflow borrowing from internal sources is sound fiscal policy that reduces the need for more expensive external borrowing. The Administration's proposal appears to be a suitable approach to cashflow management and the anticipated reduction in the size of external borrowing will reduce the state's interest costs. Nevertheless, the reduction in borrowing does result in a significant decline in the cash cushion during some months compared to the current year. The committee may want to receive additional details from the Administration regarding cashflow borrowing. The Administration should be prepared to address the cost of external borrowing, the timing of the issuance, and the adequacy of cashflow coverage.

> *Questions:* *(1) Current cashflow analysis in the budget year shows smaller margins in certain months than the current year; are the margins adequate? (2) What are the options for the state should the margins narrow further?*

Staff Recommendation: Informational item.

2. **Budgetary Borrowing Repayment Plan (Governor's Budget Proposal):** The Governor proposes to pay down $4.2 billion of the remaining $27.8 billion "wall of debt" in 2013-14. In addition, the Governor's multi-year budget plan proposes to

almost fully repay "wall of debt" obligations by the end of 2016-17. The amount remaining at the end of that period would be unpaid education and local government mandate costs, deferred Medi-Cal costs, and deferred state payroll costs, totaling approximately $4.3 billion. Assuming this plan is adhered to, the 2017-18 budget and ongoing budgets would be largely free of these debt pressures and expenditures would be more in line with annual revenues.

The amount of special-fund loans proposed for repayment in the Governor's Budget is $561 million, plus total interest costs of $31.5 million. The Administration indicates repayment of these loans is necessary to support 2013-14 activities of those departments that are paid for with the associated special fund resources. Interest is required on most special fund loans and is paid when the principal is repaid. Funds proposed to be repaid are listed in the table below.

Governor's Proposal for Repayment of Special Fund Loans
(Dollars in Millions)

Affected Department and Special Fund	Principal Amount
Justice—National Mortgage Special Deposit Fund	$100.0
Consumer Affairs—Real Estate Appraisers Regulation Fund	8.1
General Services—Public School Planning, Design and Construction Review Revolving Fund	15.0
Transportation—State Highway Account, State Transportation Fund	50.0
Energy Commission—Renewable Resource Trust Fund	20.0
Resources—California Beverage Container Recycling Fund	89.4
Resources—Glass Processing Fee Account	39.0
Resources—PET Processing Fee Account, California Beverage Container Recycling Fund	27.0
Agriculture—Department of Food and Agriculture Fund	15.0
Public Utilities Commission—Utilities Reimbursement Account	25.0
Public Utilities Commission—California High Cost Fund B Administrative Committee Fund	75.0
Public Utilities Commission—California Advanced Services Fund	75.0
Other Departments, Funds and Accounts	22.9
Total	**$561.4**

Background and Detail: Through budget actions over the last decade, the state has borrowed from special funds and deferred various payments in order to close budget deficits. By the close of 2010-11, the Department of Finance (DOF) indicates a total of $34.7 billion in loans and deferrals had accumulated and remained unpaid. This amount largely represents the debt overhang from prior year budgets adopted under the previous Administration. By 2012, this amount had been whittled down to $33.0 billion and by the end of the current year, is expected to be reduced further to $27.8 billion. Special fund loans constitute $4.1 billion of the remaining $27.8 billion “wall of debt” at the end of this year. The repayment of loans from special funds is discretionary. As long as the borrowing does not interfere with the activities that the special fund supports, the repayment of these loans is on a flexible schedule.

Some obligations included in the “wall of debt” have required repayment in specified years due to constitutional requirements or to scheduled bond debt service. Examples of rigid remittance requirements are a payment of $1.9 billion scheduled for June 2013 for ‘Proposition 1A’ local-government borrowing and annual Economic Recovery Bond (ERB) payments of approximately $1.5 billion through 2016-17. Other debt payments are more flexible, for example school payment deferrals and special fund loans can be repaid over time as the budget situation allows. The Administration indicates that the plan for paying off the wall of debt corresponds to the period that the temporary taxes are in place.

Staff Comment and Questions: Generally, decisions about special fund loans will be made in the budget subcommittees by subject-matter area, although the 9620 Budget Item should be made to conform. A high-level staff review of the proposed loan repayments and fund condition statement suggests some of the loans proposed for repayment could be deferred for additional budget savings in 2013-14, if necessary. Alternatively, some fund repayments could be adjusted such that loan repayments from other funds, such as transportation, could be accelerated. Some departments may have deferred capital projects or maintenance that can be accelerated by early loan repayments. Other departments may not have spending pressures, and funds from repaid loans may result in surplus reserves over a period of many years.

The committee may want to hold final determination on loan repayments until the May Revision when final revenue forecasts are known. The Administration should be prepared to discuss their overall plan for special fund loan repayment for the remainder of 2012-13 and for 2013-14.

> <u>*Questions:*</u> *(1) How did the Administration determine which loans should be repaid and which should be deferred? (2) When a decision was made to repay a certain special fund, how was the repayment amount determined? (3) Given significant “wall of debt” progress in other areas of the budget, why does the Administration propose to repay special funds loans in 2012-13 and 2013-14 beyond the level that appears necessary for certain special funds?*

Staff Recommendations: Informational item.

8860 Department of Finance

Department Overview: The Department of Finance (DOF) is the state's fiscal control agency and acts as the Governor's chief fiscal policy arm.

Budget Overview: The Governor Budget proposes expenditures of $69.2 million and 492.8 positions compared to expenditures of $68.7 million and 486.2 positions in the current year.

Item Proposed for Discussion / Vote:

1. **Direct Transfer Authority for Cost of Department of Finance Services (Budget Trailer bill):** The Governor's Budget proposes trailer bill language that would facilitate and expedite the ability of DOF's Office of State Audits and Evaluations (OSEA) to carry out financial, performance and compliance audits and evaluations, as well as special products. The proposed trailer bill would eliminate the requirement that DOF execute an interagency agreement for each project approved by the Department of General Services (DGS), and instead allow for so-called direct transfer authority to DOF.

   Background: OSEA conducts numerous important audits and studies throughout the years. Some of the more recent ones have involved former redevelopment agencies and their successor agencies, the Department of Parks and Recreation, the California Public Utilities Commission, Cal Fire, and various special funds. The activities are reimbursable, as required under statute, and OSEA charges the agencies and departments for direct and indirect costs of the services provided. Currently, the interagency agreement must be completed before OSEA begins work, which can add to delays in starting the project.

   Staff Comment and Questions: DOF notes that the process for entering into an interagency agreement can be lengthy—sometimes several weeks or months can elapse before one is in place. Collecting amounts owed following the activity is also cumbersome and administratively burdensome. Under the proposed language, OSEA would still agree on a scope of work with the agency or department and DOF indicates that it would work with legislative staff in scoping audits requested by the Legislature. OSEA has been called upon with increasing frequency in recent years, often for studies that need to be completed quickly.

   <u>Questions:</u> (1) Given that DGS is being eliminated as a participant in the OSEA activities, should there be another control point for the process? (2) Is there a need to formalize the process in terms of scoping or notification regarding the selected project?

   Staff Recommendation: Approve placeholder trailer bill language.

   <u>Vote:</u>

Control Section 35.5 General Fund Revenues Accrual Methods

Item Overview: Budget Control Section 35.5 defines total resources available to the General Fund for a fiscal year before any transfer to the Budget Stabilization Account for purposes of Paragraph (1) of subdivision (f) of Section 10, and subdivision (g) of Section 12, of Article IV of the California Constitution.

Item Proposed for Discussion / Vote:

1. **Net Final Payment Accrual Methodology (Governor's Proposed Budget Trailer Bill).** The Governor's Budget proposes making permanent the accrual method adopted as a part of the 2012 Budget Act. Specifically, the Administration proposes that the Legislature enact a budget trailer bill to codify permanently the use of this new accrual method. The proposed trailer bill would direct DOF to use the estimated net final payment accrual methodology for tax revenues accrued under any *initiative* measure enacted on or after January 1, 2012. In effect, the measure would require use of the "estimated net final payment accrual methodology" for initiative measures passed in 2012 or thereafter, including Propositions 30 and 39. This is consistent with how DOF treats revenue accruals in the Governor's Budget. The new accrual method for Propositions 30 and 39 and subsequent initiative tax changes means, for example, that each calendar year's Proposition 30 collections will be attributed in part to the fiscal year that ends on June 30 of that calendar year with the rest attributed to the fiscal year beginning on July 1 of that calendar year. For instance, a portion of tax year 2013 Proposition 30 revenues would be accrued to the 2012-13 fiscal year as the first fiscal year for 2013 tax collections, with the rest accrued to 2013-14 as the second fiscal year for 2013 tax collections.

   Background: In past years, in an effort to address budgetary stress, the state has shifted accrual methodologies for certain revenues, resulting in changes as to how revenues are attributed across fiscal years. The state's accrual methodology was originally adopted in 1966; however, in 2008, these rules were changed by shifting tax revenues that would otherwise have been attributed to 2009-10 to 2008-09, instead. Last year, as part of the Budget Act of 2012, Control Section 35.5 (e) directed that a significant portion of revenues derived from new tax laws enacted in 2012, including from Propositions 30 and 39, be accrued to 2011-12 instead of 2012-13 (even though the measures were passed after the conclusion of 2011-12). This approach is referred to by the administration as "net final payment accrual methodology." Accrual method changes, such as this one, do not change the amount of revenue collected or assumed to be collected by the state, but instead change the fiscal years to which revenue is attributed in the state's budgetary-legal basis accounting system.

   LAO Perspective: The LAO has recommended against the adoption of the proposed budget trailer bill and cited several factors, including added complexity of the state's budgeting system, especially Proposition 98 calculations, and increased chances of large forecasting errors. Nevertheless, the LAO recommends that, given the significant budgetary changes that would be required to undo the net final payment accrual method immediately, the Legislature authorize this accrual method in Control Section 35.5 in each annual budget act until a replacement accrual method is adopted. The office also has specific suggestions regarding adoption of an alternative accrual methodology.

Staff Comment: The Administration's proposal does not appear to treat revenues on a consistent basis with respect to accrual methodology, and has, as a means of delineation, employed a somewhat arbitrary reliance on the origin of the tax law change. In addition, as the LAO notes, the proposal complicates forecasting and revenue estimates and Proposition 98 calculations. These aspects are particularly problematic with respect to budgetary considerations subject to legislative deliberations. Leaving in place existing accrual methodology for the budget year, while embarking on a broader approach to accrual methods, would seem an appropriate approach. The committee should ask that the Administration present its trailer bill proposal and ask LAO to comment on the merits and drawbacks.

Staff Recommendation: Do not adopt the net final payment accrual methodology in the Administration's proposed trailer bill; adopt budget bill (BBL) language to allow for final payment accrual methodology until a suitable permanent approach is determined.

Vote:

7730 Franchise Tax Board

Department Overview: The Franchise Tax Board (FTB) is one of the state’s two major tax collection agencies and administers the personal income tax and the corporation tax programs, the largest and third-largest contributors to the state's revenue, respectively. The department also performs some non-tax collection activities, such as the collection of court-ordered payments, delinquent vehicle license fees, and political reform audits. The FTB is governed by a three-member board, consisting of the Director of Finance, the Chair of the Board of Equalization, and the State Controller. An executive officer, appointed by the board, manages the daily functions of the department.

Budget Overview: The Governor's Budget proposes expenditures of $750.2 million ($719.1 million General Fund) and 5,771 positions for FTB. This represents a continuation of substantial increase in support for the agency compared to the 2009-10 fiscal year. Expenditures grew from $533.1 million in 2009-10 due primarily to reinstating some of the budget reductions from earlier years as well as new programs. The budget reinstatements were made to reverse negative revenue impacts of the prior Administration’s statewide cuts and furloughs, which included the state's tax collection agencies. In addition, the budget calls for augmentations for specific tax compliance programs and technology improvements related to the department's revenue collection activities.

Items Proposed for Discussion / Vote:

1. **Departmental Reorganization (Informational Item):** Last year, as a component of the Governor's initiative to make government more efficient, the current budget includes two significant changes that will affect the department's way of doing business. First, it called for consolidating the activities of the Employment Development Department (EDD) that relate to tax collection (primarily personal income tax withholding and payroll tax administration) with FTB activities into a new California Department of Revenue (CDR). In general, this could make sense in an organizational context as well as increase the level of information exchanged among the various programs. Some concerns relate to the potential of impairment of activities during the consolidation and the ease with which activities of EDD can be split off from other functions that are not part of the consolidation.

   The second major change is to include this new CDR in the newly-proposed Government Operations Agency (GOA). The GOA would combine activities related to procurement, information technology, human resources and administration and include General Services, Human Resources, Technology, Office of Administrative Law, the Public Employees Retirement System, State Teachers Retirement System, State Personal Board, Government Claims Board, and DOR.

Staff Comment: The major reorganization is effective July 1, 2013 as part of the Governor's Reorganization Plan #2. The committee members may inquire of the department or DOF the procedures to be used for the consolidation and reorganization and the timeline for the process relating to the proposed CDR. In addition, the department should be prepared to discuss the advantages that may be realized in the reorganization. For example, the Governor's Budget incorporates an additional $3.8 million in tax collections by FTB and EDD as part of additional data sharing resulting from increased cooperation. The committee could inquire as to other opportunities either with EDD or the Board of Equalization (BOE), the state's other major tax collection agency.

Staff Recommendation: Informational item.

2. **Tax Gap Related Policies (Informational Item):** The tax gap is defined as the difference between what taxpayers should pay according to law and what is actually remitted. The tax gap is the result of non-compliance with the state's tax laws, either through intentional disregard or unintentional means. The presence of the tax gap puts an additional strain and burden on compliant taxpayers since, if all individuals and businesses complied, taxes for compliant taxpayers could decline and still result in generating the same amount of revenue for the state. The FTB estimates the current annual tax gap to be $10 billion ($8 billion personal income tax and $2 billion corporation tax)—or roughly 15 percent of total taxes that should be collected from these sources.

   FTB pursues various programs to narrow the tax gap. Some of these programs focus on taxpayer education and seek additional compliance from those who may not be aware of certain tax requirements. Other measures relate to enforcement efforts to improve compliance among individuals and businesses that chose not to comply with the state's tax laws. These measures result in additional revenue for the state that would otherwise not be received. Equally central to the core value of good tax collection practices is that such efforts make the tax system fairer to everyone by distributing the burden according to adopted laws.

   In general, the efforts and programs of FTB are designed to address the following components of the tax gap:

   - Non-filers—Entities that simply avoid filing required income tax forms.
   - Under-reporters/Over-reporters—Entities that under-report the amount of income or over-report income deductions or tax credits.
   - Non-Payers—Entities that file but do not remit tax owed.

   Tax enforcement and compliance has become increasingly driven by information, data, and technology over the last couple of decades. The FTB processes more than 15 million personal income tax returns and one-million business enterprise returns annually. Given the volume and complexity of tax returns, filings and programs, it has become imperative that tax agencies remain current in information technology in order to access and exchange information. FTB's operations are heavily reliant on effective storage and use of data from a variety of sources, in order to maintain adequate compliance and enforcement activities. The FTB has made significant progress in this area, and this continues to be a focus of its activities (see discussion under Enterprise Data to Revenue issue). These efforts can also have a positive impact on reducing the tax gap.

Staff Comment: The department should provide background information to the committee regarding the status of tax gap efforts. This should include results from discreet programs as well as general successes in narrowing the tax gap through increased data sharing and advances in technological capabilities. The LAO should provide comments regarding the department's efforts in this regard and any additional measures that the department could take to improve compliance.

Staff Recommendation: Informational item.

3. **Section 1031—Like-Kind Exchanges (Staff Issue):** California's income laws provide for "like-kind exchanges," which allow the owner of qualified business or investment property (such as a building or equipment) to sell the property and purchases other similar property. When the newly-acquired property is sold, the deferred gain on the original property is then subject to taxation. In this manner, the program acts as a means to defer the gain on the sale of property. Qualified property does not include property used for personal purposes (e.g., home or family car), property sold by a business (e.g., inventories), specifically excluded property (such as securities), and certain other types of property. California conforms to federal law with respect to this program.

   Program Detail: There are significant policy and revenue implications of the program. The like-kind exchange program facilitates exchanges of business assets and allows owners of exchanged property to keep the full value of exchanged property invested in their businesses. Without the program, some otherwise productive transactions might not be undertaken in order to avoid having any resulting gains subject to taxation. Thus, the program could facilitate a more efficient use of productive assets by allowing such exchanges to occur *ex tax*. By allowing investors to retain the lower basis in the property, the tax gains deferral in like-kind exchanges can increase the revenue loss of the "step-up" provision of the estate tax. The step-up provision allows the basis of inherited property to increase for tax purposes to its fair market value at the time of death of the original owner. In addition, if the property owner exchanges California property for non-California property, California may never tax the full amount of the gain on the California property because of the inability to ensure income tax compliance with respect to any gain on a sale by a non-resident. Like any other deferral, to the extent taxes are finally imposed, no consideration is given regarding the loss of the use of revenues between the time of the transaction and the date the taxes are paid.

Alternative Approaches: The loss of revenues due to compliance issues associated with out-of-state, like-kind exchanges is substantial. FTB indicates that if the like-kind exchange were limited to in-state exchanges, the revenue gain would be $110 million to $130 million annually. However, some analysts have raised the prospect that limiting like-kind exchanges to in-state properties may raise constitutional issues, in that it may result in disparate treatment of in-state and out-of-state businesses activity and interfere with interstate commerce.

Alternative means by which to address the tax avoidance associated with out-of-state like-kind exchanges have been suggested, including:

- **Holding Period.** Require a holding period on purchased or exchanged property. This would restrict flipping of investment property and reduce the attractiveness of tax avoidance.
- **Reporting Requirement.** Establish an annual reporting requirement for taxpayers who engaged in a like-kind exchange. Similar annual reporting is required of insurance companies regarding the transfer of certain assets, and reporting is required by some states.
- **Deposit Methods.** Institute withholding of capital gains taxes for like-kind exchanges. Alternatively, require the posting of a bond or allowing the state to establish a property lien.
- **Data Collection.** Pursue information and enforcement of like-kind exchanges with federal and state governments to track the event and location of capital gains realizations.

LAO Perspective: In prior years, the LAO has urged the elimination of the like-kind exchange either in whole or in part. As part of its review of the 2008-09 budget, LAO called for limiting the like-kind exchange to in-state properties only. Subsequently, as part of its 2009-10 budget analysis series, LAO recommended a total elimination of the like-kind exchange.

Staff Comment and Questions: This issue is not a proposal of FTB or the Administration. There is an active market of brokers putting together parties interested in like-kind exchanges in order to avoid or defer taxation. For example, see the listing for the “Professional Trade Association for Qualified Intermediaries under IRC Section 1031”, under the umbrella of the Federation of Exchange Accommodators. The like-kind exchange can happen repeatedly and need not be on a one-for-one basis; like-kind exchange of property only partially used for business is also allowed, although in this case only the gain related to the business portion of the property would be deferred. If California were to alter its treatment, depending on the approach, it could be out of conformity with federal law and potentially add substantial additional record keeping requirements for business. Separate property sales and purchase records would need to be maintained for state and federal purposes. FTB staff and LAO should comment on the policy and legal implications of either full elimination or partial elimination of like-kind exchanges, or other means of ensuring compliance. In particular, they should comment on advantages and disadvantages of alternatives to address non-compliance resulting from this program, including the holding period and reporting options identified above.

<u>Questions:</u> (1) What is the most efficacious approach California could pursue to stem the revenue loss from in-kind exchanges? (2) Is this approach potentially in conflict with Constitutional protections with respect to interstate commerce? (3) How would you assess the value of the reporting requirement--what is the likely compliance with this and what would be the enforcement options?

Staff Recommendation: Hold open and direct staff to pursue various options for tax compliance with respect to in-kind exchanges, including measures designed to collect the correct amount of tax related for out-of-state in-kind exchanges.

<u>Vote:</u>

4. **Civil Proceedings—Limit on Attorney Fees (Budget Trailer Bill):** The Governor's Budget proposes in a budget trailer bill to limit the means through which attorneys may be compensated in suits against the state involving taxation. The statutory change would affect taxes administered by both the FTB and the BOE. Under the bill, the provisions in the tax laws applicable to personal income tax, corporate franchise tax, and sales and use taxes, regarding prevailing party and reasonable litigation costs would be the exclusive means by which litigation costs and attorneys' fees may be awarded against the FTB and the BOE. These provisions would generally be extended to property taxation and other taxes and fees administered by BOE. The provisions would limit fees to $160 per hour (adjusted on the basis of changes in the California Consumer Price Index) unless the court determines that a special factor justifies a higher rate.

   Background: Current state law provides two methods for determining attorney's fees in tax related cases: the Revenue & Taxation Code (R&TC) which caps attorney's fees at an hourly rate, and the Code of Civil Procedure which uses a multiplier to determine attorney's fees. The proposed change in statute would place the state in virtual conformity with the federal government by limiting fees to those determined under the R&TC. Current federal law provides similar provisions to the state R&TC for capping attorney's fees for parties that prevail against the Internal Revenue Service (IRS). The Administration notes that over $2 million in fees have been paid on four cases over the last 10 years under the Code of Civil Procedure.

LAO Perspective: LAO notes that the proposal may foreclose the option of highly qualified tax counsel based on hourly fee limitation. In addition, it notes that the change may have an effect on limiting suits which have a legitimate public purpose.

Staff Comment and Questions: The proposal would not limit, in any way, the ability of taxpayers a taxpayer's right to file a claim for refund for any tax and only regulates the way they pay unrelated third parties seeking refunds on their behalf. In addition, the provisions would not disallow contingency fee structures, but rather address the fees that could be paid under such plans. The proposal apparently addresses a drafting error from 1983 when the state intended to conform to federal law requiring all attorneys' fees related to tax cases to be awarded under the R&TC with an hourly cap versus under the Code of Civil Procedure. Nevertheless, the fee limit could serve to discourage suits that may have a substantial public purpose in clarifying or correcting existing law and regulation.

Questions: *(1) How was the $160 hourly fee limit determined? (2) Is this below the standard for quality tax counsel, and if so, should the fee limit be increased? (2) What might be the special circumstances under which this fee could be increased by the courts? (3) Is this the means by which suits that have a public purpose would still be able to be brought?*

Staff Recommendation: Hold open and direct staff to work with Administration in potential refinements to the proposed trailer bill.

Vote:

5. **Enterprise Data to Revenue Project (Governor's Budget BCP#1).** FTB processes more than 15 million personal income tax returns and one million business enterprise returns annually. Its operations are heavily reliant on effective storage and use of data from a variety of sources. This request is for a third year of funding for its Enterprise Data to Revenue (EDR) Project, which will address the agency's return processing and utilization of data and connect various systems. The request calls for $152.1 million General Fund and 184 permanent positions in 2013-14. The request includes conversion of 26 positions associated with the project from limited-term to permanent. In addition, the proposal includes a placeholder for the department's project needs in 2014-15 of $87.6 million and 36 positions. Of the $152.1 million in 2013-14, $133.5 million is for a vendor payment (for 2014-15, the vendor payment is $68.5 million). EDR is a fixed-price, benefits-funded project in that timing of the vendor payment is contingent on the state receiving additional revenues attributable to the project. Because of flexibility inherent in the contract structure, FTB is requesting encumbrance and expenditure authority for a portion of the 2013-14 vendor payment until 2014-15.

Anticipated revenue attributable to EDR is $261.6 million in 2013-14 and $684.6 million in 2014-15.

Detail of Project: EDR will replace several older FTB information technology systems and streamline other existing systems. Over the long term, the project is expected to generate and safeguard significant state revenues in the high hundreds of millions of dollars. As a result of certain components coming on-line, the project and related activities generated $7.5 million in revenues in 2009-10, $25.4 million in 2010-11, and $115.7 million in 2011-12. The amounts projected for each of these years were $3.8 million, $13.7 million and $65.3 million, respectively. Total cost of the project through 2017-18 is estimated to be $689.9, with approximately $398.9 million payable as a vendor payment. Total revenue generated by the EDR project over this period is expected to be roughly $4.7 billion, for a benefit cost ratio of 6.8:1.

The continuation of the EDR project is expected to fund the technology-intensive portion of the project. FTB indicates that the initial revenues generated by the EDR project were primarily from adding staff to process the current backlog of business entity returns and begin collection correspondence in order to accelerate revenue. Beginning in 2011-12, substantial revenues were generated by the EDR project proper.

Main Goals: The EDR Project has three major goals. First, it seeks to capture all tax return data in an electronic form. Second, the project will integrate the various existing "siloed" tax databases at FTB into a data warehouse. Third, the project will enable FTB to add third-party data (for example, county assessor data) to its data warehouse. The FTB asserts that the EDR Project will allow it to substantially improve detection of underpayment and fraud in order to collect taxes from those who are not paying the full amount that they owe. In addition, FTB indicates that the project will enable it to improve service and give taxpayers better access to their tax records.

Project Components: The project includes the following improvements to FTB's systems that process personal income tax and business entity tax returns:

- An underpayment modeling process that would be integrated with the Accounts Receivable Collections System and Taxpayer Information System.
- An enterprise data warehouse with data search and analysis tools.
- A taxpayer records folder that is accessible to the taxpayer and allows taxpayers and FTB staff to access the information.
- Re–engineering of existing business processes—including imaging of tax returns, data capture, fraud and underpayment detection, tax return validation, filing enforcement, and other audit processes—and integration of these enhanced business processes with FTB's existing tax systems.
- Improved business services at FTB such as address verification, issuance of notices, and a single internal password sign-on for its IT systems.

Benefits-Funded Approach: FTB indicates that it plans to finance the EDR Project using a benefit-funded approach. Contractor payment for system development and implementation will be conditioned on generating additional revenue that will more than cover the cost. This approach is intended to protect the state and also give the contractors a strong incentive to develop the project in a manner that produces significant revenue quickly. The FTB has used this approach previously. FTB's benefit-funded approach makes use of revenue gains from reducing the business entity backlog to more than offset costs in 2009-10 through 2012-13. Although these gains could be accomplished regardless of whether project development goes forward, it makes sense to move forward now because cleaning up the backlog is a necessary condition to efficient project development. In subsequent years, the estimates in the project's Feasibility Study Report (FSR) indicate large increases in annual revenue gains that would be more directly attributable to the IT project. From 2011-12 through 2015-16, annual revenue gains increase from $115.7 million to $1.1 billion, while IT project implementation costs increase from $37.0 million in 2011-12 to a peak of $147.6 million in 2013-14 and then decline to $54.3 million by 2015-16. The method of financing EDR is similar to that used by the Employment Development Department for certain technology projects.

Staff Comment: The net benefit of this project (as estimated in the FSR) ramps up quickly. As noted above, the project began to produce significant net revenues starting in 2011-12. The FTB has among the best track records in California state government for the successful development and implementation of major information technology projects. FTB projects have experienced some delays and cost increases in certain phases, although these problems generally have not prevented successful completion of project phases. Generally, the project has come on-line faster than anticipated. Existing Supplemental Report Language requires FTB to report to the Legislature when revenue, costs, scope or schedule variances exceed 10 percent. The committee may ask the LAO and the California Technology Agency (CTA) to comment on the project.

Staff Recommendation: Hold open.

<u>Vote:</u>

6. **Central Processing Unit Capacity Increase (Governor’s Budget BCP#2):** The FTB is requesting one-time funding of $3.6 million in 2013-14 and $700,000 on an ongoing basis beginning in 2013-14 to increase processing capability, memory storage and software upgrades on FTB’s mainframe computing system to meet workload growth projections through 2014-15. The request is pursuant to a feasibility study report and approved by the State and Consumer Services Agency and California Technology Agency (CTA).

Background: FTB is responsible for maintaining the mainframe environment so the EDR system can be implemented. The department indicates that workload growth projection will exceed the CPU capacity in 2013-14, with demanded needs of 104 percent. Industry standards recommend operating at 90 percent of capacity. As a result, backlog of required reports and data operations are likely to occur with increased response times and a reduction in services. In terms of workload increases, these have reportedly been across the board over the last few years. For example, for personal income tax (PIT) and corporation tax (CT) programs, the workload measure in million instructions per second (MIPS) has grown from 988 in 2008-09 to a projected 1,381 in 2013-14—an increase of 40 percent over the four years.

Staff Comment: The proposal is a necessary investment in department technology, especially in view of additional data demands that will be placed on the CPU by the EDR system. The committee may want to ask the department about the expectations of the how long the investment will satisfy increasing data and information technology demands in the state.

Staff Recommendation: Approve the budget request.

Vote:

0860 Board of Equalization

Department Overview: The State Board of Equalization (BOE) is comprised of five members—four members each elected specifically to the board on a district basis and the State Controller. The BOE administers the sales and use tax (including all state and local components), oversees the local administration of the property tax, and collects a variety of excise and special taxes (including the gasoline tax, insurance tax, and cigarette and tobacco products taxes) and various fees (including the underground storage tank fee, e-waste recycling fee, and fire prevention fee). The BOE establishes the values of state-assessed property, including inter-county pipelines, railroads, and regulated telephone, electricity, and gas utilities. The BOE also hears taxpayer appeals of FTB decisions on personal income and corporation taxes.

Budget Overview: The Governor's budget proposes resource support of $555.9 million ($313.5 million General Fund), and 4,847 positions for the BOE in fiscal year 2013-14. The budget proposes a total funding increase of $28.7 million (5.4 percent), and a General Fund support increase of $16.3 million (5.5 percent), compared with spending estimates for the current year. Proposed staffing in the budget would increase by 135 positions (2.8 percent) from the current-year estimate.

Items Proposed for Discussion / Vote:

1. **Enhancement of E-Services (Governor's Budget BCP#1):** The Governor's Budget proposes $950,000 ($690,000 General Fund) and 4.0 limited-term positions in 2013-14 and 2014-15 to make enhancements to the e-registration system. The additional staff and resources will pay for enhancements to allow taxpayers to register online with more ease and make account maintenance adjustments that are currently handled by BOE staff.

   Background: Additional funding for the department's electronic services expansion has allowed for implementation of a new registration system, electronic filing, and online requests for extensions, relief of penalty and declarations of timely mailing. The BOE expects the savings resulting from the new system to be $13.42 million by the end of 2013-14. Savings from the system for 2008-09 through 2013-14 were or are expected to be redirected. The next step in the electronic services process is to allow taxpayers to make changes to their accounts on-line, including changes in business location, mailing address, business name, officer information, e-mail addresses, and phone numbers.

   Staff Comment and Questions: The advantages of electronic services can accrue to taxpayers by increasing convenience as well as reducing costs. BOE indicates that significant savings have occurred through it electronic services efforts, totaling $53.6 million over the five year period ending 2013-14. This is largely through a reduction in staffing resources that are necessary for administration. The committee may inquire as to whether additional reductions in the department's real estate footprint should not also occur. As part of the proposal, BOE notes that the accounts receivable inventory continues to be high and that the redirection of resources could generate an additional $12.9 million in 2013-14 and $17.5 million annually thereafter. This could be accomplished through the redirection of 24.5 positions. This would reportedly have an impact on the identification of future audit leads.

<u>Questions:</u> (1) To what were the savings derived from the electronic services expansion redirected? Were all these savings diverted to revenue producing activities? (2) Could the savings from the project be diverted to the accounts receivable inventory? (3) Can the state expect to realize savings on the real estate side from increased e-services? (4) Are there expected to be any changes (plus or minus) in the district satellite offices as a result of expanded electronic services, or has this been discussed?

Staff Recommendation: Approve resources for two-year limited-term positions to perform electronic services modifications and redirect 24.5 positions to focus on accounts receivable activities in 2013-14 and realize an additional $12.9 million in revenue. Adopt budget bill language (BBL) requiring the department to report to the fiscal committees of the Legislature on the impact of the redirection on audit leads by March 1, 2014, in conjunction with budget hearings.

<u>Vote:</u>

2. **Fuel Tax Swap Refund Workload (Governor's Budget BCP#2).** The Governor's Budget proposes resources for continued processing of workload associated with the fuel tax swap that replaced the sales tax on gasoline with an excise tax calibrated to result in an equivalent amount of revenue. The proposal would convert two tax auditor positions from limited-term to permanent and reclassify two tax technician positions to tax auditor positions. The positions are engaged in refund claims made under the diesel fuel tax whose workload has been affected by the fuel tax swap.

Background: The fuel tax swap eliminated the sales tax on gasoline and increased the excise tax by an amount that each year will generate an equivalent amount of revenue. The fuel tax swap also increased the sales tax on diesel fuel to provide additional funding for mass transportation (which had been eliminated by virtue of the elimination of the sales tax on gasoline). The mechanism requires ongoing monitoring, reconciliation and refund operations to maintain revenue neutrality and ensure consumer protections.

Staff Comment: Staff has no concerns with the proposal.

Staff Recommendation: Approve budget request for workload associated with fuel tax swap.

Vote:

3. **Joint Operations Center Ensuring Fuel Tax Compliance (Governor's Budget BCP#3):** This proposal represents a request to continue BOE's participation in a program that relates to compliance with California's fuel tax law and the collection of program revenues. The proposal continues the agency's participation in the Joint Operations Center (JOC) project for national fuel compliance, which is intended to reduce fuel tax evasion for the participating states. The program provides staff, data and expertise from participating states and the federal government to identify under-reporting, non-reporting and trends in tax evasion.

   Background and Detail: The proposal calls for the permanent funding of two business tax specialists that are currently limited-term and expire at the end of 2012-13. The source of annual funding is $300,000 from Federal Highway Administration funds. JOC has established a National Data Center and is in the process of integrating California data into the national database. In 2009, BOE began the process of analysis and investigation of leads being generated by the data center. In the ensuing years, JOC put its operations into effect and is receiving and combining data from state, federal and private party sources. Analytical tools are being used to identify anomalies, inconsistencies and omissions in the data, and generate leads for JOC audit teams to pursue. Audit teams are currently combining state and federal resources to conduct joint audits and investigations.

   Staff Comment and Questions: BOE is committed through a memorandum of understanding to two full-time staff positions. The operations are of direct benefit to the state and, indirectly, through apportionment of federal dollars collected through the program.

   Questions: *(1) Was BOE's JOC participation affected in any manner by the limited-term nature of the funded positions?*

   Staff Recommendation: Approve positions as three-year, limited-term positions.

   Vote:

4. **Narrowing the Tax Gap (Informational Issue):** The tax gap is defined as the difference between the amount of tax lawfully owed and the amount actually collected. Both BOE and FTB have estimated tax gap amounts over the last few years. BOE estimates the current gap for taxes that it administers at approximately $2.3 billion in lost revenues annually due to noncompliance, with General Fund reductions well in excess of about $1.0 billion annually. The major components of the tax gap are: (1) use tax liabilities of businesses and individual

consumers; (2) tax evasion by non-filers; and (3) under-reporting and nonpayment by registered taxpayers.

BOE has a number of programs—largely through the sales and use tax program—that are aimed at reducing the size of the tax gap. Some of these are designed to increase voluntary compliance and focus on education and outreach efforts to inform consumers and businesses regarding their tax collection and remittance obligations. In other cases, tax gap efforts are focused more on the compliance and enforcement activities, such as the Statewide Compliance and Outreach Program. BOE has a number of additional tax gap initiatives currently in place. These programs include more effective use of software applications, utilizing North American Industry Classification System (NAICS) codes, investigating misuse of resale certificates, and conducting special audits of auto auctions and gas stations. These programs are generally outlined in BOE's report to the Legislature on compliance and audit activities provided in December of each year. In addition, this report is to include information regarding BOE's Enhancing Tax Compliance Program. Current tax gap activities and revenue impacts are listed below:

Board of Equalization Tax Gap Initiatives
(Dollars in Millions)

Tax Gap Program	2011-12 Estimated Revenue	2011-12 Actual Revenue
US Customs	$14.4	$9.4
Agriculture Station Inspection	31.9	36.0
AB4X 18 Qualified Purchaser	36.7	51.3
Statewide Compliance and Outreach	34.5	84.0
Instate Service	37.4	37.9
Tax Gap II	NA	NA
Out of State 1032 Audits	11.0	34.3
Enhancing Tax Compliance	58.1	132.4

BOE has had a tax gap strategic plan in place since 2007. In bringing the components of the plan into operation, BOE has initiated a number of specific programs—including those outlined above. BOE staff should describe for the committee the results of its tax gap initiatives to date, the overall success of the program, and any impact of budget reductions on strategic planning for its Tax Gap initiatives, including the impact of the personal leave program.

Staff Comment: The department should outline its current approach to narrowing the tax gap, and in particular, its progress in coordinating with other state agencies—as well as other states—in these activities. The committee may want to pursue questions relating to audit selection and any new tax gap programs that are currently being designed or pursued, including those identified above.

Staff Recommendation: Informational item.

5. **Clarifying and Reconciling the "Triple Flip" (Budget Trailer Bill):** The Governor's Budget proposes budget trailer bill language that clarifies existing statutory language regarding the so-called "triple flip,' which provided for the simultaneous reduction of local sales taxes and increase in property taxes to local governments in order to provide for a dedicated payment stream for the Economic Recovery Bonds (ERBs).

   Background: As part of the previous Administration's proposed budget "workout," the state issued voter-approved ERBs in the amount of $15 billion. In order to establish security on the bonds, legislation provided for a dedicated sales tax funded by a shift of ¼ cent local sales tax to the state. Local governments were compensated on a dollar-for-dollar basis by an increase in property taxes from Educational Revenue Augmentation Fund (ERAF) resources that would otherwise have gone to K-12 education. Local education, in turn, is made whole by an increase in the state minimum funding guarantee under Proposition 98. The "triple flip" is in place until the bonds are retired (estimated to be 2016), after which point, the ¼ cent sales tax will revert to local governments, property tax shifts from ERAF to local governments will cease, and the General Fund payments to local education will decline by an amount equal to the reinstated property tax revenues.

   Detail: Sales taxes are distributed to local governments three months after collection, which amounts are the basis of the ERAF property tax shift to compensate local governments for the ¼ cent sales tax reduction. Thus, during a fiscal year, the amounts actually distributed to local governments correspond to a period of time that includes one-quarter of the prior fiscal year and three-quarters of the current fiscal year. The original legislation was designed to hold local governments harmless during the period the bonds are outstanding. However, because of the three month lag period between the collection of the sales tax and distribution to local governments, local governments (under the current language) will come up short in the amount of one-quarter's worth of revenue. This is because, when the "triple flip" ends, the prior quarter's revenue is to be allocated to local governments as a final shift. But under the timing of distribution, this distribution actually would correspond to the amount collected in the prior quarter, *minus one*. Because this lag was not incorporated in the original language, the Administration proposes language that, after the ERBs are paid-off, would compensate local governments for the final two quarters of sales tax from the special ¼ cent sales tax.

   Staff Comment: There is no disagreement that the intent of the "triple flip" was to hold local governments harmless, and it is apparent that the current language is flawed in this regard. The Administration has proposed language that attempts to address this flaw, and the LAO has indicated that there may be further clarity that could be added to the proposed language. The language also needs to clarify the timing of sales tax shifts such that the total state and local sales tax remains constant and the restatement of the local ¼ sales tax does not overlap with the state's ¼ cent sales tax.

Staff Recommendation: Approve placeholder trailer bill language and direct staff to work with the Administration in refining language to achieve stated purposes and intent.

Vote: