Senate Budget and Fiscal Review—Scott D. Wiener, Chair

SUBCOMMITTEE NO. 4 Agenda

Senator Christopher Cabaldon, Chair
Senator Roger W. Niello
Senator Lola Smallwood-Cuevas

Thursday, April 24th, 2025
9:30 a.m. or upon adjournment of session
State Capitol – Room 113

Consultants: Elisa Wynne and Jessica Uzarski

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ITEMS FOR VOTE ONLY

7730 FRANCHISE TAX BOARD

Issue 1: AB 518 Data Sharing for CalFresh

Budget Proposal. The Governor's budget proposes an augmentation of $161,000 (General Fund) and one permanent position in 2025-26 and $154,000 (General Fund) in 2026-27, and ongoing to implement Assembly Bill 518 (Wicks, Chapter 910, Statutes of 2024) by facilitating the distribution of data to California Department of Social Services (CDSS) in accordance with federal and state laws and FTB's policies and procedures.

Background. Among its provisions, AB 518 authorizes the FTB to share data with the California Department of Social Services (CDSS) for the purpose of improving the administration of CalFresh, increasing CalFresh participation, measuring the impact of CalFresh, and increasing access to critical public health and poverty-alleviating services and other services and benefits available to low-income individuals. Existing California law permits the Franchise Tax Board (FTB) to release individual tax information to specific state agencies. Agencies must have a specific reason for requesting the information, including investigating items of income disclosed on any return or report, verifying eligibility for public assistance, locating absent parents to collect child support, or locating abducted children.

Existing federal law establishes the Supplemental Nutrition Assistance Program (SNAP), known in California as CalFresh, under which supplemental nutrition assistance benefits allocated to the state by the federal government are distributed to eligible individuals by each county. Existing law also authorizes the California Department of Social Services (CDSS), under CalFresh provisions, to administer outreach programs and adopt rules and regulations requiring counties to conduct outreach programs to the extent permitted by federal law and eligible for federal financial participation.

AB 518 requires FTB to partner with CDSS to identify data-sharing opportunities, and to provide data where appropriate and as supported by statute. This work requires both external engagement with CDSS and internal coordination between FTB's business areas.

Staff Recommendation. Approve as Budgeted.

7600 DEPARTMENT OF TAX AND FEE ADMINISTRATION (CDTFA)

Issue 2: Centralized Revenue Opportunity System (CROS)

Budget Proposal. The Governor's budget requests $9.3 million in each of 2025-26 and 2026-27 from a variety of fund sources ($4.9 million General Fund each year) for the Centralized Revenue Opportunity System (CROS) at CDTFA. The request includes $6.1 million in contract services for maintenance and operations (M&O) and $3.2 million for the GenTax Software License.

Background. The CDTFA administers California's sales and use, fuel, tobacco, alcohol, and cannabis taxes, as well as a variety of other taxes and fees that fund specific state programs.

The CROS Project (Feasibility Study Report Project 0860-094) is an information technology modernization effort that has enabled the CDTFA to expand tax and fee payer services, to improve the efficiency and effectiveness of its operations, and to enhance its ability to generate increased revenues reducing the tax gap.

CROS is a tax collection and distribution information technology system approved in 2011 and designed to improve the efficiency and effectiveness of the CDTFA's operations, expand tax and fee payer services, and enhance the CDTFA's ability to generate increased revenues. On August 30, 2016, the CDTFA completed the CROS Project's Procurement Phase and signed an agreement with FAST Enterprises Inc. (FAST) to implement its commercial off-the-shelf software solution, GenTax, as the CROS Solution. GenTax is specifically designed for integrated tax administration and provides full functionality for processes such as registration, returns, payments, refunds, collections, revenue accounting, audit, correspondence, imaging, analytics, and workflow.

Given that CROS was implemented using GenTax, a proprietary commercial off the shelf software, CDTFA will need to maintain vendor support to assist with program updates and changes to the system. CDTFA contracts with FAST for maintenance and operations costs on a 2 year period, and the current contact ends June 30th 2025. Software licensing agreements are renewed on an annual basis.

The CDTFA requests $9.3 million for OE&E for 2025-26 and 2026-27.

- $6.1 million annually for maintenance and operations costs (Contractor Services)
- $3.2 million software licensing.

Staff Recommendation. Approve as budgeted.

ITEMS FOR DISCUSSION

8780 MILTON MARKS LITTLE HOOVER COMMISSION

Issue 3: Commission Overview

Background. The Little Hoover Commission, formally known as the Milton Marks "Little Hoover" Commission on California State Government Organization and Economy, is an independent state oversight agency created in 1962. The Commission's mission is to investigate state government operations and policy, and to make recommendations to the Governor and Legislature to promote economy, efficiency and improved service in state operations. In addition, the Commission has a statutory obligation to review and make recommendations on all proposed government reorganization plans.

The Commission has broad and independent authority to evaluate the structure, organization, operation and function of every department, agency and executive branch of state government, along with the policies and methods for appropriating and administering funds. Unlike fiscal or performance audits, the Commission's studies look beyond whether programs comply with existing statutes and regulations. They instead explore how programs can and should function today and in the future. In conducting its work, the Commission focuses on how the state may improve outcomes of its programs, increase government transparency, reduce spending without sacrificing services, eliminate duplication or wasteful practices, and consolidate services or abolish, among other things.

As part of its duties, the Commission also plays a direct role in the Governor's reorganization plan process. The Governor has the authority to examine the organization of executive branch agencies and determine what changes may be necessary to promote more efficient and effective government services. The reorganization process can be used to consolidate, transfer or abolish programs and agencies. The process can be used to create new agencies, but the process cannot be used to create new functions. The law requires the Governor to submit any reorganization plan to the Little Hoover Commission "at least 30 days prior" to submitting the plan to the Legislature. The Commission's role in the reorganization process is only advisory. Its conclusions and recommendations are not binding on the Governor or the Legislature. The Commission reviews the plan and submits a report to the Governor and the Legislature within 30 days of the plan being submitted to the Legislature. The Commission conducts one or more public hearings, providing a forum for affected agencies, constituencies and interest groups. In addition to invited witnesses, the Commission hears testimony from other interests or members of the public.

The Commission is funded through an annual General Fund of roughly 1.4 million per year, and has 7 positions estimated as of the 2024-2025 Budget.

0971 California Alternative Energy And Advanced Transportation Financing Authority (CAEATFA)

Issue 4: Position Authority Augmentation

Budget Proposal. The Governor's budget includes 7.0 permanent positions for California Alternative Energy & Advanced Transportation Financing Authority (CAEATFA) using existing funding from a 2022-23 Budget Change Proposal which provided support and technical assistance for the California Hub for Energy Efficiency Financing (CHEEF) program. The proposal notes that increased staffing resources will enhance the support for CAEATFA's demanding infrastructure needs. All requested positions will be funded with existing appropriation authority.

Background. To assist the State of California's ambitious renewable energy efficiency goals, the California Public Utilities Commission (PUC) authorized the establishment of the California Hub for Energy Efficiency Financing (CHEEF) program in 2013 to help leverage ratepayer and private financing by using new and innovative strategies to attract and leverage private capital.

The CHEEF financing pilot programs were established to "test new and innovative strategies to help leverage ratepayer and private financing to assist in achieving energy efficiency goals. The CHEEF programs focus on attracting and leveraging private capital, given the challenge in meeting the State's energy efficiency goals using traditional approaches of IOU rebates and incentives. The CHEEF creates a centralized platform serving as an open-market infrastructure to encourage additional private capital investment for energy efficiency and demand response measures. To the extent the funding source allows, the CHEEF programs support the state's decarbonization goals by facilitating the adoption of heat pump technology for air and water heating in existing buildings, while also lowering costs and expanding access to capital for Californians.

The CHEEF program has multiple market sectors that are growing (GoGreen Home, Business and Multifamily), and this requests notes that the CHEEF program no longer has the staffing level needed to sustain and accommodate the growth. The CHEEF program is experiencing a surge in consumer and lender participation. In direct relation to this increase, the administrative support for this program has become more complex and demanding. Additionally, CAEATFA has received $30 million in additional funding from the California Energy Commission (CEC). The department anticipates receiving additional funding from the federal National Clean Investment Fund (NCIF) to implement the expansion of financing for green energy upgrades, which is in alignment with the current CHEEF program.

CAEATFA notes that the current 19 permanent positions allocated to support the program is inadequate to meet the growing needs and demands of the program. An additional 7.0 positions beginning in 2025-26 would support the continuity of operations and address the steady increase of administrative support activities related to the CHEEF programs as well as any additional new program(s). The requested positions will use existing funding authority approved from a 2022-23 Budget Change Proposal. The 2022-23 BCP included $27.4 million for 2022-23 through 2026-27, and requested five permanent staff positions. CAEATFA proposes to fund the requested new positions by redirecting approximately $1,347,000 currently used for the Electric & Gas Industries

Association (EGIA) contract. The activities covered under this contract would be moved "in-house" to the new CAEATFA staff.

According to CAEATFA, the increased staffing will allow the time for programmatic and monitoring of the process, bringing visibility to any issues the lenders or borrowers may have, the feasibility of the program both fiscally and administratively, and the positive outcomes the programs are creating. The positions requested will execute various permanent workloads, including marketing, research, position control, data analyses, contracts, invoices, processing, quality assurance, etc.

Staff Recommendation. Hold Open.

0984 California Secure Choice Retirement Savings Board

Issue 5: CalSavers Informational Update

Background. The CalSavers Retirement Savings Program (CalSavers or Program) is overseen by the CalSavers Retirement Savings Board (Board) chaired by the State Treasurer and provides a retirement savings program for private-sector workers who lack access to an employer-sponsored retirement savings plan. Employers that do not offer a qualified retirement plan, and have at least one employee are required to facilitate CalSavers for their employees by specified deadlines or face penalties for noncompliance. The Program is voluntary for employees, but is operated on an automatic enrollment opt-out basis. Individuals can participate through their employer or on their own and can choose their contribution rate, change their investments or opt out at any time.

To date, loan funding of $16.9 million was been drawn down to support the program. CalSavers is currently in its rollout and scaling-up phase, and General Fund support of the program was anticipated when the program was initiated. The request notes that program growth depends on employer compliance and since its inception, a number of factors have slowed implementation, including legislative expansion of the program in 2022 to include employers with as few as one employee, an employer compliance deadline extension, a postponement of the imposition of employer penalties for non-compliance, and slower than anticipated growth due to the COVID-19 pandemic and other factors.

Program costs and revenue will be determined by the number of employers participating in the Program, the number of employees participating in the Program, the contributions made by participants into the Program, and the investment return earned on those contributions. The most recent projections from CalSavers provide for continuous growth over the loan period as employers come into compliance, and employees opt-in to the program. As of December 31, 2024, 145,839 employers have registered with CalSavers, and of these 55,459 have started payroll deductions. At this same point in time, there are 539,110 funded accounts, with an average funded account balance of $2,061.

The 2024-25 Budget Act included a General Fund loan of $12 million ($2 million annually for fiscal years 2024-25 through 2029-30) to provide resources for the Board and the CalSavers Retirement Savings Program (Program) to continue to operate, including funding for existing staff, employer compliance enforcement services through the Franchise Tax Board (FTB), external consultants, and marketing, administrative, and overhead costs

Staff Recommendation. Information Only

7600 DEPARTMENT OF TAX AND FEE ADMINISTRATION (CDTFA)

Issue 6: Tobacco Programs and AB 3218 / SB 1230 Implementation

Request. The Governor's budget includes $3.5 million in 2025-26 and $5.5 million in 2026-27 and $3.3 million annually thereafter from the Cigarette and Tobacco Products Compliance Fund (Compliance Fund) for CDTFA to implement AB 3128 (Chapter 849, Statutes of 2024) and SB 1230 (Chapter 462, Statutes of 2024), which enact the Unflavored Tobacco Product List (UTL) and include enforcement authority for flavored tobacco products and tobacco product flavor enhancers. Resources for implementation work of $3.3 million in 2024-25 and $2 million in 2025-26, in addition to this proposal, have been identified and are able to be absorbed by CDTFA.

CDTFA notes that they will evaluate the actual impact resulting from the legislation, particularly regarding enforcement, and in the future will recommend and request the necessary resources such as fee adjustments and additional spending authority.

Background. California's existing law, SB 793 (Chapter 34, Statutes of 2020) prohibits tobacco retailers or any of their agents or employees, from selling, offering for sale, or possessing with the intent to sell or offer for sale, a flavored tobacco product or a tobacco product flavor enhancer. The CDTFA is not currently authorized to seize flavored tobacco products unless excise taxes have not been paid, nor does CDTFA currently have access to a comprehensive list of products to identify unflavored tobacco products.

AB 3218 and SB 1230 provide the authority for CDTFA for inspections, seizure and destruction of flavored tobacco products, imposition of fines and penalties, and other enforcement related activities. The legislation simplified enforcement by deeming any product not on the Unflavored Tobacco List as flavored and requiring the Attorney General to create a UTL to post on their website by December 31, 2025. Implementation of AB 3218 and SB 1230 will impact nearly 30,000 cigarette and tobacco account holders, including retailers, wholesalers, and distributors, and will provide CDTFA with the authority to properly implement and administer the mandate of AB 3218. The hazardous waste destruction component of seizing illegal products is the costliest part of this process. The destruction process involves destroying illegal product, through an external vendor, four times a year at two different warehouses.

CDTFA noted in its analysis of AB 3218, that a combination of lower-than-expected penalty revenues and the contract requirements necessary to destroy the seized products, could create pressure to increase licensing fees or obtain other General Fund support to keep this program operating and the Compliance Fund solvent. While AB 3218 allows for a penalty per individual package, it is unclear how much revenue will be generated. Since any additional revenue is unknown, the costs related to this work create a structural imbalance (expenditures exceed revenues) in the Compliance Fund.

Legislative Analyst's Office (LAO) Comments and Recommendation.

The LAO reviewed CDTFA's Tobacco Programs in a post on their website on February 14, 2025 and noted that in general, tobacco tax revenues have declined more rapidly than expected based on previous trends. The LAO notes that since the flavor ban revenues have declined much faster, from $1.84 billion in 2021-22 to $1.6 billion in 2022-23, then to $1.35 billion in 2023-24 (not including the new tax on electronic cigarettes). This suggests that the annual revenue loss from the flavor ban might be around $300 million to $400 million. However the LAO notes that it is unclear what is driving this revenue change, it could be due to reduction in tobacco use or in flavored tobacco use, or it could be due to usage that skirts the ban altogether (consumption from illegal sales or acquiring products out of the state).

The LAO notes with respect to enforcement activities CDTFA is spending substantially fewer resources on its tobacco programs than it was before the pandemic and has fewer filled positions in the tax and licensing programs. Inspections have decreased significantly and citations issues have also declined. At the same time, the number of tobacco seizures has increased. LAO notes that there are some potential explanations, including that CDTFA is performing their requirements more efficiently and inspections are targeted to those establishments more likely to be out of compliance. But the LAO notes that this could also be due to an overall decline in compliance. For example, due to the flavor ban or other factors, consumer demand for illicit tobacco products could be growing over time. If so, this could make noncompliance more lucrative for businesses, leading to lower compliance, which in turn could drive up the citation rate and seizure rate per inspection.

In regards to this specific proposal, the LAO notes that:

Decision for Next Year: The Cigarette and Tobacco Products Compliance Fund had a $2 million surplus in 2023-24 and entered 2024-25 with a $12 million balance. In principle, these resources, together with the proposed augmentation, should cover the cost of implementing these laws without any need to redirect resources away from other aspects of the licensing program. This, however, is only a temporary solution. In 2026, the Legislature will need to decide how much to appropriate for this program on an ongoing basis. It also will need to assess whether the new penalty revenues are sufficient to maintain the fund's structural balance. If not, the two main alternatives are (1) a statutory increase in licensing fees, or (2) cuts to other aspects of the licensing program.

Concerns about Hiring and Retaining Inspectors: Under the Governor's proposal, CDTFA should have adequate budgetary authority to take on the new statutory responsibilities without detracting from its existing responsibilities. In practice, however, budgetary authority might not be the most binding resource constraint. CDTFA has struggled just to fill tobacco enforcement positions provided under its existing appropriations. This calls into question how much of the proposed spending actually will materialize. We are concerned that these responsibilities ultimately could spread existing enforcement resources even more thinly.

The LAO notes that the Legislature may wish to ask the following questions:

- What are the major ways that consumers obtain untaxed tobacco products?

- What strategies do CDTFA and other law enforcement partners use to address these avenues for tax evasion?

- Why has the number of tobacco inspections declined so much?

- We have seen workload trends presented in terms of total inspections, seizures, citations, and appeals. The administration has noted that these measures can be difficult to interpret. For example, when CDTFA seizes a retailer's noncompliant products, this counts as one seizure, regardless of the total amount of product seized. Can the administration provide workload measures that account for some of these limitations?

- What steps has the administration taken to improve recruitment and retention of tobacco enforcement personnel?

- What additional steps could be taken?

- What will happen if CDTFA cannot expand its tobacco enforcement workforce despite its growing responsibilities? How could the department modify its approach to enforcement to manage this situation?

Staff Recommendation. Hold Open.

7730 FRANCHISE TAX BOARD

Issue 7: Pass Through Entity Elective Tax Extension

Budget Proposal. The Governor's budget includes a proposal to extend the Pass-Through Entity Elective Tax (PTET) from 2026 through 2030, and subject it to a trigger if the federal cap on the state and local tax (SALT) deduction is extended. Additionally, beginning in tax year 2026, it would allow business entities to make a late prepayment, subject to a 12.5-percent reduction in the credit generated from the late payment.

Background. Under current federal law, as adopted in the 2017 federal Tax Cuts and Jobs Act, California personal income taxpayers are limited to deducting no more than $10,000 of SALT payments on their federal returns. However, business entities can still fully deduct state and local income taxes paid under federal law.

In response, the Pass-Through Entity Elective Tax (PTET) and Tax Credit program was created in the 2021 Budget Act to help certain business owners in California fully deduct, on their federal tax returns, the California taxes they pay on pass-through business income, by allowing certain pass-through entities to pay tax on behalf of their owners. This mitigates the impact of the SALT cap, without reducing state revenues. This program is set to expire along with the federal SALT cap after 2025.

In addition, under current law, taxpayers are required to make a prepayment in June that is the greater of $1,000 or 50 percent of the taxpayers' PTET liability in the prior year. Late prepayments are not allowed, hence a taxpayer who misses the deadline or underpays the required amount is unable to participate in the PTET for that year, losing the federal tax benefits. This structure was put in place to prevent distortive impacts on fiscal year revenues by aligning the PTET payments made by business entities with the personal income tax estimated payment, which are affected by PTET credit usage.

The proposal would allow for the continuation of the state's PTET if the federal SALT cap is extended beyond 2025. In addition, the proposal would allow for taxpayers to make a late prepayment in case of a missed or underpaid June prepayment. The amount of the prepayment that is late is subject to a penalty wherein the generated PTET credit is reduced by one-eighth (12.5 percent), which is intended to incentivize taxpayers to pay their anticipated prepayment amount prior to the deadline

The proposal does not have any budgetary scoring because the 2025-26 Governor's Budget forecast, consistent with current law, assumes that the SALT cap sunsets at the end of 2025 and, therefore, the PTET would not be operative after tax year 2025.

Finance estimates that in its first three years since its inception in 2021, the PTET has saved California taxpayers approximately $3.5 billion to $4 billion per year on their federal taxes.

Staff Recommendation. Approve proposal, adopt placeholder trailer bill language.

Issue 8: Single Sales Factor Apportionment for Financial Institutions

Budget Proposal. The Governor's budget includes a proposal to require multi-state financial firms to use a mandatory single sales factor tax policy instead of the equally weighted three-factor formula, beginning with taxable year 2025.

Background. Current law requires multistate firms to use a mandatory single sales factor tax policy, however multi-state and multi-national corporations pay taxes in California by computing how much of their taxable income is apportioned to California using an apportionment factor that represents its share of business activity in the state divided by its total business activity in the U.S. or in the world. There are different apportionment formulas that can result in a higher or lower apportionment factor depending on the characteristics of a given corporation. The three-factor apportionment formula is calculated using the share of a company's property, payroll, and sales in California divided by its property, payroll, and sales in the U.S. or the world. The single sales factor apportionment formula, on the other hand, is calculated using only a company's sales in California divided by its sales in the U.S. or the world.

Since the passage of Proposition 39 in 2012, most corporations have been required to use single sales factor apportionment for calculating how to apportion their profits to California for state tax purposes. However, financial institutions (including savings and loan businesses), extraction companies (mining and oil and gas businesses), and agricultural producers have since 1994 been subject to a separate apportionment formula than other businesses and were not affected by Proposition 39's requirement to use single sales factor apportionment. Instead, they continued to use three-factor apportionment, which uses a company's payroll and property factors, in addition to their sales factor.

In general, a California–based corporation, one with significant payroll and property in the state, would benefit from switching from the current three-factor apportionment formula to a single sales factor apportionment formula. In contrast, an out–of–state corporation that has relatively high sales in California compared to its shares of property and payroll in California would not benefit from switching to the single sales factor apportionment formula. This change would remove an incentive for financial firms to physically locate in other states, and instead promote economic growth within California.

According to the Department of Finance, moving banks and savings and loan businesses to single sales factor apportionment is estimated to generate the following multiyear revenue gains:

Dollars in Millions	2025-26	2026-27	2027-28	2028-29	Total
Single Sales Factor for Financial Institutions	$330	$280	$260	$270	$1,140

Legislative Analyst's Office (LAO) Comments and Recommendation.

The LAO reviewed this proposal in a post on their website on February 13, 2025 and noted the following:

Some Firms Would Pay More and Some Pay Less, but Net Revenue Increase Expected. The Governor's proposal would generate winners and losers among affected firms. Increasing the weight placed on sales (thereby reducing the weight on property and payroll) would reduce the tax burden for firms with a significant physical presence in the state while increasing the tax burden for firms located outside the state but who have a high concentration of California sales. The administration anticipates the latter effect is larger and, therefore, estimates that shifting financial institutions to the single sales factor will increase revenues by $330 million in the budget year, declining slightly to $270 million by 2028-29.

Firms May Make Strategic Decisions in Response to Change. Businesses impacted by the Governor's proposal could make different location and sales choices that impact economic growth in California. On one hand, single sales factor may incentivize financial institutions to increase their physical presence in the state, thereby generating new jobs and spending. On the other hand, an increased weight on sales made in California could discourage firms located elsewhere from providing financial services—such as loans—in California, which could negatively affect economic growth.

Empirical Evidence Provides Weak Support for Economic Development Effects. The existing literature does not provide strong support for the claim that shifting to single sales factor has a meaningful effect on economic development. One reason for this result is that a lot of the benefit of a reduced tax burden on property and payroll accrues to firms already located in-state and do not expand in response to the change. This is also known as a windfall benefit. Another issue in California is the interaction between apportionment and other tax rules. Specifically, when the base corporation tax rate is higher, the incentive provided by single sales factor to relocate employees and property is smaller. Since California has both a high tax rate for financial institutions and a throwback rule that increases the share of sales attributed to California, the economic development effect of single sales factor for these firms is reduced.

Rationale for Industry-Specific Exemptions Does Not Apply to Financial Institutions. There are two primary justifications for allowing exemptions from an apportionment formula. First, an exemption may result in fairer apportionment: Businesses in agricultural and extractive industries typically have a fixed production location but may make a relatively small fraction of their sales in California, and thus have a disproportionately low tax liability under single sales factor even though they benefit from the state's natural resources and public infrastructure. Therefore, apportioning their income via the three-factor method may be more appropriate. Financial institutions do not have the same location dependence and can make sales in California regardless of where they are physically located, so single sales factor is appropriate from a fairness perspective. Second, some states provide exemptions to apportionment as a tax incentive to specific industries. However, given that financial institutions already have a higher corporate income tax rate (10.84 percent) than the base rate (8.84 percent), it seems unlikely that these businesses would fall into this category.

The LAO further recommends that the Legislature approve the Governor's proposal as there is no clear argument for financial institutions to have an exemption from the single sales factor. Given the broad trend towards states adopting the single sales factor in recent years, California broadly following suit at a minimum keeps the playing field level with its competitors

Staff Comments. Staff notes that a similar proposal was included in the Senate's 2024-25 budget plan, but was not ultimately part of the final budget agreement.

Staff Recommendation. Approve proposal, adopt placeholder trailer bill language.

Issue 9: Military Retirement Exclusion

Budget Proposal. The Governor's budget includes trailer bill language to provide tax relief for California families with members who served in the military and to improve the state's competitiveness in attracting and retaining military retirees to the state. Specifically, this proposal would, beginning in tax year 2025 and through tax year 2029, exclude from income for state tax purposes up to $20,000 in:

(1) Retirement pay received by a taxpayer from the federal government for services in the uniformed services; and
(2) Annuity payments received by a qualified taxpayer pursuant to a Department of Defense Survivor Benefit Plan.

The income exclusion is available for individuals or heads of household with up to $125,000 in income and joint filers who do not exceed $250,000 in adjusted gross income.

Background. Both federal and California law currently tax military retirement income and survivor benefits as income. Out of the 41 states that impose an income tax, California is the only state without a full or partial exemption. Currently, there are 29 states that fully exempt military retirement pay and survivor benefits while 11 have partial exemptions. The most common partial exemption is to limit the exemption to a specified dollar amount. Idaho has the most generous partial exemption, exempting up to $40,000 of qualified retirement benefits including military retirement pay for single filers and over $60,000 for joint filers. The states with the least generous exemptions include Delaware (up to $12,500 for all filers of age 60 and over; $2,000 if under 60), Vermont (up to $10,000 of exempted income with Adjusted Gross Income limits of $60,000 for single filers; $75,000 for joint filers) and Maryland (up to $12,500 for age 55 and under; up to $20,000 for over 55). Finally, Oregon has a very limited partial exemption that only applies to military service prior to October 1991. As of 2023, California is home to over 141,000 military retirees.

This proposal is estimated to lead to a revenue loss of $130 million in 2025-26, and $85 million ongoing thereafter.

Legislative Analyst's Office (LAO) Comments and Recommendation.

The LAO reviewed this proposal in a post on their website on February 13, 2025 and noted the following:

Provides Some Tax Relief. The partial income tax exclusion of military retirement income would reduce state taxes for 130,000 veterans in the state. The maximum benefit available under the proposal equates to a $600 tax reduction for the average military retiree. The tax savings would be larger for military retirees with higher incomes, most commonly working veterans with nonmilitary wages. Conversely, the tax savings would be smaller for military retirees with minimal tax liabilities.

Moves California More In-Line With Other States. Under the proposal, California would no longer be the only state to fully tax military retirement benefits. Due to the relatively modest exclusion ($20,000) and income limitations, California's tax treatment of military retirement benefits would nevertheless remain among the country's most limited.

Compared to Balance of Factors That Influence Location Decisions, Proposal's Financial Incentive Is Minor. Taxpayers make decisions about where to live and work based on a complex balance of factors that includes job prospects, community preferences, cost of living, climate, quality of government services, and local tax levels. Relative to these broader factors, the proposal's financial incentive is minor. Therefore, the income tax exclusion is not likely to change many veterans' decisions about where to live after their service. As such, the proposal likely achieves little on the administration's stated goal of making the state a more competitive destination for military veterans. That said, under the proposed change, the state would no longer be the only state that fully taxes military retirement income. In this sense, although it is a small financial incentive, the proposal may well improve veterans' perception of California.

Weak Economic Rationale to Exclude Military Retirement Income From Taxation. Providing tax relief to military veterans with retirement income who already live in the state is not likely to provide compelling economic benefits to the state. Tax expenditures are often put forth to encourage certain behaviors or spur economic activity that benefits the state or other groups. Yet neither outcome is likely to occur to a noticeable extent under this proposal. As such, the proposal does not have a strong economic rationale when compared to alternative uses of these funds, either for a different tax expenditure or other state spending. For their part, these alternatives could have positive benefits that should be weighed against the potential benefits of the proposal.

Tax Expenditures Should Clear High Bar. Relative to spending proposals, tax expenditures tend to be reviewed less rigorously once they are adopted. Furthermore, again relative to spending proposals, assessing the effectiveness of tax expenditures is challenging given the limited information the state receives about taxpayers who benefit. As such, proposed tax expenditures should clear a very high bar for adoption.

The LAO notes that given the weak rationale for this proposal, the Legislature's decision on this proposal may depend on the Legislature's goals. If the Legislature simply wants to provide limited tax relief to veterans, that might also improve veterans' perceptions of the state, it could adopt the administration's proposal. If the Legislature instead prefers that this tax expenditure have a clear economic or fiscal rationale, it could reject the administration's proposal

Staff Recommendation. Hold Open.

Issue 10: Wildfire Settlement Tax Relief

Budget Proposal. The Governor's budget includes a proposal to exclude from gross income all wildfire settlement payments paid from 2025 through 2029 for the purpose of state taxation, irrespective of when the fire occurred.

Background. For past taxation relief on wildfire settlements, separate legislation has been introduced for each separate wildfire. Existing law provides gross income exclusions for settlement amounts related to: the 2015 Butte Fire (AB 1249, Chapter 749, Statutes of 2022), the 2017 Thomas Fire (SB 1246, Chapter 841, Statutes of 2022) and North Bay Fires (AB 1249), the 2018 Woolsey Fire (SB 1246), the 2019 Kincade Fire (SB 131, Chapter 55, Statutes of 2023), and the 2020 Zogg Fire (SB 131).

The 2020 Bobcat Fire, 2021 Dixie Fire, and the 2022 Mill Fire are not covered by a gross income exclusion, but were proposed in legislation in 2024 (SB 542 (Dahle) and AB 1973 (Lackey)). In both cases, the bills were vetoed by the Governor with a message that they should be included in the budget framework.

This current proposal would provide certainty on the taxation of wildfire settlements for California families experiencing hardship after a wildfire disaster instead of requiring separate legislation for each separate settlement. There is no fiscal impact that is budgetarily scored because the bill is prospective and future wildfire settlements are generally not included in the state's revenue forecasts due to the unpredictability and volatility of disasters. However, this proposal does leave a gap in taxation relief for those Californians impacted by wildfires but who received settlements prior to 2025 and whom were not identified in enacted legislation.

While its timing of applicability is different, this proposal aligns with the Federal Disaster Relief Act of 2023 by applying the exclusion to the extent that losses, expenses, or damages compensated by the settlement payment are not compensated for by insurance or otherwise. According to the Department of Finance, federal and state tax treatment of settlement claims, absent a specific legislative exception, depend on the type of settlement. Settlements for personal physical injuries or physical sickness are generally not taxable. Settlements for property loss or damages to property are also generally not taxable up to the adjusted cost basis of the property. On the other hand, settlements for emotional distress or mental anguish and settlements for lost wages or lost profits are generally taxable. Whether settlement claims or portions of settlement claims from a wildfire trust fund are taxable depends on the type of settlement and facts and circumstances of the case. The "Federal Disaster Tax Relief Act of 2023" was enacted on December 12, 2024. The federal bill allows individuals impacted by a federally declared wildfire disaster and those who received settlements as compensation to exclude that money from their gross income on their federal taxes. The federal bill is largely retroactive and covers any wildfire disasters federally declared in 2014 or later and applies to payments received from 2020 through 2025. The exclusion only applies to the extent that losses, expenses, or damages compensated by the payment are not compensated for by insurance or otherwise.

Staff Recommendation. Hold Open.

Issue 11: Enterprise Data to Revenue (EDR 2) Project

Budget Proposal. The Governor's budget requests $107.1 million General Fund and the full time equivalent of 42.0 permanent positions, and 4.0 limited-term positions for the Franchise Tax Board (FTB) for the fifth-year implementation of the Enterprise Data to Revenue (EDR2) project, which is the second phase of the Tax System Modernization (TSM) plan. The resources received from this proposal will allow FTB to continue supporting the optimization of business processes throughout the EDR2 life cycle.

Background.

In 2007, the staff created a 30 year three-phased modernization strategy for FTB's information technology systems. The primary objective of this strategy addresses refreshing FTB's aging legacy systems, while also taking the opportunity to further advance FTB's strategic goals using the latest technologies and industry best business practices.

- Phase 1 (EDR Project, completed December 2016) – Build the key infrastructure and foundational architecture for the three phased effort and update FTB's existing imaging, case management, return processing, and modeling processes while also developing two new applications (Taxpayer Folder – internal view for FTB staff and MyFTB – external view for taxpayers and practitioners) to consolidate taxpayer data for ease of use, increased customer service and better transparency.
- Phase 2 (EDR2 Project, projected start July 2021) - Leverages the architecture delivered and will expand case management, modeling, MyFTB, and self-service options. This project will also decommission end-of-life legacy systems for Audit, Filing Enforcement and Collections.
- Phase 3 – (projected start 2026) This Final Phase will replace FTB's end-of-life legacy accounting systems and finish addressing FTB's six key business problems.

The EDR2 project represents Phase 2 of an enterprise-wide TSM effort to align FTB's IT infrastructure with its strategic business plan. The EDR2 project will continue to significantly improve the department's ability to address the state's annual $10 billion tax gap through strategically planned TSM efforts consistent with FTB's strategic plan.

The EDR2 project is vital to FTB's operations. The technology currently supporting two of FTB's major legacy systems - Accounts Receivable Collection System (ARCS) and professional Audit Screening and Support System (PASS), which annually allow FTB to collect over $4 billion in compliance revenue, are nearing end-of-life and will no longer be supported after December 31, 2025. Implementing the EDR2 project at this time is critical. Replacing these systems before they reach end-of-life will ensure FTB business operations generating significant compliance revenue for the state will not experience any critical failures. Additionally, the EDR2 project will improve efficiency and provide a better taxpayer experience while increasing revenue.

The following table shows the systems FTB plans to replace with EDR2 and their original implementation dates and ages.

System	Date Implemented	System Age in Years (as of 2024)
ARCS	1999	25
INC	2001	23
PASS	1997	27

The EDR2 project follows the California Department of Technology's (CDT's) Project Approval Lifecycle (PAL) Process. The most recent document approved for the EDR2 project was the Stage 4 Project Readiness and Approval (S4PRA). The S4PRA was approved on April 1, 2021 and included the EDR2 vendor selection and project approval.

The EDR2 project's Request for Proposal (RFP) was released on April 30, 2019 on the Cal e-Procure website. In May 2020, FTB received the final proposals with proposed solutions from the bidders. Contract Award to the contractor was made in June 2021. The EDR2 project start date was July 1, 2021. The most recent report is the Special Project Report #1, approved on January 1, 2024.

The EDR2 project plans to achieve the following objectives in 2025-26:

- Utilize the new data analytic tools to support the development of new work including functionality for models, treatment paths, and data visualization (reports and dashboards);
- Perform data analysis and clean-up of the INC application data prior to the conversion of the data into the EDR2 case management platform;
- Analyze and resolve issues with collection cases that will not convert in an automated fashion prior to contractor's automated conversion from the PIT collection legacy to new system;
- Enhance the ability to successfully select best value cases for compliance efforts and complete quality cases efficiently;
- Ensure new data fields can be captured from paper returns and other stand-alone tax forms to assist with developing potential modeling strategies and business rules which will result in increased revenue;
- Develop and implement Training and Organizational Change Management activities to support FTB enterprise including the field offices who will utilize the systems impacted by the EDR2 project implementation and changes;
- Maintain the data integrity and availability in FTB's tax systems and their ability to perform critical state tax functions;
- Enhance the capabilities of the previously implemented solution that is used by the Underpayment BSOW to identify available assets to levy during the Personal Income Tax involuntary collection cycle;
- Perform design and development of change requests identified to resolve design gaps and implement in the final release of the project.

FTB notes that this request is funding for the 2025-26 fiscal year and that a BCP will be submitted each year to cover the costs of the project. Final delivery of the EDR2 solution to FTB is expected in January 2026 with full state acceptance of the solution in January 2027 (end of the warranty period.) According to the FTB, the total cost of EDR2 is estimated to be just over $750 million and will ensure continued collection of over $4 billion in annual revenues. After full implementation, the project is projected to bring in additional new revenues of $300 million annually.

The most recent CDT's Independent Project Oversight Report, completed in December of 2021, notes that the project is on track and performing as expected and does not identify any needed corrective actions at this point.

Staff Recommendation. Hold Open.

Issue 12: Asset Forfeiture Spending Authority Increase

Budget Proposal. Budget Proposal. The Governor's budget includes an increase in spending authority for the Asset Forfeiture Account for Fiscal Year (FY) 2025-26. FTB is requesting to increase the spending authority from $740,000 to $2,500,000 to purchase permissible resources for FTB's Criminal Investigation Bureau (CIB) activities that support their strategic goals

Background. FTB's CIB is made up of sworn peace officers who serve the people of California by investigating violations of the Revenue and Taxation Code in a manner that maintains public confidence and encourages compliance. CIB participates on various federal, state, and local task forces that investigate financial crimes and has had equitable sharing agreements with the US DOJ, US DOT, and the CA DOJ. Participation in these task forces and agreements has allowed FTB to receive an equitable share of assets seized in criminal activities in which FTB aided. One investigation of significance that CIB participated in involved Rabobank National Association, which was found guilty of felony conspiracy for obstructing regulators and concealing deficiencies in its anti-money laundering program. Rabobank was ordered to forfeit $368,701,259 in FY 2018-19, of which FTB received its equitable share totaling more than $20 million dollars. The success of this investigation is the main source of FTB's Asset Forfeiture Account balance of $21,513,212 (as of June 2024).

On October 30, 2024, FTB was notified by the US DOJ and DOT that because it is not an independently funded law enforcement agency, FTB is no longer eligible for continued participation in the Equitable Sharing Programs. This means, no new funds will be added to the account, however, FTB may expend all federal shared funds currently on hand for permissible purposes by June 30, 2026.

Since the Governor's budget was released, the Department of Finance submitted a Section 26.0 letter to the Joint Legislative Budget Committee approving a request from the Franchise Tax Board (FTB), for the purpose of increasing its spending authority from the Asset Forfeiture Account by $760,000 in fiscal year 2024-25 to support FTB's CIB activities. FTB has noted that given the restrictions on the use of funds in the account, the 2024-25 JLBC letter and this budget request represent the planned permissible expenditures from the account before the deadline. The remaining funds (approximately $18.3 million) will be returned to the federal government.

Staff Recommendation. Hold Open.

9210 LOCAL GOVERNMENT FINANCING

Issue 13: Vehicle License Fee Backfill – Information Only

The Governor's budget does not include a backfill to counties for the Vehicle License Fee (VLF) shortfall when their VLF shortfall exceeds available funding in their Education Revenue Augmentation Fund (ERAF) revenues. The Department of Finance estimates that it would cost $118.1 million to backfill revenues in the three counties with insufficient ERAF, San Mateo, Alpine, and Mono.

Background. The VLF is a tax on ownership of a registered vehicle. All revenue from vehicle license fees is distributed to counties and cities and used for general purposes and some specific, required health and human services-related purposes. In the mid 1990's the state lowered the VLF rate and reimbursed counties and cities for the reduced VLF revenue with state General Fund, known as the "VLF Backfill". Also in response to a severe budget deficit in the 1990's, the state met its legal obligation to fund schools by diverting specified amounts of local property taxes into an "Education Revenue Augmentation Fund" or ERAF in each county. ERAF funds are then transferred to local K-14 school entities. Some school districts, known as "Basic Aid School Districts" do not receive any ERAF allocations as local property taxes for K-14 education, already cover the level of funding provided for K-14 education, therefore the school district was not receiving state General Fund that could be offset by ERAF.

In 2004, a new mechanism for backfilling the VLF was created and a portion of property taxes from schools (through ERAF or other K-14 property taxes if ERAF was insufficient) was provided to counties and cities to replace the VLF Backfill, known as the "VLF swap". Prior to 2004, the amount counties and cities received was based on their populations. Today, counties and cities' VLF swap amounts increase annually based on growth in the assessed value of property within their boundaries. After the adoption of the VLF swap, statewide growth in assessed valuation—and, as a result, VLF swap payments—has significantly exceeded growth in VLF revenues. Although the VLF swap reduced the amount of property tax revenue in ERAF available to fund schools, state law specified that the shift would not affect the calculation of excess ERAF. Over the past several years, some counties, currently San Mateo, Alpine, and Mono have been unable to cover insufficiencies in their VLF funds with ERAF funding. When all or most school districts in the county are in basic aid status, the county is unable to direct enough K-14 property taxes or ERAF from school districts, as it will not generate a General Fund backfill.

The VLF shortfall has been relatively low in past years, but growing property tax revenue combined with declining enrollment has increased the shortfall and projections assume continued growth. General Fund appropriations have been provided in prior budget acts to cover the shortfall each year since 2012, ranging from a few hundred thousand up to $92 million depending on the year. The 2024-25 budget act included $72.5 million to backfill VLF shortfalls.

Staff Recommendation. Information Only.