Senate Budget and Fiscal Review—Nancy Skinner, Chair

SUBCOMMITTEE NO. 4 Agenda

Senator Anna Caballero, Chair
Senator Jim Nielsen
Senator Richard D. Roth

Wednesday, February 10, 2021
1:00 p.m.
State Capitol - Room 4203

Consultant: Nora Brackbill and Joe Stephenshaw

ITEMS FOR VOTE ONLY

ITEMS FOR DISCUSSION

Public Comment

VOTE ONLY ITEMS 1, 2, 3, 6, AND 8 – APPROVED 3-0
VOTE ONLY ITEMS 4, 5, 7, AND 9 – APPROVED 2-1 (Nielsen NO)
ALL OTHER ISSUES HELD OPEN

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ITEMS FOR VOTE-ONLY

0950 STATE TREASURER'S OFFICE (STO)

Issue 1: Electronic Resources Augmentation

Request. The Governor's budget proposes $400,000 in reimbursements for the Investment Division to meet the increasing cost of electronic services necessary to safely and prudently invest state money for the Pooled Money Investment Account (PMIA).

Background. The Investment Division plays a pivotal role for the State Treasurer in meeting his/her constitutional obligations as the State's banker and chief investment officer. The Investment Division invests temporarily idle funds in the Centralized Treasury System in the PMIA portfolio. The PMIA, created by legislation in 1955, is made up of commingled monies from the General Fund, Surplus Money Investment Fund (SMIF), and the Local Agency Investment Fund (LAIF). SMIF represents the available cash from all the special funds which do not have investment authority of their own and from those special funds which have independent investment authority but choose to participate in the program. LAIF was established in 1977 pursuant to Government Code Section 16429.1 to provide California cities, counties, and special districts with an investment alternative.

The goal of the Investment Division is to prudently manage and safely invest the State's idle or surplus monies to maximize the earnings and to meet the cash flow needs of the State. There is a high degree of visibility and sensitivity regarding the investment of public funds and the subsequent outcome of these investments. The investment program includes a wide variety of complex investment instruments which requires ongoing analysis and review from the management team. The program utilizes more than 100 brokers, dealers, banks and direct issuers of commercial paper and corporate debt. As of June 30, 2020, the PMIA totaled $101 billion with daily investment activity for the month averaging $1.6 billion.

The STO's Investment Division currently utilizes seven fee-based electronic services on a daily basis. These services are critical to the business and operational needs of the division, as well as standard in the investment community. The PMIA has grown by over $30 billion in the past five years, from $69.6 billion on 6/30/15 to $101.0 billion on 6/30/20, with no increase to staffing levels.

Staff Recommendation. Approve as budgeted.

0981 CALIFORNIA ACHIEVING A BETTER LIFE EXPERIENCE ACT BOARD

Issue 2: Continued Administration of the California Achieving a Better Life Experience Act Board

Request. The Governor's budget proposes $1.2 million General Fund, ongoing, to provide the following resources:

1. $845,000 to fund administrative costs and the continued implementation of the California Achievement a Better Life Experience (CalABLE) Program; which includes funding for staff, funding for external consultants and funding necessary for operating and overhead costs; and

2. funding in the amount of $350,000 to support the marketing and outreach activities of increasing awareness and participation in the program.

In addition, CalABLE requests budget bill language to extend the repayment date of the General Fund loans made to CalABLE, beginning in the 2016-17 fiscal year through the 2019-20 fiscal year, to the 2024-25 fiscal year.

Background. On December 19, 2014, President Obama signed the Stephen Beck Jr., Achieving a Better Life Experience Act of 2014 (ABLE), which allows individuals who become blind or disabled before reaching age 26 to create tax-free savings accounts. ABLE accounts generally follow the same rules as 529s: individuals can make nondeductible cash contributions to an ABLE account in the name of a specified beneficiary, and with tax-free earnings. ABLE account distributions are also not included in the beneficiary's income, as long as they are used for qualified services for the beneficiary and distributions do not exceed the cost of those services.

The ABLE Act directs states to establish one ABLE account for each eligible beneficiary. The ABLE Act additionally directs the IRS to issue regulations by June 19, 2015 and implement the program to guide states as they enact legislation to create ABLE accounts. AB 449 (Irwin), Chapter 774, Statutes of 2015, implements the ABLE Act in California, and directs the California Achieving a Better Life Experience Board to administer ABLE accounts on behalf of qualified Californians.

SB 324, (Pavley), Chapter 796, Statutes of 2015 established the Achieving a Better Life Experience Act Board and the California ABLE Program Trust for the purpose of creating a statewide program known as the Qualified ABLE Program. Under the Qualified ABLE Program, a person may make contributions, for the benefit of an individual who is an eligible individual for that taxable year, to an ABLE account that is established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account.

In July of 2020, CalABLE began developing projections for strategic planning purposes. These preliminary projections, which are based on several assumptions (including growth rate, number of enrollees and their contribution levels and withdrawal rates), show that program expenditures will exceed fee revenues annually for an extended period. This shortfall and need to supplement revenue with additional funding to support its annual expenditures, has led to the need to seek an ongoing General Fund appropriation rather than additional funding through General Fund loans. CaLABLE has received $4.8 million in General Fund loans since its inception.

According to the Administration, with an ongoing General Fund appropriation, the board can focus on developing competitive advantage and advocacy strategies that will increase enrollment growth without additional pressure to extend loans to the program. Revenue generated can then be used solely for loan repayment, further reducing the time estimated for repayment.

Staff Recommendation. Approve as budgeted.

1701 DEPARTMENT OF FINANCIAL PROTECTION AND INNOVATION (DFPI)

Issue 3: Information Security Strategy and Operations

Request. The Governor's budget proposes $710,000 ($238,000 Credit Union and $470,000 Fund Financial Protection Fund) in 2021-22 and $573,000 ($191,000 Credit Union Fund and $382,000 Financial Protection Fund) in 2022-23 and ongoing for 1.0 Information Technology Manager I, 1.0 Information Technology Specialist II, 1.0 Information Technology Specialist I, and information technology tools to strengthen the DFPI's information technology security safeguards and protocols, and to comply with state information technology security requirements.

Background. The State of California information technology security directives require state departments to increase California's preparedness and response to destructive cyber-attacks and implement comprehensive information technology (IT) security processes, procedures, and practices. The directives include Executive Order B-34-15; IT Security Assessments, Chapter 518, Statutes of 2015 (AB 670); Cyber-Security Incident Response Planning, Chapter 508, Statutes of 2016 (AB 1841); the State Administrative Manual (SAM) Section 5300; the Statewide Information Management Manual (SIMM) Section 5305; and the 2017 California Department of Technology's (CDT) Strategic Plan - Vision 2020. The goals of the CDT Strategic Plan - Vision 2020 are to:

- Protect California's technology assets and maximize information access.
- Develop a robust and collaborative security risk reduction strategy.
- Develop an enterprise approach to security leadership and governance.
- Improve and invest in mission critical security capabilities.
- Foster a security-minded culture throughout California's workforce.

One of the CDT's primary objectives is to make certain that all state departments create and maintain comprehensive IT security safeguards and protocols to protect information and data transactions between the state and its customers. To carry out this mission, the CDT contracts with the California Military Department (Military Department) to perform biennial IT security assessments, and the CDT's Office of Information Security (OIS) performs audits on all state departments. The goal is to make sure state departments achieve acceptable compliance ratings. Noncompliant departments are more vulnerable to security breaches and attacks.

The DFPI, the state's primary regulator of over 400,000 individuals and businesses providing financial services, underwent the Military Department's Independent Security Assessment in May 2017 and May 2019; and the CDT's Information Security Program Audit in July 2018 and a December 2019 Check-In Audit. The final reports from both showed many deficiencies in DFPI's ability to implement and manage the state's required security controls due to an overall lack of maturity in DFPI's security program. DFPI's sole security officer is unable to perform the numerous daily workload activities necessary to meet the State's mandated IT security requirements.

Staff Recommendation. Approve as budget.

Issue 4: Legal Division Rulemaking Workload

Request. The Governor's budget proposes $426,000 in 2021-22 and $408,000 in 2022-23 and ongoing for 1.0 Attorney III and 1.0 Legal Analyst to address increased rulemaking workload.

Background. Since 2013, the Legislature has passed several complex laws to be administered by the Department, including: (1) the Property Assessed Clean Energy law (PACE), (2) the Small Dollar Lending Pilot Program, and (3) the Commercial Financing Disclosure law. These new programs require initial and ongoing rulemaking. The Legislature continually passes new bills that require the Department to update existing regulations or revise those currently being drafted. Each Department program tracks rules under its administration that require updating. Approximately one out of every four new legal opinions issued by the Legal Division identifies ambiguities in the law that should be addressed through rulemaking.

Government Code section 11017.6 requires the Department to prepare a rulemaking calendar each year that includes all proposed rulemaking activities anticipated for the year. This annual filing assists the Office of Administrative Law (OAL) with its staffing needs. Historically, there are always more rulemaking packages anticipated than are completed. Because of workload constraints, Department attorneys are unable to timely draft and submit all the rulemaking packages identified on rulemaking calendars each year. As a result, the Department has prioritized working on rulemaking packages required by the Legislature at the expense of updating and/or clarifying existing laws.

Between 2015 and 2020, to keep pace with the new and changing laws under its administration, the Department identified the need for 27 new rulemaking packages. Due to the lack of adequate staff resources, however, the Department was only able to submit ten packages to the OAL. Six of the ten packages were approved by the OAL; the other four are still active. Of the remaining 17 packages, 7 were abandoned due to the prioritization of other rulemaking packages. Ten are still in the drafting phase. Of those ten being drafted, three of them have been carried over for more than five years.

Staff Recommendation. Approve as budget.

Issue 5: Student Loan Borrower Protection (AB 376)

Request. The Governor's budget proposes $733,000 Financial Protection Fund in 2021-22 and $705,000 in 2022-23 and ongoing to support 1.0 Staff Services Manager II to serve as the Student Loan Ombudsman, 1.0 Senior Financial Institutions Examiner to examine the Student Loan

Servicing Program licensees and investigate borrower complaints, and 1.0 Attorney IV to manage increased enforcement activities, as required by AB 376 (Stone) Chapter 154, Statutes of 2020.

Background. Chapter 24, Statutes of 2016, the Student Loan Servicing Act (SLSA), required all student loan servicers operating in California to obtain licenses as of July 1, 2018. The SLSA also subjects licensees to regulatory supervision and oversight by the department. The department adopted application documents and currently licenses about 36 servicers operating in California. The SLSA requires that the department examine all licensees at least once every 36 months. In 2019, the department promulgated regulations implementing the SLSA.

AB 376, which is effective January 1, 2021, imposes additional servicing standards on student loan servicers, increases borrower protections, and expands prohibitions against predatory student loan industry practices. AB 376 requires the Commissioner to designate a Student Loan Ombudsman no later than 180 days following July 1, 2021 to work within the Department.

The Department currently has eight authorized positions to implement the provisions of the SLSA, including 1.0 Financial Institutions Manager, 1.0 Attorney III, 1.0 Information Technology Specialist, 2.0 Senior Financial Institutions Examiners, 2.0 Associate Governmental Program Analysts, and 1.0 Staff Services Analyst.

The Department requests 1.0 Staff Services Manager II to handle the required duties of the Student Loan Ombudsman. The Department requests 1.0 Senior Financial Institutions Examiner to help manage the anticipated increased examination and investigation workload associated with the requirements of AB 376. The definition of a servicer has been expanded and other department licensees not previously covered are now covered. For example, the expanded definition includes banks and credit unions that service student loans. AB 376 adds new licensee requirements, which increases the need for an expanded examination program to verify compliance. The Department requests 1.0 Attorney IV to manage the increased enforcement caseload expected from AB 376. This law (1) enhances student loan borrower protections, which were not previously in the SLSA; (2) expands the definition of which companies are covered by the law (meaning more unlicensed activity); and (3) increase the number of complaints and the information received about unfair, deceptive, and fraudulent practices coming to the Department because these issues will be affirmatively sought out.

Staff Recommendation. Approve as budget.

7600 DEPARTMENT OF TAX AND FEE ADMINISTRATION (CDTFA)

Issue 6: Local Prepaid Mobile Telephony Services Surcharge Sunset Removal

Request. The Governor's budget proposes $347,000 from the Local Charges for Prepaid Mobile Telephony Service Fund and two positions in fiscal year 2021-22, growing to $469,000 and three positions in 2024-25 and ongoing to administer the Local Prepaid MTS collection program.

In addition, the Local Prepaid Mobile Telephony Services Act was expected to sunset December 31, 2020. Therefore, the resources required for the closeout of the program were going to be covered by the General Fund. Now that the sunset has been extended, the CDTFA requests to decrease the General Fund authority by 0.5 positions and $79,000 in 2022-23 and 2023-24 as the program will continue to be funded by the Local Prepaid Mobile Telephony Services Act.

Background. The provisions of the Prepaid MTS Surcharge Collection Act, AB 1717 (Perea), Chapter 885, Statutes of 2014, imposed a new prepaid MTS surcharge and local charge to be administered and collected by the CDTFA, which became operative January 1, 2016 on the sale of prepaid MTS. The prepaid MTS surcharge is imposed pursuant to the Prepaid MTS Surcharge Collection Act and the local charges are imposed pursuant to the Local Prepaid MTS Collection Act of 2014, which are separate acts within the tax law that were both added by AB 1717. Both the Prepaid MTS Surcharge Collection Act of 2014 and the Local Prepaid MTS Collection Act of 2014 contained a sunset date of December 31, 2019. SB 344 (McGuire), Chapter 642, Statutes of 2019, extended the sunset date for the Local Prepaid MTS Collection Act from December 31, 2019, to December 31, 2020.

On November 15, 2018, the United States District Court, Northern District of California (Metro PCS California, LLC v. Michael Picker et al, case number 17-cv-05959-SI), enjoined state agencies from enforcing the provisions of the Prepaid MTS Surcharge Collection Act because it conflicts with federal law. A notice of appeal of the court's decision was filed on December 14, 2018, but a judicial stay of the injunction was not requested, thereby ending CDTFA's enforcement of the Prepaid MTS Surcharge Collection Act. However, the local charges are administered under a separate act, the Local Prepaid MTS Collection Act of 2014 (AB 1717). Since the court did not declare the Local Prepaid MTS Collection Act of 2014 invalid, the CDTFA continues to administer the Local Prepaid MTS Collection Act provisions contained in Part 21.1 of Division 2 of the Revenue and Taxation Code (commencing with section 42100).

SB 1441 (McGuire), Chapter 179, Statutes of 2020 extended the sunset date of the Local Prepaid Mobile Telephony Services Act from December 31, 2020 to December 31, 2025. As a result, the CDTFA will continue to manage operating requirements on the local program at least through 2025. If the program sunsets in 2025, the CDTFA will submit a negative BCP retaining only the resources needed to close out the program.

Staff Recommendation. Approve as budgeted.

7730 FRANCHISE TAX BOARD

Issue 7: AB 1876 –Earned Income Tax Credit/ITINs

Request. The Governor's budget proposes $2 million General Fund and 17.0 permanent and 1.0 permanent-intermittent position in 2021-22 and $1.7 million General Fund and 17 permanent and 1.0 permanent-intermittent position in 2022-23 and ongoing to implement and administer provisions of AB 1876 (Committee on Budget) Chapter 87, Statues 2020.

Background. To help the poorest working families in California, the 2015 Budget enacted the state's first-ever Earned Income Tax Credit (EITC). Per the 2015 Budget Act, the taxpayer and/or a qualifying child was required to have a Social Security number (SSN) to claim the state EITC. However, Individual Taxpayer Identification Numbers (ITINs) are commonly used by undocumented taxpayers who have a tax filing requirement. As a general rule, a taxpayer filing with an ITIN has been able to claim the same exemptions, deductions, and credits as a taxpayer filing with an SSN. A major exception to this rule is the state EITC.

The 2020 Budget Act expanded the state EITC, for taxable years beginning on or after January1,2020, allowing the credit to an eligible individual who has, or whose spouse has, a qualifying child younger than 6 years old and if the eligible individual, including their spouse and/or qualifying child has an ITIN. AB 1876 further expands the CalEITC credit to all eligible individuals who have an ITIN, including their spouse and/or qualifying children, significantly expanding eligibility for the credit.

An estimated 200,000 or more families with ITINs will qualify for this state EITC expansion. These potential EITC recipients do not generate the same types of data that FTB usually uses to calculate and validate state EITC amounts. People using ITINs cannot receive a federal EITC, meaning FTB cannot use claimant data from the IRS when checking on the credit amount someone is claiming. Nor can they use their ITINs to receive a W-2, as such, FTB cannot use W-2 data to match information they report on their tax returns.

FTB is requesting these resources in order to ensure returns are processed and refunds are issued timely as well as ensuring improper payments of this refundable credit are minimized.

Staff Recommendation. Approve as budgeted.

Issue 8: Privacy and Security Assessments

Request. The Governor's budget proposes $1.7 million General Fund and $42,000 Special Funds and 12 positions in 2021-22; and $1.6 million General Fund and $39,000 Special Funds in 2022-23 and ongoing. These resources will accommodate newly mandated state and federal workloads within the functions of FTB's Privacy Program and Information Security Oversight Unit (ISOU).

Background. Currently, under the direction of the Chief Security Officer (CSO), the implementation of FTB's Privacy and Information Security Programs are executed by the Privacy, Security, and Disclosure Bureau (PSDB). PSDB develops policies and procedures to ensure the safety and security of FTB's employees; the confidentiality, integrity, and availability of FTB's information systems and the information contained within and the privacy of the personal data collected and used by department. FTB's Chief Privacy Officer (CPO) is responsible for numerous functions regarding the department's responsibility to protect confidential and sensitive data and to ensure the enterprise is collecting, using, and sharing data appropriately. The CPO promotes awareness of and ensures the privacy of employee and taxpayer data, and appropriate use of FTB data that meets federal and state requirements mandates, laws and regulations.

In the last 12 months, 3 significant new federal and state mandates related to enhanced security and privacy reviews and controls were issued in draft form or were adopted. These requirements are, or soon will be, required to be performed as described in the various procedures. They are as follows:

- IRS Publication 1075 – Internal Revenue Service (IRS) requirements stated in the draft Publication 1075, effective December 2019, requires FTB to review and provide analysis for privacy requirements to develop and disseminate an enterprise–wide privacy program plan. This plan should include a description of the privacy program, management's commitment to compliance, strategic goals and objectives and identification and implementation strategies for ongoing efforts to meet these objectives. The plan must include policies and procedures that address the use of Personally Identifiable Information (PII) for internal testing, training, and research (updated IRS Publication 1075). Failure to adhere to these standards risks FTB's ability to obtain critical return information from the IRS that is used to process over 19 million California tax returns and supports the generation of over $4 billion in compliance revenue annually.

- State Administrative Manuel (SAM) 5310.8/SIMM 5310-C mandates, effective August 2019, and revised November of 2019. Under the provisions of SAM 5310.8 and SIMM 5310-C, FTB's Privacy Program is now required to conduct (Privacy Impact Assessments) PIAs on business processes, projects and systems that involve the collection, creation, maintenance, distribution, or disposal of personal information as defined in Civil Code section 1798.3. The objective of a PIA is to identify privacy risks and protections throughout the life cycle of personal information collected to support business processes. PIAs are also conducted to ensure that programs or information systems that contain or use personal information comply with legal, regulatory, and policy requirements regarding privacy. As required by the new mandates, in order to protect personal information, information asset owners are required to apply all applicable statewide and state entity information privacy and security mandates, laws, policies, standards, and procedures. This includes conducting a Privacy Threshold Assessments (PTA) and, if necessary, a PIA when the collection, use, maintenance, storage, sharing, disclosure, or disposal of personal information (as defined by Civil Code section 1798.3) is involved. State entities are required to use the State Information Management Manual (SIMM) 5310-C, which defines PTAs and PIAs, or an equivalent tool to meet this requirement.

  Failure to adhere to these mandates results in FTB being out of compliance with statewide mandates and subjects FTB to both audit findings and the inability to timely identify privacy gaps and risks which ultimately could result in a data breach or the erroneous retention and use of personally identifiable information.

- State Administrative Manuel (SAM) 5305.5/SIMM 5305-A Mandates, effective January 2018, FTB's current security program requirements include planning, oversight, and coordination of information security program activities to effectively manage risk, provide for the protection of information assets, and prevent illegal activity, fraud, waste, and abuse in the use of information assets. This workload is managed by the department's Information Security Program. FTB's assessment process has two goals: 1) determine the privacy risks and effects of collecting, maintaining, using, and disclosing personal information; and 2) evaluate protections and alternative processes for handling personal information to eliminate or mitigate potential privacy risks. In general, FTB's current program focuses on common grouping of programs and system security plans have been developed for these broad groups. Under SAM 5305.5, FTB is required to complete and file System Security Plans for all critical state systems versus common groupings.

Failure to adhere to these mandates results in FTB being out of compliance with statewide mandates and subjects FTB to audit findings and the inability to identify privacy gaps and risks as required which ultimately could result in a data breach to our systems.

If the department does not comply with the new IRS mandates, the privilege to use Federal Tax Information provided by IRS could be revoked. This revocation could result in an annual revenue loss.

In addition to complying with the mandates, this request will strengthen FTB's ability to expand and maintain a compliance program that effectively mitigates internal and external security threats and stays up to date with the latest regulatory changes. It enables the department to evaluate and measure current privacy and information security measures.

To strengthen FTB's strong privacy practices and assist with protecting personal information, the department requests resources for the department's Privacy Program and Information Security Oversight Unit.

Staff Recommendation. Approve as budgeted.

Issue 9: SB 1447 – Small Business Hiring Credit

Request. The Governor's budget proposes $377,000 General Fund and 4.0 positions for 2021-22 and $189,000 General Fund and 4.0 positions for 2022-23 (ending December 31, 2022) to administer provisions of SB 1447 (Bradford), Chapter 41, Statute 2020.

Background. SB 1447 creates a small business hiring credit fund. The fund will allow small business employers to reserve a credit that can be applied against qualified sales, use, or income taxes.

The California Department of Tax and Fee Administration (CDTFA) will administer the tentative credit reservation process and allocate the credit. FTB will be responsible for managing, processing, and ensuring the tax credit under the Personal Income Tax (PIT) law and/or the Corporations Tax law is claimed accurately.

Beginning January 1, 2020, a small business employer could receive a tentative credit reservation equal to $1,000 for each net increase in qualified employees. The credit must have been reserved between December 1, 2020 and January 15, 2021 and shall not exceed $100,000 for any qualified small business.

To claim the credit the claimant must file a timely return. It is estimated that 30 percent of those that apply for the credit will receive the credit and apply the credit to income tax due. This equates to an estimated 16,800 returns claiming the credit. Resources are necessary for managing the portion of these returns that need to be audited.

In order to ensure timely audits, processed returns and accurate refunds are issued, FTB is requesting three Tax Technicians and one Program Specialist I.

Staff Recommendation. Approve as budgeted.

ITEMS FOR DISCUSSION

0509 GOVERNOR'S OFFICE OF BUSINESS AND ECONOMIC DEVELOPMENT (GO-BIZ)

GO-Biz provides a single point of contact for economic development, business assistance and job creation efforts. GO-Biz works with companies and organizations across the nation to market the benefits of doing business in California, recruit new businesses, retain businesses, and support private sector job growth. GO-Biz serves as the Governor's lead entity for economic strategy and the marketing of California on issues relating to business development, private sector investment, economic growth, export promotion, permit assistance, innovation and entrepreneurship. GO-Biz makes recommendations to the Governor and the Legislature regarding policies, programs, and actions for statewide economic goals.

GO-Biz's budget priorities this year include helping businesses recover from the economic effects of COVID-19, expanding support to underserved populations, and attracting and retaining high-value jobs through incentives and support for innovation. Many of these proposals fall under the California Office of the Small Business Advocate (CalOSBA), which serves as the principal advocate in the state on behalf of small businesses. CalOSBA is responsible for sharing information about small business programs, helping small businesses navigate programs and services, and responding directly to small business issues. CalOSBA has grown significantly lately, both in direct administration of small business and startup programs, and direct support of small businesses, particularly as it relates to disaster relief and COVID-19.

Budget. The budget includes $266.6 million ($193.6 General Fund) and 131.3 positions in 2021-22. The following chart from the Governor's budget displays expenditures and positions for GO-Biz for the prior year, current year, and budget year.

		Positions			Expenditures		
		2019-20	2020-21	2021-22	2019-20*	2020-21*	2021-22*
0220	Go-Biz	46.4	48.1	49.1	$25,546	$283,762	$12,157
0225	California Business Investment Services	11.5	16.3	16.3	2,893	3,331	3,525
0230	Office of the Small Business Advocate	5.3	8.8	14.8	21,772	1,106,554	25,349
0235	Infrastructure, Finance and Economic Development	34.1	40.1	40.1	89,804	154,118	170,015
0240	Community Reinvestment Grants Program	7.0	10.0	11.0	44,423	45,517	55,548
TOTALS, POSITIONS AND EXPENDITURES (All Programs)		**104.3**	**123.3**	**131.3**	**$184,438**	**$1,593,282**	**$266,594**

FUNDING		**2019-20***	**2020-21***	**2021-22***
0001	General Fund	$102,177	$1,530,694	$193,582
0649	California Infrastructure and Economic Development Bank Fund	35,135	12,382	12,747
0918	California Small Business Expansion Fund	144	2,139	2,159
0995	Reimbursements	17,327	16,908	1,399
3083	Welcome Center Fund	71	111	111
3095	Film Promotion and Marketing Fund	5	10	10
3237	Cost of Implementation Account, Air Pollution Control Fund	746	1,038	1,038
3314	California Cannabis Tax Fund	9,219	-	-
3348	Cannabis Tax Fund - Governor's Office of Business and Economic Development -Allocation 2	19,614	30,000	40,000
3376	Cannabis Tax Fund - Gov Office of Business and Economic Development	-	-	15,548
TOTALS, EXPENDITURES, ALL FUNDS		**$184,438**	**$1,593,282**	**$266,594**

Issue 10: California Competes (CalCompetes) Tax Credit Expansion and Grant Program

Governor's Budget. The budget includes $430 million General Fund to expand the CalCompetes program, including $180 million in additional tax credits split equally between the 2020-21 fiscal year and the 2021-22 fiscal year, and $250 million for grants in the 2020-21 fiscal year. This is part of a package of proposals on which the Administration requests the Legislature take action early in 2021.

Background. Recent, high-profile business relocations have driven a narrative that California is not business friendly. Businesses have cited high corporate and personal income tax rates, cost-of-living, and regulatory burdens. California ranks 49th on the Tax Foundation's 2021 State Business Tax Climate Index[1]. However, as indicated by California's generally strong economy, there are many other factors that influence economic development[2]. In addition, California corporations today actually pay a lower share in income taxes than they did thirty years ago[3]. California continues to enjoy a strong, highly localized venture capital and start-up culture[4], and many of those companies have chosen to stay and grow in California. Even companies that are relocating typically leave many jobs and operations within the state. However, after largely working remotely for almost a year, we may continue to see shifts in the physical location of employees for some businesses.

CalCompetes Tax Credit Program

GO-Biz administers CalCompetes, a program intended to attract or retain businesses that are considering making new investments in California and may be looking elsewhere. Companies seeking tax credits apply to GO-Biz, and the administration negotiates five-year agreements with selected applicants, which include specific hiring and investment goals. The agreements are approved by the GO-Biz committee which consists of the director of GO-Biz, the director of the Department of Finance, the State Treasurer, and one appointee each by the Senate and the Assembly. All businesses are eligible, and the credits are awarded through a competitive process. Applicants must clearly explain how the credit will influence their decision to locate in California, such as by presenting a site selection analysis, and priority is given to businesses in areas of the state with high unemployment. The state may recapture the credit if the taxpayer does not satisfy the terms of the agreement. Starting in 2018-19, based on recommendations from the LAO, changes were made to refocus the program on companies with tradeable goods who may more easily leave the state[5]. A set-aside for small businesses was also eliminated.

GO-Biz allocates $180 million in credits each fiscal year, plus any unallocated or recaptured credits from the prior year, across three application periods. The minimum credit is $20,000, and the maximum credit for a single applicant is 20 percent of the allocation in a given year. The credits are not refundable, but taxpayers may carry the balance forward for up to six years. During the 2019-20 fiscal year, 56 of the 375 companies that applied to the program were successful. The

[1] https://taxfoundation.org/2021-state-business-tax-climate-index/
[2] https://www.ppic.org/content/pubs/report/R_411JKR.pdf
[3] https://calbudgetcenter.org/resources/corporations-pay-far-less-of-their-income-in-state-taxes/
[4] https://www.chicagotribune.com/business/ct-biz-silicon-valley-tech-exodus-california-20201216-ntj2gu2jafdx3ntmgkppd5taby-story.html
[5] https://lao.ca.gov/Publications/Report/4213

majority of California Competes awards go to businesses in three industries: (1) manufacturing; (2) professional, scientific, and technical services; and (3) financial services. A full list of awardees (including agreements) is available on GO-Biz's website[6]. So far, $1.2 billion in credits have been awarded.

The demand for this program is rapidly increasing. In the first application cycle this fiscal year, GO-Biz received over three times the average number of applications (based on the previous two years). $800 million credits were requested, while only $80 million credits were available. The demand is likely driven by both one-time and ongoing factors, including recovering from the current recession, relocation opportunities due to remote work, and general awareness of California's efforts to retain businesses. The proposed budget would increase the amount of tax credit available for allocation by $90 million in both 2020-21 and 2021-22 for a total of $270 million per year.

However, many of the allotted tax credits are either unused or have been recaptured by GO-Biz[7]. Accounting for the five-year agreement structure, roughly $500 million in credits have been earned, but only $160 million have been used. The state also recaptured roughly one-third of the dollar amount of credits awarded ($122 million) during the first three years of the program, and the majority of CalCompetes agreements that have ended resulted in some or all of the credits being recaptured. However, these numbers primarily reflect early CalCompetes agreements, before the program was adjusted in 2018-19. GO-Biz expects those changes, in particular removing the small business set-aside, to reduce the number of recaptures and unused credits moving forward.

CalCompetes Grant Program
In addition, the proposed budget includes $250 million one-time General Fund to establish a grant component of CalCompetes to help businesses with low tax liability. In 2019, only about one-quarter of the state corporation taxpayers owed more than the $800 minimum franchise tax. In general, grants would benefit companies that have little to no tax liability due to significant deductions or credits because they are growing rapidly, are new or small, or reinvest profits into the business, such as in research and development. Grants also get money out faster than tax credits.

GO-Biz would award the grants using the existing California Competes application and evaluation processes, including the same minimum ($20,000) and maximum (20 percent of the yearly allotment) sizes. Successful applicants would negotiate similar multi-year agreements specifying hiring and investment milestones. At least some significant portion of the grant would be paid upfront, but the agreement could be structured to include later payments as milestones are met. The grants would count as taxable income. If a business violated the terms of its agreement, GO-Biz would instruct FTB to recapture the grant, using the same tools they have available to collect delinquent tax liabilities.

In addition to existing program criteria, an applicant would need to meet one of the following to qualify for a grant:

[6] https://business.ca.gov/california-competes-tax-credit/awardee-list/
[7] https://lao.ca.gov/Publications/Report/4327

- Establish at least 500 net new jobs.
- Make a significant infrastructure investment, as defined by the director of GO-Biz.
- Commit to a high-need or high-opportunity area of the state.
- Receive a designation from the Director of GO-Biz that the application is a strategic priority to the state.

The new program would dedicate at least $50 million of the $250 million one-time General Fund to high-need, high-opportunity areas of the state. These areas are likely based on regional unemployment rates, similar to what is used for the tax credits.

LAO Comments.

Despite Program Features, Concern About Effectiveness Remains. The economic impact of CalCompetes is unclear, as the state will never know whether the business would have left the state if it did not receive the credits (or grant). The high recapture rate is concerning. It suggests that many businesses could not meet their agreements and raises questions about the number of new private-sector jobs created by this program. In additional, many businesses seem to be struggling to use the credits they were awarded. A better understanding of the barriers businesses face in meeting their agreements and using their credits could help the Legislature.

Proposed Grants Raise Significant Questions. The administration correctly notes that not all taxpayers benefit from tax credits. Grants are one way to address this issue, but there may be others. For example, the state could allow a portion of the tax credits to be transferable or refundable. The state also could temporarily allow taxpayers who cannot use credits to sell some of them back to the state at a discount. Even these more modest changes would represent a significant shift in the state's longstanding approach to economic development incentives.

How Would State Manage Risks of Grants? The existing California Competes program does not allow businesses to claim credits until they achieve their hiring and investment commitments. The high recapture rate noted above indicates that this caution has been justified. We suggest that the Legislature consider the risk to the state from paying grants in full upon the approval of the California Competes agreement. FTB could have difficulty recovering grant funds from certain businesses, such as those with minimal assets or under bankruptcy protection. The Legislature could consider putting in place additional guardrails, such as setting a maximum grant amount or requiring that grants only be paid upon the business meeting its commitments.

Growing Companies Have Unprecedented Access to Private Funding. Another advantage of a grant over a tax credit is that the business does not have to wait to receive the money. Under current economic conditions, however, the types of businesses served by California Competes—in particular, businesses that are expanding—have good private sector financing options. Growing businesses can raise funds in two ways: they can sell stock equity or borrow money from a bank (or a non-depository lender). Despite the challenging economic conditions because of the pandemic, this is a remarkably good time for businesses to raise capital through either approach. There were nearly 1,600 initial public offerings in the United States in 2020, a 42 percent increase over 2019. With the stock market at all-time highs, many other corporations raised capital by selling additional shares of stock. At the same time, interest rates are at historically low levels, making borrowing inexpensive.

LAO Suggestion.

Reject Proposed One-Time Expansions of California Competes. California Competes is not a suitable vehicle for addressing the economic effects of the pandemic because it does not target the hardest-hit industries. Furthermore, because the hiring and investment agreements cover a five-year period, the timing of any potential economic benefits does not address the urgency of the current economic situation. While the Governor's grant proposal responds to this timing issue to some extent, it raises other important issues for the Legislature to consider.

Staff Recommendation: Hold Open

Issue 11: Infrastructure and Economic Development Bank Small Business Finance Programs

Governor's Budget. The budget includes two proposals totaling $100 million one-time General Fund in 2021-22 for small business finance programs at the California Infrastructure and Economic Development Bank (IBank).

- *Small Business Finance Center (SBFC).* The proposed budget includes $50 million to be used at IBank's discretion across any SBFC program with a funding priority for underserved California small businesses, including the California Rebuilding Fund.

- *Small Business Loan Guarantees.* The proposed budget includes $50 million to recapitalize the Small Business Loan Guarantee Program (SBLGP).

Background. IBank was created to finance public infrastructure and private development that promotes economic growth. IBank has a broad authority to issue tax-exempt and taxable revenue bonds, provide financing to public agencies, provide credit enhancements, acquire or lease facilities, and leverage state and federal funds. IBank's SBFC promotes statewide economic development by increasing opportunities for entrepreneurs, the self-employed, microbusiness and small business owners to have better access to capital and other technical resources. IBank works closely with CalOSBA on its small business programs.

Small Business Loan Guarantees
SBFC's primary program is the SBLGP, which provides guarantees for loans issued to small businesses from financial institutions, typically banks, which otherwise would not approve such term loans or lines of credit. The loan guarantee serves as a credit enhancement and an incentive for financial institutions to make loans to small businesses that otherwise would not be eligible for such financing. The fund received $84 million in federal funding in 2011 through the State Small Business Credit Initiative (SSBCI) and has used that to support hundreds of millions of dollars in loans, with funds revolving and continuously serving new businesses. This program is utilized by larger small businesses (up to 750 employees) with larger loan sizes (average amount of $500,000 or more).

However, the fund has been challenged by the economic impacts of COVID-19 and the large demand for small business loans. $50 million was provided last year, but the program is again approaching capacity and will be fully leveraged by summer 2021. It will require additional funding to continue supporting small businesses, especially as the economy recovers from the effects of COVID-19. The proposed budget includes $50 million one-time General Fund, which can be leveraged to provide to up to $250 million of loans.

Small Business Finance Center Funding
According to IBank, some businesses were unable to use the loan guarantee programs because many lending institutions did not have the capital to extend loans. In order to address the capital needs of small businesses, particularly underserved businesses dealing with the economic impacts of COVID-19, IBank recently provided an anchor investment commitment to help create the California Rebuilding Fund. The fund combines investments from private, philanthropic, and public sector sources, and is structured such that IBank shoulders most of the risk, encouraging

more lower-risk investment from other sources. Low interest, non-forgivable loans are available to businesses who employed 50 or less full-time equivalent employees and had gross revenues of $2.5 million or below in 2019. The loans would originate and be serviced by Community Development Financial Institutions, who would also provide advisory support. The Fund launched on November 20, 2020 and has received over $600 million in loan requests according to IBank.

The Governor's proposed budget does not provide funding for the California Rebuilding Fund specifically. Instead, it includes $50 million for IBank to use at its discretion across any SBFC program with a funding priority for underserved small businesses, including the Rebuilding Fund. If the demand for loans from the Rebuilding Fund remain high, all $50 million would go towards that. If the demand changes, or there are other changes in the economic outlook or in federal aid programs, the money could be moved to other tools that also support underserved businesses. Other potential uses include Jump Start start-up loans, ClimateTech guarantees, and new initiatives that address Jobs, Economy Recovery, Small Business Innovation and Climate priorities within the SBFC. The Administration has requested this amount of discretionary funding due to the unpredictable economic climate and evolving federal aid programs.

LAO Comments.

Loan guarantee program has merit. Improving small businesses access to capital has merit, and the SSBCI program is intended to complement federal SBA loan programs. Ideally, these programs would be capitalized using federal funds and, if the federal government provides money to the states for SSBCI, then this $50 million may not be necessary.

Notification of alternative use of funding. The administration has indicated that it intends to use the SBFC funding to help capitalize the Rebuilding Fund. The Legislature should require IBank to notify the JLBC if it redirects these funds to a different small business capital assistance program.

Staff Recommendation: Hold Open

Issue 12: California Dream Fund

Governor's Budget. The proposed budget includes $35 million one-time General Fund in the current budget year to support microgrants up to $10,000 to seed entrepreneurship and small business creation in underserved groups that are facing opportunity gaps. This is part of a package of proposals on which the Administration requests the Legislature take action early in 2021.

Background. CalOSBA currently administers the Technical Assistance Expansion Program (TAEP), which provides grants to small business technical assistance centers that provide free consulting and trainings to help businesses start and grow. This program is allocated $17 million annually through 2023-24. TAEP grants focus on expanding service to underserved business groups, which include women, minorities, veterans, as well as communities that are low-wealth, rural, and disaster impacted, and immigrant communities. TAEP grantees in 2020-21 were mostly Small Business Development Centers (SBDCs), as well as Women's Business Centers and the Veterans Business Outreach Center, among others[8].

The underserved business groups that TAEP targets may have difficulty obtaining capital, especially in the current economic climate. The California Dream Fund (CADream) grants would be provided as a supplement to TAEP, so the centers can provide microgrants to participants that utilize their training and advisory services. TAEP grantees would apply for this funding as part of the normal TAEP application in July, and the funding would be available for the next federal fiscal year (Oct 2021 – Sept 2022). TAEP grantees would select CADream grant recipients, with guidance from CalOSBA. TAEP grantees would be required to provide specialized startup training to accompany CADream grant distribution. A maximum five percent administrative fee would be awarded to the TAEP grantee for all CADream funds. TAEP grantees already track success through metrics such as the number of jobs created and the amount of capital raised, which could be expanded to include CADream grant information.

This proposal is also targeted at supporting small businesses in immigrant communities, by expanding the definition of underserved business communities to include individuals who are not U.S. citizens or lawful permanent residents or who are limited English proficient. Nonprofits and community-based organizations would also be allowed to receive TAEP funding (previously, grants were restricted to federally-funded centers).

This program would replace the Social Entrepreneurs for Economic Development Initiative (SEED), which was provided $10 million one-time General Fund in the 2020 Budget Act to provide training and business startup supports for targeted low-income populations including immigrants and Californians with limited English proficiency. While the California Dream Fund proposal is separate from the SEED program, it is intended to provide similar benefits, but through an existing grant program and layering on technical assistance to these businesses.

[8] https://static.business.ca.gov/wp-content/uploads/2020/10/2020-21-TA-Awardees_Final.pdf

LAO Comment.

*Proposed language is vague***.** The stated objective of these grants is to provide seed capital to entrepreneurs in underserved groups that are facing capital and opportunity gaps. The administration does not appear to have defined these terms or provided any other guidance in statute regarding how the grants would be disbursed. The Legislature may want to specify eligibility and selection criteria in budget trailer bill legislation and require reporting or other oversight measures.

Staff Comment.

Selection details. In FY 2019-20, TAEP centers trained nearly 125,000 entrepreneurs and small business owners. As the LAO noted, is not clear how CADream grantees would be selected from this pool, or how much freedom individual TAEP centers would have to set their own criteria. Would this result in a patchwork of slightly different programs at different centers? Would businesses be able to apply at multiple centers? The Legislature may want to consider whether more detail should be specified along these lines.

Results of SEED program. The funding from the SEED program is in the process of being deployed, but it may be useful to have more information about the outcomes of that program before moving forward.

Staff Recommendation: Hold Open

Issue 13: Inclusive Innovation Hub Grants

Governor's Budget. The Governor's budget includes $2.5 million one-time General Fund to provide grants for Inclusive Innovation Hubs (iHub2) administered by CalOSBA.

Background. The original iHub program started in 2013 and was housed under GO-Biz (AB 250 Holden, Chapter 530, Statutes of 2013). Thirteen regional hubs were designated and consisted of partnership between interrelated firms, local governments, economic development organizations, educational entities, and industries that collectively drive economic growth within a defined geographic area. The hubs were intended to stimulate partnerships, economic development, and job creation by leveraging assets to provide an innovation platform for startup businesses, economic development organizations, business groups, and venture capitalists. GO-Biz was required to oversee, coordinate, and provide assistance to each iHub. However, no funding was provided, the program was not closely tracked, and all of the iHub designations have expired or will expire soon.

The proposed budget includes $2.5 million to relaunch the California Innovation Hub program under CalOSBA as the Inclusive Innovation Hub program (iHub2). Similar to the original iHubs, these would be formal, established partnerships between industry, technical assistance providers, startups and entrepreneurs, universities and research institutions, and government in a specific geographic area, focused on a specific sector. However, a key difference is that iHub2 would focus primarily on underserved areas of California that do not currently have a strong startup culture, and leverage regional industries and assets to foster innovation there. Each iHub2 would provide advisory support to entrepreneurs and startups, plan programming and engagement across the partner organizations, and facilitate relationships between startups, researchers, venture capitalists, and financial institutions. The program would be focused on innovation and commercialization of new technologies, as opposed to technical assistance or workforce development, but it would coordinate with other state resources that focus on those areas, such as the TAEP network. As small businesses by definition, startups are also represented by CalOSBA, and moving the program under that umbrella would allow better coordination with state resources.

In the new program, CalOSBA would designate ten hubs for a three-year program and award them $150,000 for year one to incentivize and launch inclusive programming and $50,000 in each subsequent year. The hubs would be selected through a competitive request for proposal process, where potential hubs submit a comprehensive plan that details a targeted focus area including underserved geographies, industry sectors, or business owners, as well as the entities and expertise involved, specific goals and benchmarks, and a sustainability plan. Members of the original iHub network would have to reapply. The grant requirements would also include increased metric and performance tracking to assess the success of the program. If the program were successful, hubs would ideally become self-sustaining in the long run.

LAO Comment.

Reasoning for relaunch and changes. More information is needed about the previous iHub program (including what happened to the original network of hubs), and what changes were made for the relaunch and why.

Increased oversight. The Legislature may want to consider adding language to provide additional oversight of this program. The trailer bill legislation should require reporting to ensure that this program is effective in (1) driving innovation, (2) increasing *outcomes* for underserved business groups (not just training and opportunities).

Staff Comment.

First iHub network has mixed success. As noted by the LAO, it is not clear whether the first iHub program was successful, or if the changes proposed here would create a successful, sustainable program moving forward. Expanding startup ecosystems in new regions of the state may require significant additional state support beyond the iHub2 program.

Expansion of CalOSBA. In addition to this proposal, the budget includes two other new initiatives housed under CalOSBA: the $1.075 billion Small Business Relief Grant Program and the $35 million CADream Fund. This would represent a large increase in CalOSBA's duties this year. The Legislature may want to consider the long-term direction and bandwidth of CalOSBA when weighing these proposals.

Staff Recommendation: Hold Open

Issue 14: CalOSBA - Outreach and Engagement.

Governor's Budget. The Governor's budget includes $901,000 from the General Fund and permanent authority for six positions in 2021-22 and ongoing as part of CalOSBA to provide direct support to small businesses.

Background. CalOSBA is tasked with providing guidance, information and direct support to small businesses, including during disaster response and recovery. However, CalOSBA's capacity has been tested due to an onslaught of repeated and ongoing disasters, including wildfires and the COVID-19 pandemic. According to CalOSBA, last year they received less than 100 requests for general direct support; during disasters, this number increases exponentially. Since March 1st, 2020, they have received 3,733 requests for direct support and response. It is difficult for existing CalOSBA staff to keep up with this demand, as well as communicate with millions of businesses across the state about rapidly changing situations, regulation, and guidance.

CalOSBA does not have staff focused on communication, outreach and engagement. Currently, they have three regional advisors who cover Northern, Southern and Central California. Those advisors develop regional connections and partner with local small business organizations. CalOSBA also has four program team members who manage and implement CalOSBA's programs, including TAEP and iHubs, among others. However, the lack of a communications team makes it difficult to inform the community about these programs and about other sources of support and relevant news and information. In particular, it is difficult to reach traditionally underserved and marginalized businesses.

The Governor's budget includes six new permanent positions at CalOSBA. The team would focus on conducting the required direct support, outreach, engagement and marketing/content creation necessary, increasingly online, to connect with small businesses and help them prepare and be more resilient. The team would prioritize underserved business groups, including women, minority, and veteran- owned businesses and businesses in low-wealth, rural, and disaster-impacted communities, especially African-American and Latinx businesses.

Staff Comment.

Nonprofit and other non-traditional business expertise. CalOSBA is increasingly expanding its reach to serve nonprofits and other types of non-traditional small businesses, such as with the Small Business Relief Grant. The Legislature may want to consider specifying or encouraging CalOSBA to include expertise in those areas on this new team.

Staff Recommendation: Hold Open

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

Overview. CAEATFA was established by Chapter 908, Statutes of 1980, to promote the prompt and efficient development of energy sources which are renewable, or which more efficiently utilize and conserve scarce energy resources. Recognizing the importance of developing a secure energy future to protect the environment and ensure economic stability, the Authority advances the state's goals of reducing greenhouse gas emissions by providing financing options to assist industries in increasing the deployment of sustainable and renewable energy sources, implementing measures that increase the efficiency of the use of energy, creating high quality employment opportunities, and lessening the state's dependence on fossil fuels. To support these goals, the Authority provides financing and credit enhancements to promote the establishment of facilities that use alternative methods and sources of energy, and facilities needed for the development and commercialization of advanced transportation technologies.

The Authority consists of five members: the State Treasurer, who serves as the chairperson, the State Controller, the Director of the Department of Finance, the Chairperson of the State Energy Resources Conservation and Development Commission, and the President of the Public Utilities Commission

Budget. The budget includes $7.8 million from special funds and reimbursements and 10.0 positions in 2021-22. The following chart from the Governor’s budget displays expenditures and positions for CAEATFA for the prior year, current year, and budget year.

		Positions			Expenditures		
		2019-20	2020-21	2021-22	2019-20*	2020-21*	2021-22*
0850	California Alternative Energy and Advanced Transportation Financing Authority	9.0	10.0	10.0	$5,934	$6,502	$7,822
TOTALS, POSITIONS AND EXPENDITURES (All Programs)		**9.0**	**10.0**	**10.0**	**$5,934**	**$6,502**	**$7,822**

FUNDING		**2019-20***	**2020-21***	**2021-22***
0465	Energy Resources Programs Account	$519	$511	$525
0995	Reimbursements	3,699	4,031	5,387
9332	California Alternative Energy Authority Fund	1,716	1,960	1,910
TOTALS, EXPENDITURES, ALL FUNDS		**$5,934**	**$6,502**	**$7,822**

Issue 15: Sales Tax Exclusion

Request. The Governor’s budget proposes a $100 million one-time increase to the cap on the CAEATFA sales and use tax exclusion, doubling the amount available in 2021.

The administration estimates that the proposed increase in the annual cap would have a direct fiscal cost to the state and local governments totaling $38 million over a five-year period, starting in 2021-22. This estimate is less than $100 million for two reasons: 1) based on historical usage rates, the administration estimates that participants would use $60 million of the additional $100 million awarded, and 2) the overlap with a separate partial exemption (described later under LAO Comments) would offset an estimated $22 million of the revenue loss.

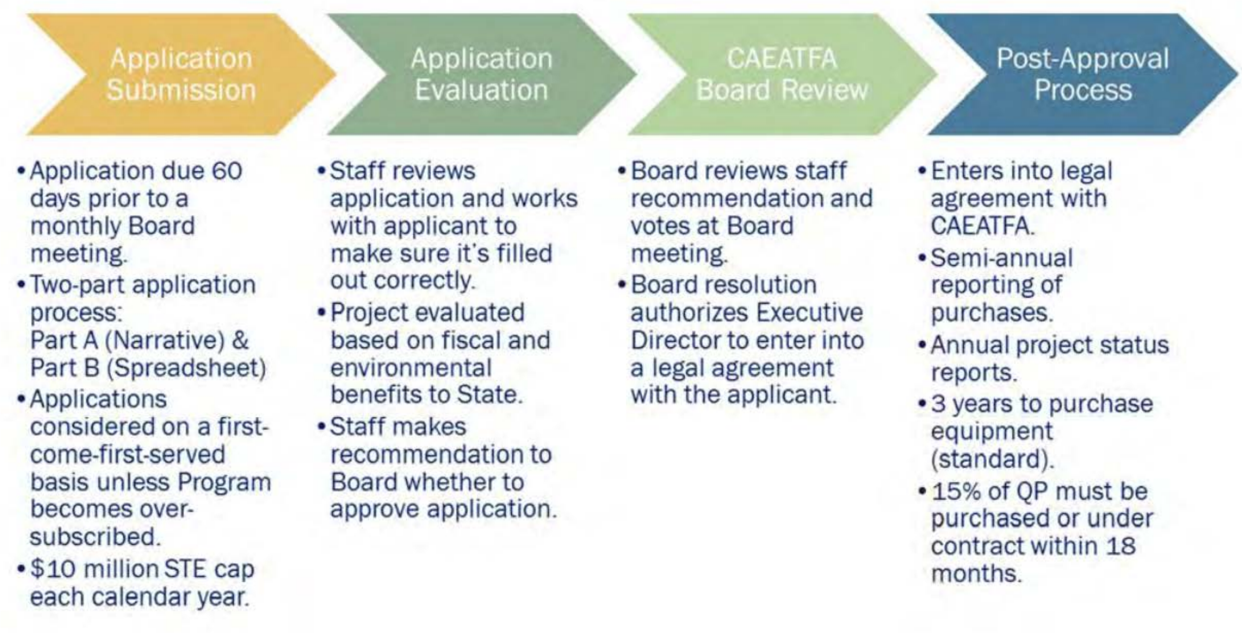
Background. California's state and local governments charge a sales and use tax on retail sales of tangible goods, including many goods purchased by businesses. The overall rate ranges from 7.25 percent to 10.5 percent. The average rate is 8.6 percent. Of that, 3.94 percent raises money for the state's General Fund. Local governments' portion of the sales tax ranges from 3.31 percent to 6.56 percent. The California Department of Tax and Fee Administration administers the sales tax and also administers most sales tax exemptions.

CAEATFA is housed within the State Treasurer's Office and operates a variety of programs that provide financial assistance, such as tax exemptions, loans, and bonds, largely to entities developing technologies intended to reduce air pollution and conserve energy. CAEATFA consists of five members: the State Treasurer (who serves as the chairperson), the State Controller, the Director of the Department of Finance, the Chairperson of the California Energy Commission, and the President of the California Public Utilities Commission.

CAEATFA awards $100 million in Sales and Use Tax Exclusion annually to certain manufacturers, to assist them in purchasing machinery and equipment to retain and expand high-end manufacturing across the state and to incentivize the manufacturing of green technologies that will help reduce greenhouse gases, as well as reductions in air and water pollution or energy consumption. The following table provides the legislative history of the program.

CAAEATFA STE Program Legislative History	
Bill	**Description**
Senate Bill 71 (Padilla), Chapter 10, Statutes of 2010.	Directed CAEATFA to implement the STE Program and authorized CAEATFA to approve eligible projects for a STE on equipment and machinery (Qualified Property) used for the "design, manufacture, production, or assembly" of either advanced transportation technologies or alternative energy source products, components, or systems, as defined.
Senate Bill 1128 (Padilla), Chapter 677, Statutes of 2012.	Expanded the STE Program to include Advanced Manufacturing projects. The legislation also placed an annual limit of $100 million in STE awards for each calendar year.
AB 199 (Eggman), Chapter 768, Statutes of 2015.	Expanded the scope of the STE Program to include projects that process or utilize recycled feedstock.
AB 1583 (Eggman), Chapter 690, Statutes of 2019.	Extended the Program's sunset date from January 1, 2021 to January 1, 2026.

Under the STE Program, applications are evaluated to determine the extent to which the anticipated benefits to the state from a project exceed the estimated cost of the avoided sales and use tax. Specifically, through the net benefits test established in the STE Program's regulations, applicants are evaluated based on criteria designed to measure the fiscal and environmental benefits of their projects. The following figure from CAEATFA's 2019 annual report displays an overview of the application process.

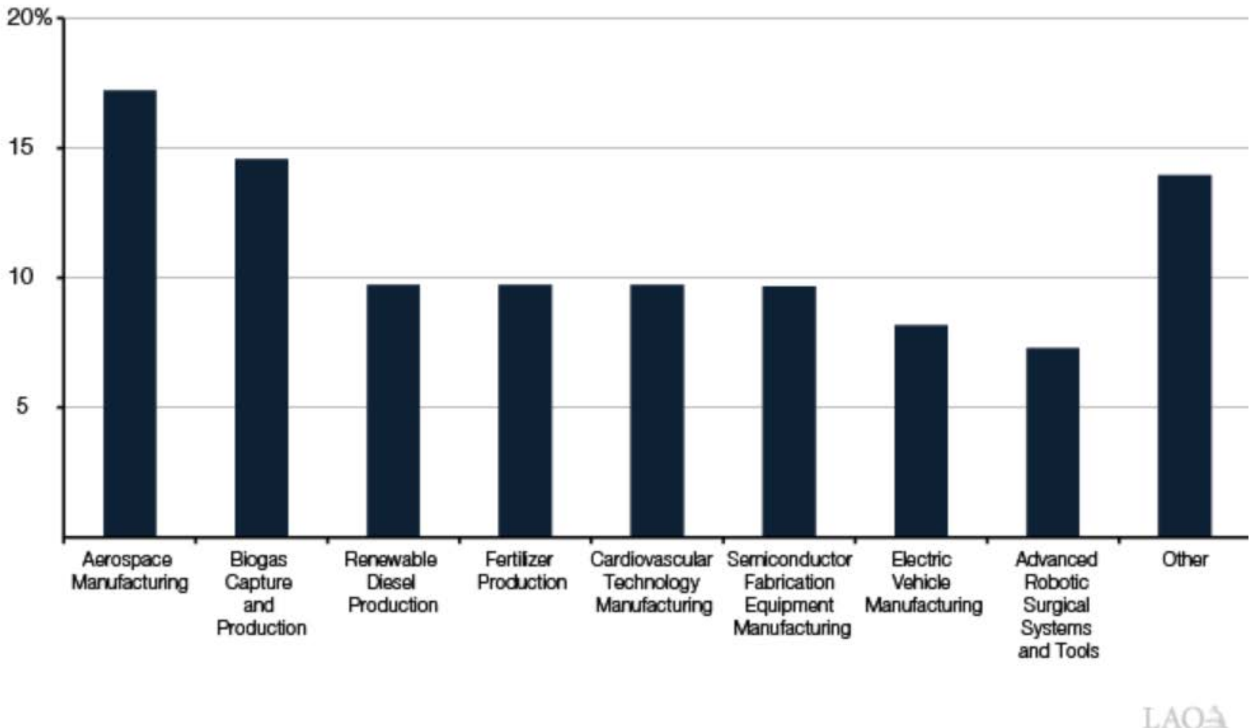


By the July 2019 Board meeting, CAEATFA exhausted the $100 million STE cap – the first time in program history for it to be fully awarded prior to the end of the year and in 2020 and 2021, applications were received that exceeded the cap by the first application deadline.

The Legislative Analyst's Office (LAO) points out that historically, Tesla accounted for a large share of CAEATFA exclusions. In the last couple of years, however, CAEATFA has awarded exclusions to manufacturers across a variety of industries as detailed in the following chart from the LAO.

Exclusions Recently Awarded by Industry

Share of Exclusions Awarded, 2019 to 2020



LAO Comment. The LAO points out that, in addition to the CAEATFA exclusion, the state offers a partial exemption that allows manufacturers and some other types of businesses to buy equipment without paying the 3.94 percent state General Fund portion of the sales tax. Most purchases made under the CAEATFA exclusion would be eligible for the partial exemption, but some (such as many recycling facilities) would not.

The LAO also points out that the majority of the revenue loss would fall on local governments. Specifically, in addition to realignment revenue losses that must be backfilled by the state, the administration's estimates suggest that the proposal would reduce local sales tax revenues by $24.7 million. This results in local governments bearing roughly two-thirds of the direct fiscal cost of the proposal.

Additionally, the LAO makes the following observations:

- **Proposal Does Not Target Hardest-Hit Businesses.** The pandemic has forced many businesses to reduce their operations or close. These adverse effects have been especially severe for businesses in the travel, retail, food and hospitality, health and wellness, and personal care services sectors. The CAEATFA exclusion offers assistance primarily to the manufacturing sector, which has not been among the hardest-hit sectors of the economy.

- **Allocation Process Is Complex.** To use the CAEATFA exemption, equipment purchasers must fill out extensive applications, wait for board approval, and submit periodic reports to CAEATFA. These requirements make participation more costly, but they have led to greater transparency than the state typically provides regarding the use of tax expenditures.

- **Benefits Occur Gradually.** Historically, the usage rate of exclusions has peaked one to two years after the participant receives the award. As a result, many of the benefits of exclusions awarded in 2021 will not materialize quickly enough to address the current economic crisis.

- **Recent Regulations Try to Manage Awards Within Cap.** In 2019 and 2020, CAEATFA issued emergency regulations to address various issues, including the growing demand for exclusions. These include: 1) a reduced "soft cap" on individual awards from $20 million to $10 million, 2) a set aside of $20 million for the smallest applications (less than $2 million each), 3) a set aside of $15 million to be awarded competitively to large applications (more than $10 million), with each applicant receiving, at most, an additional $10 million, 4) a changed evaluation process to award slightly higher scores to applicants who do not qualify for the partial exemption, and 5) creating a new requirement for participants to make at least 15 percent of the projected purchases within 18 months of receiving the award.

The LAO recommends that the Legislature reject this proposal. Because it relies primarily on local funding, by rejecting this proposal, the Legislature would allow local governments to exercise their own judgment regarding the best use of these resources. Furthermore, the CAEATFA exclusion does not provide rapid relief to the businesses most severely affected by the pandemic and economic crisis.

Staff Recommendation. Hold open.

7600 DEPARTMENT OF TAX AND FEE ADMINISTRATION (CDTFA)

Overview. CDTFA administers numerous tax and fee programs, including the Sales and Use Tax, the Cigarette and Tobacco Products Tax Program, and the excise and cultivation taxes for medicinal and recreational cannabis. The CDTFA also administers the alcohol excise tax and the insurance tax pursuant to agreements with the State Board of Equalization.

Budget. The budget includes $694.2 million ($366.1 million General Fund) and 3,986.1 positions in 2021-22. The following chart from the Governor's budget displays funding and positions for CDTFA for the prior year, current year, and budget year.

		Positions			Expenditures		
		2019-20	2020-21	2021-22	2019-20*	2020-21*	2021-22*
6275025	County Assessment Standards Program	4.6	5.3	5.3	$2,909	$2,721	$2,941
6275050	State-Assessed Property Program	2.4	2.8	2.8	4,841	4,554	4,920
6275075	Timber Tax Program	10.5	9.5	9.5	2,320	2,217	2,358
6275100	Sales and Use Tax Program	3,100.1	3,062.8	3,063.8	555,026	501,409	561,654
6275125	Hazardous Substances Tax Program	37.6	37.4	37.4	6,123	5,852	6,215
6275150	Alcoholic Beverage Tax Program	17.3	17.0	17.0	3,349	3,200	3,437
6275175	Tire Recycling Fee Program	14.4	14.3	14.3	2,198	2,096	2,224
6275200	Cigarette and Tobacco Products Tax Program	119.3	114.8	114.8	37,179	29,697	31,606
6275225	Cigarette and Tobacco Products Licensing Program	61.3	60.9	60.9	11,544	11,046	11,737
6275250	Transportation Fund Tax Program	128.9	133.3	133.3	31,830	32,406	34,464
6275275	Occupational Lead Poisoning Prevention Fee Program	6.6	6.5	6.5	984	940	999
6275300	Integrated Waste Management Program	4.1	4.1	4.1	621	597	632
6275325	Underground Storage Tank Fee Program	23.3	23.1	23.1	4,412	4,195	4,450
6275350	Oil Spill Prevention Program	1.2	1.2	1.2	355	337	359
6275375	Energy Resources Surcharge Program	1.9	1.9	1.9	357	338	355
6275400	Annual Water Rights Fee Program	3.8	3.8	3.8	566	589	624
6275425	Childhood Lead Poisoning Prevention Fee Program	4.2	4.2	4.2	579	558	594
6275450	Marine Invasive Species Program	3.1	3.1	3.1	563	543	577
6275500	Emergency Telephone Users Surcharge Program	10.6	10.4	10.4	1,735	1,659	1,755
6275525	E-Waste Recycling Fee Program	29.3	29.4	29.4	5,354	5,110	5,433
6275550	Lumber Fee Program	12.3	12.1	12.1	1,296	1,257	1,329
6275575	Insurance Tax Program	1.7	1.7	1.7	371	988	1,215
6275600	Natural Gas Surcharge Program	3.5	3.4	3.4	1,134	1,020	1,096
6275650	Prepaid Mobile Telephony Program	5.9	3.9	2.0	1,103	660	361
6275700	Lead-Acid Battery Cleanup Fee Program	9.1	9.0	9.0	1,529	2,128	1,654
6275725	Cannabis Taxes Program	28.6	38.2	38.2	7,679	12,425	9,104
6275760	County Revenue Property Tax Reimbursement Program	-	-	-	-	-	1,643
9900100	Administration	372.9	372.9	372.9	65,925	66,301	66,322
9900200	Administration - Distributed	-	-	-	-65,508	-65,884	-65,905
TOTALS, POSITIONS AND EXPENDITURES (All Programs)		**4,018.5**	**3,987.0**	**3,986.1**	**$686,374**	**$628,959**	**$694,153**

Issue 16: Centralized Revenue Opportunity System (CROS) Project Implementation Phase –Fiscal Year 2021-22

Request. The Governor's budget proposes $23.9 million to provide resources required to support the final phases of the CROS Project and the transition to Production Support Maintenance and Operations. The CROS Project is an information technology modernization effort designed to enable 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**.**

Background. The Taxpayer Transparency and Fairness Act of 2017 established the CDTFA in the Government Operations Agency and shifted most of the tax and fee programs previously administered by the Board of Equalization to the CDTFA. The CDTFA administers more than 30 tax and fee programs that generate revenue essential to the State of California. The programs include California's sales and use tax, fuel, cigarette, tobacco, environmental, as well as other special taxes and fees. Over one million discrete businesses currently interact annually with the CDTFA, many involved with multiple tax and fee programs.

The CROS Project 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. The first production release, Rollout 2, included the Sales and Use Tax Program and was implemented on May 7, 2018. The second production release, Rollout 3 included Special Taxes (such as Alcoholic Beverages, Cigarette and Tobacco, and Fuel Taxes) and was implemented on August 12, 2019. The final production release, Rollout 4 will include all remaining CDTFA tax programs and was implemented on November 9, 2020.

The CROS Project includes the following activities:

- Replacing legacy mainframe-based revenue and collection information systems with an integrated and automated tax and fee system.
- Providing an enterprise data warehouse.
- Enhancing online services available to tax and fee payers and other stakeholders.
- Improving case and contact management.
- Reengineering and improving program processes.
- Improving data sharing capability and real-time data access, especially to field staff.
- Enhancing CDTFA's ability to quickly implement legislative, judicial, or electoral changes to tax/revenue codes.

According to the CDTFA, the most significant outcome of the CROS Project is an increase in the sales and use tax collections of approximately $486.1 million through 2019-20. Additional outcomes include improved services to tax and fee payers, improved operational efficiencies including accounting and General Ledger improvements, improved revenue tracking from receipt through distribution, enhanced security, and greater ability to quickly respond to statutory, judicial, or electoral changes to tax and revenue codes.

Excluding CROS vendor payments, for 2021-22, CDTFA is requesting $7.5 million for operating expenses and equipment. In addition to the standard complement of communication, postage, supplies, and additional, hardware, and software resources needed to support CROS operations, the CDTFA is requesting funding for hardware infrastructure replacement, consultant services and training.

The CDTFA requests $16.4 million for Contractor compensation in 2021-22. This amount includes:

- $5.96 million release of withhold, which is 7 percent of the 10 percent withheld (revenue-based compensation).
- $600,000 release of withhold, this is the full 10 percent withheld for unanticipated tasks related to two new programs (Cannabis and Lead-Acid Battery Fees) and selected online services in Spanish per the contract amendment.
- $9.9 million for the first-year costs of the Maintenance and Operations.

Period Compensation payments began in 2018-19, continuing based on the agreed upon Compensation Model; the CDTFA expects to continue making payments during 2019-20 through 2022-23.

Staff Recommendation. Hold open.

1701 Department of Financial Protection and Innovation (DFPI)

Overview. DFPI serves Californians by overseeing financial service providers; enforcing laws and regulations; promoting innovation and fair and honest business practices; enhancing consumer awareness; and protecting consumers by preventing potential marketplace risks, fraud, and abuse.

Budget. The budget includes $142.6 million (primarily from special funds) and 721.1 positions in 2021-22. The following chart from the Governor's budget displays funding and positions for DFPI for the prior year, current year, and budget year.

		Positions			Expenditures		
		2019-20	2020-21	2021-22	2019-20*	2020-21*	2021-22*
1510	Investment Program	182.4	177.4	177.4	$32,550	$33,266	$35,123
1515	Lender-Fiduciary Program	151.0	144.7	144.7	26,039	26,243	28,566
1520	Licensing and Supervision of Banks and Trust Companies	170.4	172.5	177.5	28,707	29,119	32,327
1525	Money Transmitters	35.5	31.3	32.8	5,366	5,523	6,199
1545	Administration of Local Agency Security	1.9	1.8	1.8	501	486	604
1550	Credit Unions	70.2	68.4	69.9	11,501	11,130	12,805
1555	CalMoneySmart	-	1.0	1.0	-	1,349	1,340
1556	California Consumer Financial Protection	-	44.0	45.0	-	8,444	9,111
1557	Debt Collectors	-	-	71.0	-	-	16,481
TOTALS, POSITIONS AND EXPENDITURES (All Programs)		**611.4**	**641.1**	**721.1**	**$104,664**	**$115,560**	**$142,556**

FUNDING		**2019-20***	**2020-21***	**2021-22***
0067	State Corporations Fund	$58,459	$-	$-
0240	Local Agency Deposit Security Fund	501	486	604
0298	Financial Institutions Fund	33,826	-	-
0299	Credit Union Fund	11,426	10,780	12,455
0995	Reimbursements	452	1,380	1,380
3360	Financial Empowerment Fund	-	1,349	1,340
3363	Financial Protection Fund	-	101,565	126,777
TOTALS, EXPENDITURES, ALL FUNDS		**$104,664**	**$115,560**	**$142,556**

Issue 17: Debt Collector Licensing and Regulation (SB 908)

Request. The Governor's budget proposes $10.7 million from the Financial Protection Fund and 44.0 positions in 2021-22, $10.3 million and 51.0 positions in 2022-23, and $10.9 million and 55.0 positions in 2023-24 to implement SB 908 (Wieckowski) Chapter 163, Statutes of 2020, the Debt Collection Licensing Act (Act).

Background. SB 908 created a new licensing law applicable to debt collectors and debt buyers, administered by the DFPI, effective January 1, 2022. The Department is to begin implementing the Act on January 1, 2021 and is required to allow any debt collector that applies for a debt collection license prior to January 1, 2022 to operate pending the approval or denial of the application. The Act allows the Commissioner of the DFPI to promulgate rules and regulations, and issue orders to implement the bill.

The Act requires a debt collector to apply for a license and pay fees to cover application costs, as well as submit to a fingerprint and criminal history record check with the application. The Act outlines licensee requirements and the process and reasons for application denial.

The Act establishes within the Department a Debt Collection Advisory Committee to advise the Commissioner on matters relating to debt collection, including proposed fee schedules and the mechanics and feasibility of implementing requirements proposed in regulations. The Act requires the Commissioner to appoint seven members, including one representing consumers, to the committee. The Act outlines the terms for serving on the committee and requires the committee to meet at least twice a year.

The Department recently secured limited-term funding for the registration (but not full licensing) of debt collectors and other unregulated financial service providers in compliance with AB 1864 (Limón), Chapter 157, Statutes of 2020, the California Consumer Financial Protection Law (CCFP). The Act requires the Department to license (not simply register) and monitor debt collectors, for which the Department does not currently have full resources. The Department has identified resources and positions ($5.8 million and 27.0 positions in the 2021-22 fiscal year growing to $7.1 million and 35.0 positions in 2023-24) from the CCFP program to be redirected to the Debt Collectors program. This proposal requests the remaining resources and positions needed to fully license and regulate debt collectors.

The Department expects up to 7,000 licensees to apply for a license before December 31, 2021. The estimated number of licensees is based on the debt collector registration program of the State of Texas. Applicants will operate with a provisional license while the Department validates their applications. The Department expects to process 4,000 license applications in 2021-22, and 3,000 license applications in 2022-23.

In the first year of licensure, the Department will perform examinations of new licensees. The purpose of the examination is to obtain first-hand knowledge of the licensee’s operation, establish a baseline of their compliance with California Law, and introduce the Department’s regulatory expectations. By the third year of licensure, the Department anticipates licensees will be examined every 10 years as a best practice to comply with the Act.

To license and examine debt collectors, the Department requests a total of 39.0 positions: 1.0 Executive Secretary II, 4.0 Associate Governmental Program Analysts, 17.0 Financial Institutions Examiners, 11.0 Senior Financial Institutions Examiners, 4.0 Financial Institutions Managers, and 2.0 Office Technicians (General).

A Deputy Commissioner (CEA-B) and two Regional Deputy Commissioners (Corporation Examiner IV - Supervisor), which will be redirected from the CCFP program, will oversee all policy, planning and operational aspects of the Debt Collection program as well as provide leadership and strategic direction. The Debt Collection program will be divided into two teams with one Regional Deputy Commissioner supervising the licensing team and the other supervising the examination team.

The Department will support the program in the first year mostly through reserves in the Financial Protection Fund. However, this is not sustainable. To continue to regulate debt collectors, the Department will collect revenues associated with fees from debt collectors, including application, investigation, amendment fees, and payments associated with examinations and assessments, and settlements. The following table details the total revenue needed to cover the cost for the Department to implement the Act, including the cost of resources redirected from the CCFP.

Cost of Debt Collector Licensing (In Thousands)

Appropriation Description	2021-22	2022-23	2023-24
This proposal	$10,713	$10,253	$10,920
Redirected from CCFP	$5,768	$7,180	$7,104
Total DCL Cost	**$16,481**	**$17,433**	**$18,024**

Department licensees are required to support the Department's cost to regulate them. Debt collectors are expected to pay for the cost of debt collection activities. The proposed fee schedule for debt collector regulation is modeled on the fee schedules of the Department's existing licensing laws. Thus, the Department expects to support the program by charging licensees flat-rate application, investigation, amendment, and hourly examination fees while using a pro rata method to calculate annual assessment fees. The following table displays projected revenue from these sources. The Department calculated the projected application and investigation fees assuming it will process 4,000 applications in 2021-22, 3,000 applications in 2022-23, and 700 applications in 2023-24.

Proposed Debt Collector Licensing Revenues (In Thousands)

Funding Source	**2021-22**	**2022-23**	**2023-24**
Application fees @ $350 per application	$1,400	$1,050	$245
Investigation fees @ $150 per application	$600	$450	$105
Amendment fees @ $300 per amendment	$150	$300	$1,650
Examination revenues	$167	$1,076	$2.783
Assessments – pro rata to cover costs	$0	$13,757	$12,441
Settlements	$600	$800	$800
Financial Protection Fund Reserve	$13,564	$0	$0
Total Projected Revenues	**$2,917**	**$17,433**	**$18,024**

To operate in California, debt collectors must be licensed by January 1, 2022. Thus, the department expects to receive license applications in 2021. The Department requests statutory changes to Financial Code section 100007, subdivision (b), to allow the Department to begin collecting a $350 application fee with each application.

In determining the proposed $350 application fee, the department considered both the cost recovery allowable under the State Administrative Manual section 8740, and the application fees charged to other comparable department licensees. The proposed $350 application fee, comparable to the application fees charged to other similar department licensees, is fair and reasonable. The department's application fees for similar programs range from $200 to $850 with an average fee between $315 and $416.

Staff Comment. Staff notes that the department's estimate of potential licensees is consistent with the fiscal estimates of SB 908, although it is at the high end of the range. The Senate Floor Analysis for SB 908 included an estimated range between 3,000 and 7,000 licensees. As noted above, the department's estimate is based on the debt collector registration program of Texas. Industry representatives have raised concern that an estimate of 7,000 is not an accurate reflection of Texas's licensing program because 1) Texas registers more professions than California law requires, 2) Texas does not purge their registration rolls and a significant number of businesses that had registered are no longer in business, and 3) some organizations are licensed multiple times.

The subcommittee may wish to ask the department to respond to these concerns raised by certain industry groups regarding the estimated number of licensees.

Staff Recommendation. Hold open.

7730 FRANCHISE TAX BOARD (FTB)

Overview. FTB is responsible for collecting personal income tax and corporation tax revenue; operating various collection programs; and conducting field audits for the Fair Political Practices Commission.
Tax program activities include taxpayer assistance and tax return processing, filing enforcement, audits, and tax collection functions. The program also includes the collection and distribution of voluntary contributions to, and on behalf of, certain non-profit charitable organizations.

Budget. The Governor's Budget includes $973.9 million ($936.6 million General Fund) and 5,940.6 positions in 2021-22. The following chart from the Governor's budget displays funding and positions for FTB for the prior year, current year, and budget year.

		Positions			Expenditures		
		2019-20	2020-21	2021-22	2019-20*	2020-21*	2021-22*
6280	Tax Programs	5,209.6	5,227.4	5,375.5	$850,832	$828,948	$933,854
6285	Political Reform Audit	13.0	13.0	13.0	2,112	64	-18
6290	Department of Motor Vehicles Collections Program	81.1	81.1	81.1	10,059	9,344	10,032
6295	Court Collection Program	112.2	101.2	101.2	14,219	12,438	13,600
6300	Legal Services Program	-	-	-	2,979	3,077	3,077
6305	Contract Work	62.2	62.2	62.2	15,303	13,327	13,324
9900100	Administration	310.6	310.6	307.6	36,195	37,018	36,762
9900200	Administration - Distributed	-	-	-	-36,195	-37,018	-36,762
TOTALS, POSITIONS AND EXPENDITURES (All Programs)		**5,788.7**	**5,795.5**	**5,940.6**	**$895,504**	**$867,198**	**$973,869**

Issue 18: Mainstreet Business Tax Credit

Request. The Governor's budget proposes $100 million General Fund for the Main Street Small Business Tax Credit (Main Street Credit), a tax credit for small businesses that increase their number of employees. The Administration has said that it plans to pattern the credit after the newly extended federal Employee Retention Credit (ERC), but has not yet provided new statutory language.

Background. In September 2020, the Legislature created the Main Street Credit, which provides income or sales tax credits to eligible small businesses that added jobs in the second half of 2020. Each eligible business receives a credit of $1,000 for each new job. Eligibility is restricted to firms that meet two conditions: 1) they have 100 or fewer employees and 2) their gross receipts dropped by at least half between the second quarter of 2019 and the second quarter of 2020. These eligibility criteria were patterned, in part, after the federal ERC. The state capped the total amount of credits available to all businesses at $100 million and allotted the credits on a first-come, first-served basis.

The federal government created the ERC in March 2020 as part of the Coronavirus Aid, Relief, and Economic Security Act. The ERC provided firms with 100 or fewer employees a credit for 50 percent of wages paid to employees they retained in 2020 (up to $5,000 per employee). Similar to the Main Street Credit, businesses are eligible for the ERC if their quarterly gross receipts dropped by at least half compared to the same quarter in 2019. Firms with smaller drops in gross receipts were eligible if they had to suspend or curtail operations in response to governmental shutdown orders.

LAO. The LAO noted the following in their assessment of this proposal:

1. The credit is relatively well-targeted to businesses affected by pandemic for two reasons. First, eligibility is limited to businesses that have experienced a drop in gross receipts during the pandemic. Second, the credit is available to many businesses in the hardest-hit industries, such as travel, retail, food and hospitality, health and wellness, and personal care services.
2. It leaves out new businesses in affected sectors. One limitation of tying eligibility to a drop in gross receipts from the prior year is that new businesses would not be able to qualify, as these businesses did not have gross receipts in 2019 or early 2020. Nonetheless, new businesses in heavily impacted industries may face challenges with expanding and hiring new employees in the coming months.
3. Not all main street credits are claimed. Nearly 10,000 businesses applied for a total of $56 million of Main Street Credits in 2020. This suggests that, despite a fair amount of interest among businesses, the credit could have been set at a higher value without exhausting the $100 million allocation.

Based on their assessment, the LAO has recommended that the Legislature focus resources on this proposal, rather than other proposals included in the Governor's budget, and broaden the proposal by:

- ***Broadening Eligibility to Other Impacted Businesses.*** The LAO suggests considering which groups of businesses impacted by the pandemic would not be served either by the Governor's proposal or by the federal ERC. One example is newly formed businesses in heavily impacted sectors. An option to include these businesses would be to allow new businesses to qualify for the credit if they are in certain sectors—based on their North American Industry Classification System code. Such an approach, however, could create additional administrative responsibilities for the California Department of Tax and Fee Administration and the FTB.

- ***Increasing the Value of the Credit.*** The LAO also suggests increasing the value of the credit beyond $1,000 per employee. One option would be to set the credit at a percentage of wages paid to each new employee—as with the ERC. For example, if funding for the credit program were increased to $400 million, the value of the credit could be increased to 40 percent of wages (up to $4,000 per employee) and still provide credits for roughly twice as many new hires as the Main Street Credit.

Staff Recommendation. Hold open.

Issue 19: Elective S-corporation Tax

Request. The Governor's budget proposes to allow California Personal Income Tax (PIT) filers with income from S corporations to pay an optional 13.3 percent tax at the entity level. This 13.3 percent rate is equal to the top PIT marginal rate. In return, the filer would receive a nonrefundable credit for their full share of the new S corporation tax.

Background. An S corporation is a corporation that elects to be taxed as a pass-through entity. Income, losses, deductions, and credits flow through to the shareholders, partners, or members. They then report these items on their personal tax return. Some key features of S corporations are:

- They do not pay federal income taxes.
- California taxes every S corporation that has California source income at 1.5 percent.
- They are limited by the types of owners (shareholders) and cannot exceed 100 shareholders.
- A separate bank account and separate records are required with this form of business.
- S corporations are subject to the annual $800 minimum franchise tax.

For many individuals with S corporation income, electing to pay the new S corporation tax would reduce their total federal and state taxes. The new state S corporation tax would reduce these taxpayers' federal taxable income, resulting in lower federal taxes. At the same time, they would receive a state PIT credit to compensate for the increased cost of the new S corporation tax. The LAO points out that for most taxpayers with incomes of $1 million or more, the state PIT credit would fully offset the cost of the new S corporation tax. For most of those with incomes below $1 million, the credit would offset most, but not all, of the increased cost. Regardless, total federal and state taxes would go down for both groups. This would help taxpayers recoup some of the tax benefits lost by Californians when the State and Local Tax deduction was limited as part of the 2017 federal Tax Cut and Jobs Act.

LAO. The LAO finds that the general concept behind the Governor's proposal has merit: to restructure state tax payments of certain business owners in a way that reduces their federal taxes without reducing state tax collections. There are various ways, however, the Legislature could carry out the general aim of the Governor's proposal. These alternatives warrant the Legislature's consideration. Given the complexities of this issue and its limited relevance to the state budget, the LAO suggest that the Legislature consider such alternatives in the policy committee process.

Staff Recommendation. Hold open.