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

SUBCOMMITTEE NO. 4 Agenda

Senator Stephen C. Padilla, Chair
Senator Roger W. Niello
Senator Lola Smallwood-Cuevas

Thursday, May 16, 2024
Upon Call of the Chair
State Capitol – Room 113

Consultants: Elisa Wynne and Tim Griffiths

ITEMS FOR VOTE ONLY

ITEMS FOR DISCUSSION

Public Comment

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ITEMS FOR VOTE ONLY

7730 FRANCHISE TAX BOARD (FTB)

Issue 1: Middle Class Tax Refund Technical Clarification

Budget Proposal. The Governor's budget proposes trailer bill language that makes a technical correction to specify that the unexpended or unused balance of payments made for purposes of the Middle Class Tax Refund shall be deposited by the Franchise Tax Board (FTB) into the General Fund. Existing language specifies that funds shall be returned to the state no later than May 31, 2026, but did not specify the fund.

Staff Recommendation. Approve placeholder trailer bill language.

Issue 2: Extend Exemption for Cannabis Businesses

Budget Proposal. The Governor's budget proposes trailer bill language that extends the timeline from December 1, 2025 to December 1, 2030 to specify that personal income tax law does not conform to federal income tax law that disallows credits or deductions for businesses engaged in sales of controlled substances, including commercial cannabis activity.

Staff Recommendation. Approve placeholder trailer bill language.

Issue 3: Terminate Fund Transfers to Delinquent Tax Collection Fund

Budget Proposal. The Governor's budget proposes trailer bill language that removes the requirement for transfer of funds from the General Fund to the Delinquent Tax Collection Fund. This transfer was in place to cover the cost of FTB contracting with third parties for collection activities. With the full implementation of deliverables of the Enterprise Data to Revenue (EDR) project, FTB no longer outsources collection efforts. This collection activity has been suspended since the new system was put in place, but the budget authority has not been removed. This proposal is technical clean-up to remove the outdated transfer authority.

Staff Recommendation. Approve placeholder trailer bill language.

Issue 4: Repealing the Expiration Date for Electronic Notifications to Taxpayers

Budget Proposal. The Governor's budget proposes trailer bill language to eliminate the unset date (currently January 1, 2025) for allowing the Franchise Tax Board to provide notification to the taxpayer in a preferred electronic communication method designated by the taxpayer that a specified notice, statement, bill, or other communication is available for viewing in the taxpayer's folder on the Franchise Tax Board's internet website, and would allow the taxpayer to file a protest, notification, and other communication to the Franchise Tax Board in a secure manner.

Staff Recommendation. Approve placeholder trailer bill language.

Issue 5: Enterprise Data to Revenue Project 2

Budget Proposal. The Governor's budget requests $127.1 million General Fund and the full time equivalent of 28.0 permanent positions, and 10.0 limited-term positions for the Franchise Tax Board (FTB) for the fourth-year implementation of the Enterprise Data to Revenue (EDR2) project, which is the second phase of the Tax System Modernization (TSM) plan. The resources received from this proposal will allow FTB to continue supporting the optimization of business processes throughout the EDR2 life cycle.

The May Revision further includes a request to extend the encumbrance period of funding allocated in the 2023 Budget Act for the Enterprise Data to Revenue 2 project. Specifically, this would extend $31.3 million appropriated in the Budget Act of 2023 from June 30, 2024 to June 30, 2025. These funds would be used for necessary project work that was unanticipated and for vendor compensation payments

Background.

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

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

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

The EDR2 project plans to achieve the following objectives in 2024-25:

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

FTB notes that this request is funding for the 2024-25 fiscal year and that a BCP will be submitted each year to cover the costs of the project. According to the FTB, the total cost of EDR2 is estimated to be just over $750 million and will ensure continued collection of over $4 billion in annual revenues. After full implementation, the project is projected to bring in additional new revenues of $300 million annually.

The EDR2 project is vital to FTB's operations. The technology currently supporting two out of three of FTB's major legacy systems {(Accounts Receivable Collection System (ARCS), Integrated Nonfiler Compliance (INC), and Professional Audit Screening and Support System (PASS)}, which annually allow FTB to collect over $4 billion in compliance revenue, are nearing end-of-life and will no longer be supported after December 31, 2025. Implementing the EDR2 project at this time is critical.

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

Staff Recommendation. Approve as proposed.

Issue 6: Income Threshold Fix for CalEITC, YCTC, and FYTC

Budget Proposal. The Governor's May Revision proposes trailer bill language that would align the maximum earned income thresholds for the California Earned Income Tax Credit (CalEITC), the Young Child Tax Credit (YCTC), and the Foster Youth Tax Credit (FYTC). This technical fix would ensure the YCTC and FYTC maximum earned income thresholds are adjusted to that of the CalEITC. Implementing this change will reduce confusion among tax payers and simplify the process of claiming these credits.

Staff Recommendation. Approve placeholder trailer bill language.

7600 Department of Tax and Fee Administration (CDTFA)

Issue 7: SB 96 Historic Venues Restoration and Resiliency Act

Budget Proposal. The Governor's budget proposes clean up trailer bill language to address implementation issues in the SB 96 (Chapter 595, Statutes of 2023). SB 96 enacted the Historic Venue Restoration and Resiliency Act to require that retailers making sales at historic venues during qualified events segregate the taxable sales from those sales on a separate line or form when filing sales tax returns to CDTFA.

The proposed trailer bill makes the following changes:

1. Requires that the return filed with the CDTFA and DOF specify the taxable sales made at a qualified event for each confirmed historic venue.

2. Limits the requirement to segregate taxable sales on the return to qualified events that occur on or before June 30, 2029.

3. Requires that DOF, no later than 15 days after enactment of the annual Budget Act, for each confirmed historic venue located within the geographic boundaries of a city or county report to the Controller the amounts to be allocated from the fund to each city and county.

4. Changes the requirement from 90 to 10 days that a city or county, or its designee notify any retailers who will be making sales during the qualified event of their reporting obligation as specified.

5. Deletes the requirement for a city or county to deliver a report to CDTFA by January 1, 2027.

6. Specifies that CDTFA's annual report is due November 1 of each year.

Staff Recommendation. Approve placeholder trailer bill language.

Issue 8: California Tire Recycling Fee Program

Request. The Governor's budget proposes to convert the funding mechanism for the Tire Program from a reimbursement to a Budget Act appropriation from California Tire Recycling Management Fund (Tire Fund). This request will result in a net-zero budget impact due to a corresponding reduction in CDTFA's reimbursement authority.

CDTFA requests a Budget Act appropriation from the Tire Fund in the amount of $2,541,000 in 2024-25, $2,511,000 in 2025-26, and ongoing. CDTFA also requests a corresponding reduction in reimbursement authority of $2,541,000 in 2024-25, $2,511,000 in 2025-26, and ongoing to offset the Budget Act appropriation from the Tire Fund.

The Administration also requests technical trailer bill amendments to reflect this change.

Staff Recommendation. Approve as Proposed.

1700 CIVIL RIGHTS DEPARTMENT (CRD)

Issue 9: Budget and Staffing Augmentations to Implement Recently Enacted Legislation

Governor's Budget Proposal. As part of the May Revision, the Civil Rights Department (CRD) requests an ongoing allocation of $1.7 million in General Fund starting in 2024-25 and the authority to add 11 staff positions in order to implement SB 267 (Eggman, Ch. 776, Stats. 2023) and SB 848 (Rubio, Ch. 724, Stats. 2023)

Background: SB 267 prohibits landlords from discriminating against tenants on the basis that they pay some or all of their rent using a government rent subsidy such as a Housing Choice Voucher. The new law tasks CRD with receiving complaints of alleged violations, investigating, and, upon an appropriate finding, pursuing claims on behalf of aggrieved tenants.

SB 848 requires employers with five or more employees to grant a employee's request for up to five days of unpaid leave following a miscarriage, stillbirth, unsuccessful assisted reproduction, failed adoption, or failed surrogacy. The new law tasks CRD with receiving complaints of alleged violations, investigating, and, upon an appropriate finding, pursuing claims on behalf of aggrieved workers.

To carry out these new duties, CRD is requesting the additional staff and funding set forth in this proposal.

Staff Comments: The combined request is roughly consistent with the fiscal effects anticipated by the Senate Appropriations Committee during legislative consideration of the bills.

Staff Recommendation. Approve as budgeted.

2240 HOUSING AND COMMUNITY DEVELOPMENT DEPARTMENT (HCD)

Issue 10: Staff and Budgetary Augmentations to Implement Recently Enacted Legislation

Governor's Budget Proposal: As part of the May Revision, the Housing and Community Development Department (HCD) requests staffing and budgetary increases necessary for the implementation of nine housing-related statutes enacted into law in 2023.

Background: The May Revision proposes all of the following for the purposes of implementing the referenced legislation:

- *AB 434 (Grayson, Ch. 740, Stats. 2023)* - Adds specified housing laws to the list of laws that the Department of Housing and Community Development (HCD) is required to enforce.
    - $1,089,000 in annual General Fund starting in 2024-25.
    - Hiring authority for five additional positions starting in 2024-25.

- *AB 519 (Schiavo, Ch. 743, Stats. 2023)* - Creates an Affordable Housing Finance Workgroup to propose the creation of a consolidated application for affordable housing developers to access state housing funding programs and a coordinated review process for the application.
    - $1,548,000 in 2024-25 and 2025-26 General Fund; $774,000 in 2026-27 General Fund.

- *AB 529 (Gabriel, Ch. 743, Stats. 2023)* - Allows the Department of Housing and Community Development (HCD) to propose revisions and clarifications to the California Building Standards Code pertaining to adaptive reuse to the California Buildings Standards Commission (BSC) and makes other changes to state law related to adaptive reuse projects.
    - $422,000 in annual General Fund starting in 2024-25.
    - Hiring authority for two additional positions beginning in 2024-25.

- *AB 1386 (Gabriel, Ch. 760, Stats. 2023)* - Authorizes entities referring veterans to housing units funded by the Veterans Housing and Homelessness Prevention Program (VHHP) or certain housing units supported by project-based housing vouchers to refer veterans at higher income levels if units are unable to be filled, as specified.
    - Hiring authority for one additional position in 2024-25 and ongoing.

- *AB 1490 (Lee, Ch. 764, Stats. 2023)* - Authorizes an extremely affordable adaptive reuse housing development project to be an allowable use, regardless of the general plan, specific plan, zoning ordinance or regulation, as specified.
    - $195,000 in annual General Fund starting in 2024-25.
    - Hiring authority for one additional position beginning in 2024-25.

- *AB 1508 (Ramos, Ch. 765, Stats. 2023)* - Requires the Department of Housing and Community Development (HCD) to incorporate analyses of first-time homebuyer assistance programs, recommendations to increase homeownership opportunities for first-time homebuyers, and a demographic disparities in homeownership attainment in future updates to the Statewide Housing Plan (SHP).
    - $212,000 in annual General Fund beginning in 2024-25.
    - Hiring authority for one additional position in 2024-25 and ongoing.

- *AB 1633 (Ting, Ch. 768, Stats. 2023)* - Provides that a disapproval under the Housing Accountability Act (HAA) includes a local agency's failure to make a determination of whether a project is exempt from the California Environmental Quality Act (CEQA), abuse of discretion, or failure to adopt certain environmental documents under specified circumstances, and makes several other changes.
    - $474,000 in annual General Fund beginning in 2024-25.
    - Hiring authority for two additional positions beginning in 2024-25.

- *SB 555 (Wahab, Ch. 402, Stats. 2023)* - Creates the Stable Affordable Housing Act of 2023 for the purposes of studying the development of social housing through a mix of acquisition and new production.
    - $712,000 in General Fund in 2024-25 and 2025-26; $227,000 annually from 2026-27 on.

- *SB 745 (Cortese, Ch. 884, Stats. 2023)* - Requires the California Building Standards Commission (BSC) and the Department of Housing and Community Development (HCD) to develop and propose new mandatory building standards related to water efficiency.
    - $579,000 in General Fund in 2024-25; $179,000 in annual General Fund beginning in 2025-26.
    - Hiring authority for one additional position beginning in 2024-25.

Additionally, HCD requests $1,146,000 in annual General Fund and hiring authority for an additional eight positions starting in 2024-25 to provide the general administrative support staffing associated with the implementation of the nine pieces of enacted legislation described above.

Staff Comments: Each of the requests is roughly in keeping with the fiscal effect anticipated by the Senate Appropriations Committee during legislative consideration of the corresponding bill, with the exception of AB 434, for which the budget and hiring requests are approximately double the Appropriations estimate, though relatively minor in terms of overall cost to the state.

Staff Recommendation: Approve as budgeted.

Issue 11: Encumbrance Deadline Extensions for Homekey 2.0 and Regional Early Action Planning Grants 2.0

Governor's Budget Proposal: As part of the May Revision, the Housing and Community Development Department (HCD) requests extension of the encumbrance deadlines for two programs – Homekey 2.0 and the Regional Early Action Planning (REAP) 2.0 Grants for the reasons detailed below.

Background: Homekey 2.0 funds state, regional, and local public entities to develop a "broad range of housing types, including but not limited to hotels, motels, hostels, single-family homes and multifamily apartments, adult residential facilities, manufactured housing, and to convert commercial properties and other existing buildings to permanent or interim housing for the target population." Currently, awardees have until June 30, 2024 to encumber all of the funding allotted to them under the program. The May Revision requests to extend this period through June 30, 2026 in order "to allow grantees sufficient time" to meet the program's expenditure requirements.

The Regional Early Action Planning 2.0 (REAP 2.0) grant program provides funding to regional planning entities for housing and transportation-related planning and development projects that are consistent with the region's sustainable growth plans. Currently, the recipient's encumbrance deadline does not match with the date in the statute. To fix the problem, the May Revisions seeks to extend the encumbrance deadline from June 30, 2024, to June 30, 2026.

Staff Comments: With respect to the Homekey 2.0 extension, the Subcommittee may wish to inquire why recipients have not been able to meet the program's original expenditure requirements and why they need an additional two years to do so.

Staff Recommendation: Approve as budgeted.

Issue 12: Budget Augmentations, Staffing Increases, and Encumbrance Extensions Associated with Federally Funded Housing Programs

Governor's Budget Proposal: As part of the May Revision, the Housing and Community Development Department (HCD) requests the additional staffing, budget augmentations, and encumbrance date extensions detailed below in relation to two federal housing-related programs: Community Development Block Grant – Disaster Recovery and the Federal HOME Investment Partnerships Program.

Background: Under the Community Development Block Grant – Disaster Recovery program the federal Housing and Urban Development Department (HUD) provides flexible grants to help cities, counties, and States recover from Presidentially declared disasters. The budget request seeks hiring authority for two additional position and an augmentation of $24,408,000 in 2024-25 to enable HCD to implement and award funds from the program that will go to Plumas County to assist in wildfire recovery efforts. The request further asks for the encumbrance period for these funds to be extended through January 16, 2030 and for permission to transfer some of these funds to state operations.

The Federal HOME Investment Partnerships Program – American Rescue Program funds developers, non-profit service providers, and Tribal Entities to assist qualified populations including individuals and families who are experiencing or at risk of experiencing homelessness and other vulnerable populations by providing affordable housing and/or supportive services. The budget request seeks hiring authority for two additional position and an augmentation of $4,000,000 in 2024-25 to enable HCD to administer the program in California. The request further asks for the encumbrance period for these funds to be extended through September 30, 2030 and for permission to transfer some of these funds to state operations.

Staff Comments: As these programs are federally funded, the additional budget and staffing requested do not put additional pressure on the state's General Fund condition. The Subcommittee may wish to inquire why additional time to encumber the funds is needed.

Staff Recommendation: Approve as budgeted.

ITEMS FOR DISCUSSION

7600 DEPARTMENT OF TAX AND FEE ADMINISTRATION (CDTFA)

Issue 13: Bad Debt Sales Tax Deduction and Refund

Request. The Governor's budget includes a proposal to eliminate a sales and use tax deduction and refund for a lender or retailer's affiliate related to bad debt, commencing January 1, 2025. The Administration estimates that the proposal would increase General Fund revenue by $25.3 million in 2024-25 and $50.6 million per year ongoing.

Note: Department of Finance is in the process of updating the revenue impact and has indicated that the full revenue gain would not be realized until the 2028-29 fiscal year due to a backlog of claims at California Department of Tax and Fee Administration (CDTFA). This update is anticipated to be included in the May Revision.

The Governor includes proposed trailer bill language to enact this change.

Background.

Under current state law, retailers remit sales and use tax to the CDTFA on taxable goods. Retailers may claim a bad debt deduction or refund when those sales and use taxes were not ultimately realized – for example the taxable goods that turn out to be worthless, considered "bad debt". Current state law also extends this refund or credit to lenders and affiliates that finance the debt. In general, most loans to purchase goods are offered not by retailers but by retailer-affiliate lenders such as banks, credit unions, and other financial companies, meaning these are the entities that ultimately benefit from the bad debt deduction.

Lenders generally already price in the risk of retailer bad debt through interest rates or fees, and can currently claim the deduction or refund even if a profit was realized. The bad debt deduction/refund is unusual in that it is allowed to lenders even though sales tax due related to purchases made on credit is paid by the retailer, not the lender. Furthermore, the borrower pays the sales tax reimbursement related to the purchase to the retailer, not the lender. Under current sales tax law, typically only the payer of sales tax (the retailer) can claim a refund. Administrative complexity resulting from this unusual arrangement creates significant workload for CDTFA's audit team.

The largest deduction/refund claims by dollar amounts are related to auto loans (accounting for over 50 percent of total claimed dollars) while those related to credit cards account for around 20 percent of claimed dollars. Another 10 percent of claimed dollars are related to lenders who offer multiple different kinds of loans.

In comparison to other states, California provides a generous deduction. Of the 45 states that charge sales tax, California is one of just five (Includes Idaho, Michigan, Pennsylvania, and Texas) that allow the deduction for non-retailer lenders.

Rationale for the Change.

The Administration notes that the current deduction provides a double benefit to lenders and essentially subsidizes the loans that financial institutions offer. The terms of a loan include interest and late payment penalties. The loan is based on the purchase price of the item, including the amount of sales tax, meaning that interest and penalties are calculated on this higher amount. Lenders are therefore collecting both a profit on the loan and are partially protected by the state if the borrower defaults. At staff's request, the Administration has provided the following examples to clarify the current policy:

1) A borrower accumulates a balance of $1,000 on a credit card with a 30-percent annual percentage rate (APR). For five years, the borrower is unable to pay off the card's balance, making payments that only cover accrued interest that total $1,500. By the end of five years, the credit card company earned $1,500 from their initial loan of $1,000 with the principal still outstanding. The borrower then declares bankruptcy and defaults. The credit card company is allowed to claim a sales tax refund from CDTFA on the full balance of $1,000 despite having more than made their money back on the loan.

2) A borrower purchases a $33,000 car using an 8-percent APR loan issued by the car manufacturer, paying $35,871 after sales tax is applied. The borrower doesn't miss a payment and pays off the entire loan over five years. Over that period, the borrower pays a total of $7,174 in interest, $574 more than they would have paid if the loan had not included any amount related to sales tax. Given that the lender is earning interest on the portion of the loan related to sales tax, it is not clear why the sales tax portion of the loan should be subsidized.

3) A borrower purchases a $25,000 car using a 7-percent APR loan issued by the car manufacturer, receiving a loan of $27,175 after sales tax is applied. The borrower pays only enough to cover interest accrued for five years; a total of $9,511 in payments. The borrower then defaults, and the loan issuer can repossess the car, keep the $9,511 in payments, and claim a sales tax refund of $2,175, equal to the full amount of sales tax paid on the $25,000 purchase.

The Administration also notes that there is no evidence that consumers in states without this policy have less access to credit, or access to cheaper credit. Given that outstanding non-mortgage consumer credit is approximately $540 billion (roughly $184 billion of this is outstanding auto loans), the Administration notes that is unlikely that this small deduction has a material impact on debt prices or availability.

Revenue Estimate.

The budget proposal would eliminate this refund or deduction for non-retailer lenders. DOF currently estimates that this proposal would raise $50.6 million General Fund sales tax revenue ongoing starting in 2028-29. They delayed revenue is due to several years of workload backload at CDTFA that will continue to be processed even as the change in state law would be effective January 1, 2025.

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

The LAO released their analysis of this proposal on February 22, 2024, and noted that the proposal merits consideration. Their analysis concluded that lenders have multiple options for reducing losses from bad debt, other than this deduction. In addition, the LAO notes that the current subsidization of bad debt may encourage riskier lending and the refunds are very costly to administer. The LAO further noted concerns with the timing of the revenue estimate, which the Administration is working to refine.

Staff Recommendation. Hold open.

7730 FRANCHISE TAX BOARD

Issue 14: Net Operating Loss (NOL) and Business Tax Credit Suspension

Budget Proposal. The May Revision includes a proposal to suspend the use of NOL deductions for taxpayers with income over $1 million and limit the amount of most business tax credits any taxpayer could claim to $5 million business credits for tax years 2025, 2026, and 2027 to temporarily increase tax revenue. Revenue increases are estimated at $900 million ($558 million non-Proposition 98) in 2024-25 and $5.5 billion ($1.3 billion non-Proposition 98) in 2025-26. The Administration proposes language triggering the suspension removal if cumulative cash receipts for the Big 3 taxes exceed the 2024 Budget Act forecast by three percent or more from May 2024 to April 2025.

The May Revision includes the withdrawal of January proposal to conform to federal law and limit the use of NOL deductions to 80 percent of a business's taxable income in the year it is applied. The Administration anticipated revenue gains of $300 million in 2024-25 and ongoing gains of $200 million in subsequent years from this proposal.

Background.

NOLs. An NOL occurs when a business has deductions that exceed taxable income in a given year. Under current California law, taxpayers are allowed to use NOLs from prior years to offset up to 100 percent of current year income. Taxpayers are allowed to carry forward NOLs for 20 years from the year that loss was incurred. The rationale is to provide more equitable tax treatment between businesses with volatile income and businesses with steady income.

The amount of NOLs used and the number of taxpayers claiming NOLs can vary from year to year. Since the suspension is limited to taxpayers with income over $1 million, it is expected that the majority of taxpayers will still be allowed the full extent of their current law NOL deductions, but the amount of deductions claimed is expected to drop significantly. In 2019, roughly 120,000 corporations claimed NOL deductions. Of that, there were about 4,000 taxpayers who would have been subject to a suspension due to having income over $1 million.

Taxpayers who have their NOLs suspended will be allowed to carry forward their NOLs for an additional 3 years beyond the 20-year carryover limit allowed under current law. It is expected that much of the suspended NOLs will eventually be used.

Business Tax Credit Limitation. Current federal and state law allows businesses to utilize tax credits to offset their tax liability on a dollar-for-dollar basis. Business tax credits are generally intended to incentivize a particular type of behavior. Examples of the state's business tax credits include the research and development, California Competes, motion picture and television, and Low-Income Housing tax credits.

In 2020, when the state expected a revenue shortfall resulting from the COVID-19 Pandemic, California suspended the use of NOLs for businesses with more than $1 million in net income and limited the use of business tax credits. Those restrictions were in place for tax years 2020 and 2021, before being lifted for tax year 2022. The temporary suspension on NOLs and limits on credits is expected to lead to increased utilization after their restoration because businesses continued to generate and amass NOLs during the suspension.

The Department of Finance notes that there is an interaction effect between the NOL suspension and the limitation of business incentive tax credits, given the outstanding amount of credits and NOLs. Enacting both provisions would prevent taxpayers from using one provision in lieu of the other, which would significantly reduce the revenue gains from the proposal.

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

The LAO notes that the proposal to limit the use of business tax credits merits consideration. According the LAO, business tax credits are often provided to encourage specific types of behavior around hiring, or pursuing research and innovation, among other things. While they agree these are often important goals, they may not be as high of a priority for the state during a budget shortfall.

Separately the LAO notes a concern with the suspension of NOLs given that the use of NOL deductions are intended to smooth profits and losses for business activity were profits fluctuate due to the nature of the business. The LAO believes suspending NOLs is less desirable given that it removes a tool to make the tax structure more equitable.

Staff Recommendation. Hold Open.

Issue 15: Alternative Revenue Options (Information Only)

The 2024-25 Governor's Budget and recent May Revision includes a variety of solutions, including revenue increases that are intended to allow the state to close a significant budget shortfall in the budget year and subsequent fiscal years. The subcommittee has requested that the LAO provide a brief summary of other revenue raising options that the Legislature may wish to consider, including but not limited to:

- **Temporary corporation tax rate increase.** The LAO has suggested an alternative to the NOL suspension proposed at the May Revision could be to pair a suspension of business credits with a temporary corporation tax rate increase of 1.5 percentage points (from 8.84 to 10.34) to raise a roughly similar amount of revenue as the Governor's proposal. Such an approach could even be combined with future temporary rate reductions, which would allow business to recoup some of their temporary tax payments in future years. This would mirror one of the beneficial aspects of NOL suspensions, which is that businesses often can defer the disallowed NOL deductions to future years and reduce their future taxes.

- **Single Sales Factor for Financial Institutions.** Current law requires multistate firms to use a mandatory single sales factor tax policy, however agricultural, extraction, and financial firms were exempted from this change and remain on an equally weighted three-factor formula (property, payroll, and/or sales that occurred in that state). Amending statute to require multi-state financial firms to use a mandatory single sales factor tax policy instead of the equally weighted three-factor formula, beginning with taxable year 2024 is estimated to raise $260 million in revenue in 2024-25, and between $220 and $230 million ongoing.

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

- **Eliminate Capital Gains Step-Up Basis on Inherited Assets.** The LAO notes that current treatment for inherited assets allows the basis used for determining the capital gain from the sale of an inherited asset to be the "stepped-up" price, or value of the asset when it was inherited rather than when it was first purchased. This treatment may significantly reduce taxes on capital gains and was originally enacted when an estate tax was in place that was also taxing inheritance. Given that there is no longer an estate tax, the LAO notes that the there is no longer a rationale for this specific tax treatment. Eliminated the use of the "stepped-up" basis for inheritances received after July 1, 2024 would increase revenues by several hundred million in 2024-25, growing in 2025-26, and over time, reaching up to $5 billion per year.

- **Mortgage Interest Deduction Changes.** The LAO notes that the vast majority of the $3.5 billion in statewide tax savings from the mortgage interest deduction go to higher income households. Taxpayers must be able to itemize their deductions to claim the deduction, and taxpayers who itemize tend to be higher income taxpayers. If the intended purpose of the deduction is to encourage home ownership, the LAO suggest considering converting the deduction to a tax credit to reach a broader range of taxpayers, and notes this be constructed to limit revenue loss to the state.

The LAO provides an example that providing a credit equal to two percent of mortgage interest paid on up to $1 million of debt would likely increase income tax revenue by $1 billion or more per year.

Another option is to eliminate the ability to deduct mortgage interest for second homes that are used to generate rental income, for a revenue increase of $100 million to $150 million per year.

- **Eliminate First-Year Minimum Franchise Tax Exemption**. The minimum franchise tax ensures that all of these businesses pay a minimum amount for the right to conduct business in California and for the benefits of limited liability protection. State law currently exempts new businesses from paying the minimum franchise tax of $800. The LAO notes that this exemption may not be the most effective way of helping small businesses. Eliminating the first-year exemption could increase corporation tax revenue by $100 million to $150 million per year.

Staff Recommendation: Information Only

Issue 16: Charitable Conservation Easements Conformity

Budget Proposal. The Governor's budget proposes to conform state law to federal law for treatment of the charitable conservation easement deduction, limiting deductions for charitable conservation easements to two and a half times the investment cost for the purchaser, and disallowing the deduction for any taxpayer who has previously engaged in fraud. The Administration anticipates this will result in revenue gains of $55 million in 2024-25 and 2025-26, and ongoing gains of $25 million in subsequent years.

Currently, property owners who give up development rights on lands are allowed a deduction equal to the value of the property. In 2023, federal tax law was amended to curb abuse of the deduction and capped the deduction to two and a half times the value of the taxpayer's investment and eliminates the deduction for those taxpayers who have previously engaged in fraud.

Background.

Under current federal law, property owners who elect to give up rights to develop certain land are allowed a deduction equal to the property development's value. The federal Consolidated Appropriations Act (CAA) of 2023 did the following: 1) Limited the deduction for owners of pass-through entities to two and a half times the value of the taxpayers' investment; and 2) Disallowed the deductions for participants who had previously engaged in fraud.

For example, a partial owner who invested $100 dollars is now limited to claiming a deduction of up to $250. California law conforms with federal law in allowing deductions for charitable conservation easements, however, the state has not conformed to the 2023 changes listed above. California would join the majority of states in conforming to this provision of the CAA.

According to the Administration, the intent of the deduction for charitable conservation easements is to provide an incentive to conserve open lands and historic sites. The tax deduction provides private landowners an incentive to preserve their land or building for future generations. However, some taxpayers began taking improperly large deductions based on inflated appraisals or not complying with the rules and regulations governing the contributions of conservation easements, resulting in the federal law changes in 2023.

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

The LAO released their analysis of this proposal on February 22, 2024, and recommends approving the proposed conformity with federal law. The LAO concluded that federal statute was amended in 2023 to prevent the claiming of the deduction on the basis of inflated property values and it is prudent for the state to also curb potential misuse of the deduction. LAO has also noted concerns that the revenue estimates are likely to be uncertain given limited information availability on charitable conservation easements.

Staff Recommendation. Hold Open

Issue 17: Oil and Gas Subsidy Elimination

Budget Proposal. The Governor's budget proposes to eliminate the following subsidies, commencing with the 2024 tax year. The Administration anticipates this will result in revenue gains of $22 million in 2024-25 and ongoing gains of $17 million in subsequent years.

Background.

Immediate Deduction for Intangible Drilling Costs. Currently, state law allows 70 percent of intangible oil and gas drilling costs (e.g. survey work, ground preparation, etc.) to be deducted in the first year, with the remainder spread over five years. For independent oil producers, 100 percent can be claimed up front. Eliminating this allowance would instead apply standard tax law that allows expenses to be deducted when their benefit is realized. The Administration estimates that eliminating this deduction would generate $7 million in 2024-25 and the next three years

Percentage Depletion Rules for Fossil Fuels. Businesses may currently deduct a fixed percentage of gross income that is higher than normal cost-depletion when calculating the deduction of resource depletion for mineral and other natural resources. Eliminating this allowance would instead apply standard cost depletion tax law. The Administration estimates that making this change would generate $15 million General Fund in 2024-25 and $10 million ongoing.

Enhanced Oil Recovery Costs Credit. Current law allows specified independent oil producers a nonrefundable credit up to five percent of the qualified enhanced oil recovery costs for projects located in the state if oil prices fall above a specified amount for the preceding year. This proposal would eliminate the credit. The Administration does not assume any fiscal effect associated with this proposal over the next few years since crude oil prices are expected to remain above the price threshold used to determine when businesses can claim the credit.

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

The LAO released their analysis of this proposal on February 22, 2024, and recommends approving the proposals to eliminate special rules for fossil fuel producers, given that they would lead to more consistent treatment in the state's tax rules and provide some revenue for the state.

The LAO also notes that the Legislature may wish to further examine remaining percentage depletion rules still in place for some resources, such as sand, gravel, gold, and lithium, to further simplify tax rules.

Staff Recommendation. Hold Open

Issue 18: Earned Income Tax Credit (EITC) Implementation Update (Information Only)

The California EITC is a state personal income tax provision that benefits individuals and families who earn less than $30,000. The amount of the credit depends on taxpayers "earned income" (which primarily includes wages and self-employment income), filing status, and the number of qualifying dependent children. The amount of the EITC initially rises with earnings, such that the greater the filer's earnings, the larger the credit. The credit peaks at a certain income and then gradually phases out for higher levels of earnings. The tax credit is fully refundable. This means that if the amount of a taxpayer's EITC is greater than his or her liability before applying the credit, then the state pays the taxpayer that difference. The Franchise Tax Board (FTB) annually adjusts the income thresholds and credit amounts for inflation, similar to the adjustment made at the federal level (although the state uses a California-specific inflation index).

In 2015, when California created the state EITC, it was designed to supplement the federal EITC for those working individuals and families whose incomes were relatively low. As the state EITC is based on the federal EITC, it also shares certain restrictions on eligibility. Specifically, eligible filers must be a U.S. citizen or resident alien. In addition, if they do not have a qualifying child, eligible filers must be at least age 25 and younger than age 65.

2023 CalEITC Credit

Number of qualifying children	California maximum income	CalEITC (up to)	IRS EITC (up to)
None	$30,950	$285	$600
1	$30,950	$1,900	$3,995
2	$30,950	$3,137	$6,604
3 or more	$30,950	$3,829	$7,430

Source: Franchise Tax Board

2022 Budget Act. The budget expanded the existing Young Child Tax Credit to zero-income filers, indexed the credit to inflation starting in the 2022 tax year, and created a Foster Youth Tax Credit to provide a $1,000 credit to young adults who were in the foster care system.

According to the most recent data from the Franchise Tax Board, as of December 31, 2022, for the 2021 tax year, 3.6 million claims were filed, for a total credit amount of $1.05 billion ($706 million in EITC and $347 million in YCTC).

2023 Budget Act. According to the most recent data from the Franchise Tax Board, as of December 31, 2023, for the 2022 tax year, 3.5 million claims were filed, for a total credit amount of $1.34 billion ($921 million in EITC, $413 million in YCTC, and $5 million in FYTC).

Earned Income Tax Credit (EITC), Young Child Tax Credit (YCTC) and Foster Youth Tax Credit (FYTC) as of December 31, 2023

Process Year 2023-Returns Processed with EITC Allowed	Count	Amount
Total EITC/YCTC/FYTC Allowed	3,458,196	$1,340,817,270
YTD EITC Allowed	.	$921,761,114
YTD YCTC Allowed	412,468	$413,972,649
YTD FYTC Allowed	4,892	$5,083,507
YTD Wages EITC/YCTC/FYTC Allowed	2,415,921	$836,445,739
YTD Self-Employment EITC/YCTC/FYTC Allowed	1,042,275	$504,371,531

Preparer Type	EITC	YCTC	FYTC
% Returns Self Prepared	40%	36%	88%
% Returns by Preparer	60%	64%	12%

	EITC	YCTC
YTD First Time Filers	283,273	23,307

	EITC	YCTC
YTD Repeat Claimants (also claimed credit on 2021 tax return) – xx% of current filer universe	55%	46%

Individual Taxpayer Identification Number (ITIN)
Earned Income Tax Credit (EITC), Young Child Tax Credit (YCTC) and Foster Youth Tax Credit (FYTC) as of December 31, 2023

Process Year 2023-Returns Processed with EITC Allowed	Count	Amount
Total EITC/YCTC/FYTC Allowed	231,974	$124,133,035
YTD EITC Allowed	.	$89,001,735
YTD YCTC Allowed	35,895	$35,128,051
YTD FYTC Allowed	/a	$3,249
YTD Wages EITC/YCTC/FYTC Allowed	135,315	$65,474,476
YTD Self-Employment EITC/YCTC/FYTC Allowed	96,659	$58,658,559

Preparer Type	EITC	YCTC	FYTC
% Returns Self Prepared	10%	9%	56%
% Returns by Preparer	90%	91%	44%

	EITC	YCTC
YTD First Time Filers	26,629	4,478

	EITC	YCTC
YTD Repeat Claimants (also claimed credit on 2021 tax return) – xx% of current filer universe	59%	47%

EITC Outreach

Many community-based organizations and other state and local government agencies (such as school districts and county social services offices) engage in efforts to raise awareness about the state and federal EITC. The state has continued to provide $10 million annually for state outreach grants to promote the California EITC and free tax preparation. Despite the availability of these resources, the California EITC is not being claimed at the anticipated rate. In some cases, low-income individuals are not required to file a return because they do not need the minimum return filing income thresholds. Thus, many California household do not receive the credits for which they are eligible, limiting the effectiveness of the EITC program. Finally, additional outreach related to the CalEITC may also assist individuals in drawing down federal assistance through the federal EITC.

In an effort to address EITC uptake, the state increased the amount for state outreach grants to $20 million for 2022-23 and 2023-24. Grantees used this funding to carry out statewide and local outreach efforts aimed at reaching eligible families.

Staff Recommendation. Information Only

Issue 19: IRS Direct Filer Portal Update (Information Only)

On January 29, 2024, the IRS began a pilot program allowing qualified individuals to file their federal tax return directly with the IRS using the IRS supported free file tool. For the 2023 tax filing window, the Direct File pilot was available to eligible taxpayers residing in California, Arizona, Florida, Massachusetts, New Hampshire, New York, Nevada, South Dakota, Tennessee, Texas, Wyoming and Washington.

Direct File does not prepare state returns. Specifically for California, the IRS directed Californians to a CalFile application once they completed the filing of their federal return.

Direct File was available to a limited pool of eligible taxpayers, specifically, those residing in a pilot state and reporting the following items for 2023:

Basics	Income	Deductions, Adjustments, and Credits
• Form 1040 and 1040-SR • Must be a U.S. resident • Any filing status • Dependents (claiming by non-custodial parents not supported) • Language and accessibility preferences (Schedule LEP, Form 9000)	• Wages • Interest of $1,500 or less • Unemployment compensation • Social Security and Tier I Railroad Retirement Benefits[7]	• Child Tax Credit and Credit for Other Dependents • Earned Income Tax Credit • Claiming credits after disallowance (Form 8862) • Standard deduction • Student loan interest deduction • Educator expenses deduction

Source: IRS Direct File Pilot Program: Filing Season 2024 After Action Report

Results:

On May 3rd, the IRS released the *IRS Direct File Pilot Program: Filing Season 2024 After Action Report*. Over the course of the pilot:

- 140,803 taxpayers submitted accepted returns.
- More than $90 million in tax refunds were issued.
- $35 million in tax balances due were collected.

Post-pilot survey results provided by the IRS from more than 15,000 Direct File users was very positive:

- 90% of respondents ranked their experience as Excellent or Above Average.
- When asked what they particularly liked, respondents most commonly cited Direct File’s ease of use, trustworthiness, and that it was free.
- 86% of respondents said that their experience with Direct File increased their trust in the IRS.

- 90% of survey respondents who used customer support rated that experience as Excellent or Above Average.

In addition, through a survey, Direct File users noted that the system saved them time — filing their taxes with Direct File generally took less than an hour, and many reported filing in as little as 30 minutes. Almost half of Direct File users reported paying for tax preparation last year, and the Treasury Department estimated that Direct File users saved $5.6 million in tax preparation fees.

Other Key Facts:

- The new IRS service is optional and does not replace any existing filing options for taxpayers. The Direct File Portal is one more choice.

- How many taxpayers use free file services today:
    - CalFile: Approximately 80,000 – 90,000 annually
    - VITA: Approximately 410,000 in 2023 for California returns.
    - Federal Free Filing Alliance: An annual stat is not available. Per Free File Alliance Organization, 71 million returns over the last 22 years,
    - Tax software vendor free filing products: Unable to identify.

- According to Economic Security CA Action, the benefits of participation in and expansion of the pilot are significant for California Taxpayers:
    - It currently costs Americans an average of $150 and takes 9 hours to file taxes each year.
    - Last year, 58 percent of CalEITC, Young Child Tax Credit, and Foster Youth Tax Credit recipients paid to file their taxes, even though they qualify for free filing. The result is that an estimated $763 million of would-be tax refunds are diverted from low- and moderate-income families to tax prep companies every year.
    - This year under the limited scope of the pilot, 5.2 million California taxpayers were eligible for Direct File. If all of them had used it, they would have saved $832 million in filing fees alone. When Direct File is at scale in a few years, it will deliver $2.2 billion in total value to California taxpayers, between filing fees, time cost of filing, and additional federal EITC and Child Tax Credits claimed.

Federal Updates:

The most recent federal update (as of May 3rd) reflects that the IRS will make decisions regarding the future of Direct File later this spring.

Staff Recommendation. Information Only

Issue 20: Apportionment Factor Fix

Budget Proposal: The May Revision proposes trailer bill language to clarify existing law that when a corporation receives income that is excluded from taxable business income, then it must exclude this income from its apportionment factor formula.

Background: Multi-state and multi-national corporations pay taxes in California by computing how much of their taxable income is allocated to California using an apportionment factor, which represents the share of business activity a firm conducts in a state divided by its total business activity in the U.S. or in the world. A lower California apportionment factor will, all else equal, lead to lower California tax liability.

The Franchise Tax Board (FTB) has issued longstanding and consistent guidance to taxpayers that activities that are not subjected to taxation if they were to generate income, are required to be excluded from the apportionment formula. In July 2023, the Office of Tax Appeals (OTA) issued a decision that allowed for a reduction in a multi-state taxpayer's apportionment percentage through inclusion of 100 percent of repatriated dividends in their sales factor. Specifically, in the case, Microsoft made a water's-edge election in 2018 and took a 75 percent deduction for repatriated dividends from foreign subsidiaries that weren't part of the water's-edge group. However, Microsoft included 100 percent of those dividends in its sales factor denominator and sought a refund. The Franchise Tax Board argued that only the undeducted 25 percent of the dividends should have been included in the sales factor denominator, referencing its decision in Legal Ruling 2006-01. The FTB has since filed a petition for rehearing which the OTA subsequently denied.

This proposal is declaratory of existing law and expressly states that when a corporation receives income that is excluded from taxable business income, it must exclude this income from its sales factor. This aligns with the FTB's 2006 legal ruling and longstanding guidance on the matter, providing clear statutory authority and guidelines to taxpayers on how to determine what income should be included in their sales factor.

Fiscal Impact: The FTB estimates that, without action, around $1.3 billion in refunds are at risk based on similar tax filings from prior years, and there are additional annual prospective refunds of around $200 million due to lower apportionment factors for multi-state and multi-national firms.

Staff Recommendation: Hold Open.

Issue 21: Disaster Tax Relief TBL

Budget Proposal: The May Revision proposes trailer bill language to allow the Director of Finance to determine whether a taxpayer is affected by a state of emergency, when determining whether the postponement of certain tax-related deadlines applies to a taxpayer.

Background: Current law related to personal income tax and corporation tax provide for the postponement of certain tax-related deadlines in the case of a declared state of emergency though some conformity with federal income tax laws,. Under existing law, the Franchise Tax Board determines whether a taxpayer is affected by a state of emergency declared by the Governor.

This proposal would instead require the Director of Finance to determine whether a taxpayer is affected by a state of emergency and allow federal income tax laws, relating to the postponement of certain tax-related deadlines, to apply to an impacted taxpayer during an additional relief period that requests relief, as specified.

An impacted taxpayer means a taxpayer who, among other things, requests relief, as specified below, and who is required, upon request, to submit supporting documentation related to the declared disaster, as provided.

Supporting documentation would include:

- A letter from the Federal Emergency Management Agency that approves assistance to the impacted taxpayer pursuant to the federal Robert T. Stafford Disaster Relief and Emergency Assistance Act (42 U.S.C. Sec. 5121 et seq.)
- A determination of award letter from the Small Business Administration disaster loan program that approves assistance to the impacted taxpayer.
- A statement, signed under penalty of perjury, from a tax professional indicating the impacted taxpayer's books and records that are necessary to meet a tax deadline were destroyed in the disaster area or jurisdiction for which the Governor has proclaimed a state of emergency.
- A law enforcement report issued to the impacted taxpayer, related to theft or looting due to lawlessness occurring during the disaster or emergency and in the disaster area or jurisdiction for which the Governor proclaimed a state of emergency.
- An insurance claim submitted by or on behalf of the impacted taxpayer, related to the disaster or conditions of emergency.
- Verification of disaster relief related to housing assistance, property damage, employment, public health, mortgage assistance, or business operation received from a government entity, banking institution, or organization described in Section 501(c)(3) of the Internal Revenue Code

Staff Comments: According to the Administration, this proposal would provide the state additional tools to determine and extend tax deadline postponement to taxpayers who are genuinely impacted by a natural disaster or other emergency. This is intended to prevent the issues that arose when the IRS extended tax deadlines to file for the 2022 tax year multiple times throughout 2023 until those tax deadlines were finally determined to be November 15, 2023 (7 months later than the regular April 15 tax deadline). These IRS extensions were applied broadly across the majority of counties in the state and were a key factor in preventing the state from making accurate tax revenue collection estimates.

Staff Recommendation: Hold Open.

9210 LOCAL GOVERNMENT FINANCING

Issue 22: Vehicle License Fee Backfill

Budget Proposal: The Governor's budget does not include a proposal to backfill counties for the Vehicle License Fee (VLF) shortfall when their VLF shortfall exceeds available funding in their Education Revenue Augmentation Fund (ERAF) revenues. The Department of Finance estimates that it would cost $72.5 million to backfill revenues in the three counties with insufficient ERAF, San Mateo, Alpine, and Mono.

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

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

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

Staff Recommendation: Hold Open.

0515 BUSINESS, CONSUMER SERVICES, AND HOUSING AGENCY (BCSH)

Issue 23: Cut Supplemental Funding from Round Five of the Homeless Housing Assistance and Prevention (HHAP) Program

Governor's Budget Proposal: The Governor's January 2024 Budget and related budget trailer bill language propose to delay the availability for distribution of $260 million in supplemental Homeless Housing Assistance and Prevention (HHAP) funding from 2023-24 to 2025-26. *The Governor's May Revision now proposes to revert the $260 million back to the General Fund instead.*

Background: The HHAP program provides relatively flexible funding to large cities, counties, continuums of care, and tribal entities to address homelessness. There have been five rounds of HHAP funding since 2019.

Rounds 3 and 4 of HHAP originally included $360 million in "bonus" funding ($180 million for each round). This bonus money was actually just money taken out of the baseline HHAP allocation and held in reserve. The idea was that later, when performance data became available, those recipients who achieved specified homelessness reduction and prevention goals would receive a share of the bonus money while recipients who did not hit their targets would not. The intent was to provide a financial incentive for recipients to perform well.

In practice, however, the bonus funding concept proved problematic. For one thing, it encouraged recipients to set low performance goals for themselves in order to ensure that they would qualify for the bonus. For another, the bonus system had a perverse impact: it took resources from places with increasing (or more slowly decreasing) need and redirected those resources to places with decreasing need. Finally, by holding money in reserve, the bonus system artificially delayed distribution of some of the resources and services that communities and unhoused individuals needed to address immediate and critical needs.

With these drawbacks in mind, the 2023 Budget Act revised how the $360 million in HHAP Round 3 and 4 bonus money was to be handled. Specifically, the 2023 Budget Act directed Cal-ICH/HCD to distribute $100 million of the Round 3 and 4 bonus money together with the initial Round 5 HHAP distribution, thus deploying this money more quickly. The 2023 Budget Act then directed Cal-ICH/HCD to disburse the remaining $260 million in HHAP Round 3 and 4 bonus money beginning in 2024-25.

In light of the budget shortfall, the Governor's May Revision now proposes to cut this $260 million altogether and revert it back to the General Fund as budget savings.

As HHAP recipients and some advocates for the unhoused had already voiced opposition to the proposed delay of this funding, they will almost certainly have strong objections to this proposed cut.

Staff Comments: Unlike the Governor's January 2024 proposal to delay distribution of supplemental HHAP funding, the cut proposed in the May Revision will reduce the resources available to local entities to combat homelessness and the services that California's unhoused population will receive. Accordingly, the proposed cut is likely to make California's homelessness crisis worse.

To the degree that this proposed cut may be seen as a consequence of the recent State Auditor's report regarding state spending on homelessness prevention programs, the Subcommittee may wish to note that the audit did not conclude that HHAP funding was ineffective. Instead, the audit found that – for the time period studied by the Auditor – the state was not gathering sufficient data about the program to enable the Auditor to draw conclusions about its effectiveness. Since the Auditor's analysis was largely based on examination of early HHAP rounds, it may not fully reflect the current nature of the program. Indeed, as the Auditor observed in the report:

> The Legislature made significant changes to the program that began with Round 3, requiring that applicants establish measureable outcome goals, such as reducing the number of people experiencing homelessness and reducing the length of time that people remain homeless. To the extent CoCs establish meaningful outcome goals, the goals should provide better benchmarks against which the State can measure spending and evaluate cost-effectiveness.

Though these data collection and accountability mechanisms are now in place, HHAP recipients are still in the process of obligating and expending the corresponding HHAP funding. As a result, though HHAP data collection systems and requirements have gotten better, some lag remains between the implementation of these improvements and the availability of more detailed outcome data.

Staff Recommendation: Hold open.

Issue 24: Capture of Additional Savings from Administration of Homelessness Grant Programs

Governor's Budget Proposal: The Governor's January 2024 Budget proposed to recapture $100,676,000 in General Fund savings left over from the administrative set-asides associated with homelessness-related grant programs operated by the California Interagency Council on Homelessness (Cal-ICH). *The May Revision now proposes to recapture an additional $48,375,000 in administrative savings related to the operation of these programs.*

Background: Cal-ICH operates three major homelessness-related grant programs: the Homeless Housing Assistance and Prevention (HHAP) program; the Encampment Resolution Fund (ERF); and the Family Homelessness Challenge Grants (FHC) program. The funding for each of these programs includes set-asides to cover the state's costs of administration.

In recent years, Cal-ICH has been able to operate the programs without using all of the administrative set-asides available. As part of the Governor's January 2024 Budget, the Administration proposed to recapture some of the resulting savings. Specifically, the January Budget proposed reverting $19,975,000 in 2020-21 savings from HHAP program administration; $2,000,000 in savings from 2021-22 ERF program administration; $28,701,000 in savings from 2021-22 HHAP program administration; and $50,000,000 in savings from 2022-23 HHAP program administration; or a total of $100,676,000 in administrative savings.

Now, as part of the May Revision, the Governor proposes to revert further $48,375,000 in administrative savings from these homelessness-related programs. The additional savings include $14,835,000 from 2021-22 HHAP administration; $13,540,000 from 2022-23 ERF administration; and $20,000,000 from 2023-24 ERF administration.

Staff Comments: Because these are all state administrative savings, approving these proposals should not impact the resources available for homelessness services. Before approving the proposals, however, the Subcommittee may wish to satisfy itself that capturing these administrative savings will not diminish the ability of the program managers to effectively operate these grants while providing a positive customer service experience to grant recipients.

Staff Recommendation: Hold open.

Issue 25: New General Fund Allocations to Support California Interagency Council on Homelessness Activities

Governor's Budget Proposal: As part of the May Revision, the California Interagency Council on Homelessness (Cal-ICH) seeks a new General Fund allocation of $14,835,000 in 2024-25; $9,545,000 in 2025-26; and $7,795,000 annually from 2026-27 on to maintain 23 existing staff position and the contracts necessary to carry out Cal-ICH's statutory functions.

Background: The Legislature created Cal-ICH to establish a central hub convening, connecting and coordinating the activities of programs addressing homelessness throughout state government. As originally envisioned, Cal-ICH's role was also something akin to a specialized think-tank; it was supposed to gather data, conduct research, and provide an overarching strategic vision for the state's homelessness efforts. (SB 1380, Mitchell, Ch. 847, Stats. 2016.)

Not long after the establishment of Cal-ICH, the state also tasked it with the administration of three major homelessness grant programs: the Homeless Housing Assistance and Prevention (HHAP) program; the Encampment Resolution Fund (ERF); and the Family Homelessness Challenge Grants (FHCG). The funding for each of these grant programs included set-asides for administrative overhead. According to the Administration, Cal-ICH came to use part of these administrative set-asides to pay for Cal-ICH's other core functions as well.

For a variety of reasons, the 2023 Budget Act directed Cal-ICH to begin the process of transferring administration of HHAP, ERF, and FHCG to HCD. (See Issue 3 on the Agenda for this Subcommittee's April 18, 2024 Hearing for details about this transition.) The transfer is scheduled to be complete by the end of this fiscal year, June 30, 2024. Once this transition is over, Cal-ICH will no longer have access to the administrative set-aside it has been using to fund its core programming. As a result, Cal-ICH now needs alternative funding to maintain its core functions.

This budget proposal requests the requisite allocation from the General Fund. The request starts at nearly $15 million in 2024-25 and decreases through 2026-27, when it levels off at an annual amount of just under $8 million. The tapering effect is the result of up-front contracts and other start-up costs – such as information technology needs – that Cal-ICH expects to diminish after two or three years as the contracts are completed and the investments are in place.

Staff Comments: Without some alternative funding, Cal-ICH will not be able to carry out its core mission. Still, the requested allocation will require new General Fund spending at a time of significant General Fund deficits and when painful cuts are being contemplated for a wide variety of direct services to Californians – including the unhoused.

Given that context, the Subcommittee may wish to explore whether the Administration has exhausted all other possibilities for funding Cal-ICH's core work. For instance, the administrative set-asides that have funded that work up to now have not disappeared; they are merely being transferred over to HCD. Could some of that money be taken back from HCD and still utilized to pay for Cal-ICH's core work? As Issue 28 on this Agenda explains, HCD proposes to expand the staff it is dedicating to oversight over the HHAP, ERF, and FHC grant programs. The administrative set-asides will help to pay for that expansion. Still, the Subcommittee may wish to explore with the Administration whether there are enough resources in the administrative set-asides to cover this expansion and still redirect some resources back to Cal-ICH, thus reducing or possibly eliminating any new burden on the General Fund. Certainly, the significant administrative savings achieved by the HHAP, ERF, and FHC grant programs over the last several years suggests there may be some financial wiggle room there. (See Item 22 of this Agenda for details about these savings.)

Staff Recommendation: Hold open.

0968 TAX CREDIT ALLOCATION COMMITTEE (TCAC)

Issue 26: Additional Year of State Supplemental Low-Income Housing Tax Credits

Governor's Budget Proposal: As part of the May Revision, the Governor proposes to authorize the California Tax Credit Allocation Committee (TCAC) to award an additional $500 million in state Low-Income Housing Tax Credits (LIHTC) to support affordable housing development.

Background: The Low Income Housing Tax Credit (LIHTC) program functions as a mechanism to encourage private investment in affordable housing projects. The credits can support new construction or the rehabilitation of existing properties. In either event, the developer agrees to maintain the properties at affordable rental levels in exchange for the tax credit award.

By statute, California allocates a threshold amount to TCAC each year for award. (Rev. & Tax Code § 23610.5.) The amount of the allocation is adjusted annually for inflation. In 2023, it was around $122 million.

For the past several years, California has also elected to supplement this baseline statutory state LIHTC allocation with an additional $500 million. The Governor's January 2024 Budget did not include such a state supplemental LIHTC allocation. However, the May Revision now does.

As tax credits, rather than direct budget allocations, the proposed addition of $500 million more in state supplemental LIHTC does not impact the 2024-25 General Fund condition. At the same time, the Subcommittee should be cognizant that authorizing the issuance of tax credits now will result in a corresponding loss of General Fund revenues in future years.

Staff Comments: State LIHTC often provides a critical last layer to the "capital stack" that affordable housing developers must put together in order to proceed with a project. Without it, many potential projects will fall short and never get built. When that happens, any federal tax credits for which the project qualified get left on the table. For these reasons, the inclusion of another year of state supplemental LIHTC could be seen as a welcome policy development. However, the Subcommittee may wish to inquire about the likely utilization rate for these additional tax credits given that the Governor's current budget proposals also gut many of the state's other affordable housing funding programs. Absent those earlier layers in the capital stack, what is the risk that many would-be developers will never reach that last stage in which state LIHTC credits would provide the final necessary piece?

Staff Recommendation: Approve as budgeted.

1700 CIVIL RIGHTS DEPARTMENT (CRD)

Issue 27: Shift of Department Costs from General Fund to Civil Rights Enforcement and Litigation Fund

Governor's Budget Proposal. As part of the May Revision, the Governor requests to use $10 million from the Civil Rights Department's (CRD's) Civil Rights Enforcement and Litigation Fund to pay for CRD operations that would otherwise be paid for using 2024-25 General Funds.

Background: The CRD enforces many of California's civil rights laws. In some circumstances, that role includes engaging in civil litigation in the courts, either directly or in coordination with the Office of the Attorney General.

When CRD prevails in a case brought under the Fair Employment and Housing Act (FEHA, Gov. Code § 12900 et seq.), it may sometimes be entitled to recover its court costs and attorney fees from the civil rights violator. CRD can also obtain monetary awards through the courts pursuant to the equity in venture capital investment reporting program. (Bus. & Prof. Code § 22949.85.) Under that program, specified venture capitalists must report to CRD annually on the demographic make-up of the founding members of the companies that the venture capitalists invest in. If, after follow-up requests from CRD, a venture capitalist still fails to file the required report, CRD can seek a court order obligating the submission. If CRD prevails in such an action, the court can also impose a monetary penalty, payable to CRD.

Upon receiving awards in either of these ways, CRD deposits the money into a special fund designated for this purpose: the Civil Rights Enforcement and Litigation Fund. The statute governing the fund authorizes to be used to "offset the costs of the department" upon appropriation by the Legislature in the annual Budget Act. (Gov. Code § 12907(c).)

The Administration asserts that the Fund currently holds a balance of just over $10 million. It requests that the Legislature now appropriate this amount to help pay for CRD operations. Since these operational costs would otherwise come out of the General Fund, the shift results in a net savings to the 2024-25 General Fund of $10 million.

Staff Comments: If the current balance in the Enforcement and Litigation Fund is merely sitting in the account, then it may make sense to tap into now, as the state faces a significant budget shortfall. Before approving the use of the Enforcement and Litigation Fund for this purpose however, the Subcommittee may wish to satisfy itself that doing so would not in any way undermine the CRD's ability to carry out its civil rights enforcement mission.

Staff Recommendation. Hold open.

Issue 28: Expenses Associated with Relocation to May Lee Office Complex

Governor's Budget Proposal. As part of the May Revision, the Governor requests $1,188,000 from the 2024-25 General Fund to cover the one-time expenses associated with relocating the headquarters of the Civil Rights Department (CRD) from its present site in Elk Grove to the May Lee Office Complex in Sacramento.

Background: CRD reports that its headquarters have been located in a leased office space in Elk Grove for the past 19 years. In 2018, the State undertook an initiative to construct a new, state-of-the-art office complex on Richards Boulevard north of downtown Sacramento. This facility, known at the May Lee Office Complex, is now ready for CRD's occupation. CRD plans to move-in in July 2024.

CRD states that the new space will provide it with around 70,000 square feet of workspace, including 162 private offices, 23.5 support stations, and 11 special function rooms. This is more space than the Department has in Elk Grove. While the rent will be higher at the new facility, CRD asserts that "[c]onsolidation of physical infrastructure and services for CRD and other BCSH departmetns into a single facility managed by DGS will result in long-term cost reductions for maintenance and operations." In addition, CRD anticipates that the move "will improve the overall capabilities, effectiveness, and efficiencies of the overall facility's infrastructure services."

CRD explains that the request is currently one-time only as DGS is "currently in the process of determining ongoing rental rates for the May Lee Office Complex."

Staff Comments: Although this is a one-time cost as requested, rent is a recurring expense, so this item will presumably appear again in future years. To understand the longer-term fiscal impact, the Subcommittee may wish to probe further regarding what the eventually rental rate will be for CRD's new headquarters, even if that is necessarily an estimate at this time.

Staff Recommendation. Hold open.

2240 HOUSING AND COMMUNITY DEVELOPMENT DEPARTMENT (HCD)

Issue 29: Further Cuts to Affordable Housing Development Funding Programs

Governor's Budget Proposal: The Governor's January 2024 Budget included $1.2 billion in proposed reductions to a series of the affordable housing development funding programs operated by the Housing and Community Development Department (HCD). *The May Revision now proposes to cut an additional $500 million from the remaining balances in these programs.*

Background: HCD operates a series of programs that provide funding to affordable housing projects in the form of grants and loans. The Governor's January 2024 Budget proposed significant cuts to a number of these programs, but left an unallocated balance behind in some of them. The May Revision now proposes to revert these additional balances back to the General Fund as well, as follows:

- *Multifamily Housing Program (MHP)* -- MHP is HCD's flagship affordable housing program. Among HCD's portfolio of affordable housing programs, MHP funds the broadest scope of possible projects. Under MHP, HCD provides low-interest, long-term deferred payment loans on a competitive basis to applicants proposing projects consisting of new construction, rehabilitation, and preservation of permanent and transitional rental housing for lower-income households. The 2023 Budget Act contained a General Fund augmentation for MHP in the amount of $325 million. The Governor's January 2024 Budget proposed to revert $250 million of that back to the General Fund, leaving a balance of $75 million. The May Revision now proposes to revert that remaining $75 million as well.

- *Infill Infrastructure Grants (IIG)* -- As its name implies, the IIG program provides competitive grants to help fund the installation of infrastructure necessary for the construction of high-density affordable and mixed-income housing in locations designated as infill. Thus, IIG does not necessarily fund the production of housing units directly. Rather it provides the necessary funding to enable infill housing projects that might not be financially viable otherwise. The 2022 Budget Act allocated $200 million in General Fund for IIG. The 2023 Budget Act provided an additional $225 in General Fund. The Governor's January 2024 Budget proposed to pull $200 million of the 2023 amount back, leaving a balance of $25 million available for award under the IIG program. The May Revision now proposes to revert that remaining $25 million as well as an additional $10 million left over from the 2022 Budget.

- *Foreclosure Intervention Housing Preservation Program (FHIPP)* -- FIHPP is designed to provide a pool of money that qualified non-profit housing entities can use to make purchases using a procedural mechanism within California's non-judicial foreclosure system. That procedural mechanism enables prospective owner-occupants, current tenants, public entities, and specified non-profit housing organizations to acquire residential property by meeting or exceeding the winning foreclosure auction bid. The purchasing entity must then operate the property as affordable housing for at least 55 years. The 2021

Budget Act directed $500 million to FIHPP and HCD began the process of building the necessary systems to administer it. The 2023 Budget Act then reduced the overall allocation slightly and extended distribution for several years into the future. The Governor's January 2024 Budget proposed to eliminate those future commitments to FIHPP altogether, for total General Fund savings of $247.5 million, still leaving $237.5 million of the original $500 million dedicated to the FIHPP program. The May Revision now proposes to revert that remaining balance, less $1 million that has apparently been spent on program administration already.

- *Adaptive Reuse Program* – The Adaptive Reuse Program is a variation of the Infill Infrastructure Grant program also known as IIG-Catalytic. The program focuses on projects that facilitate conversion of properties to residential use, such as a former office building being transformed into housing. The 2022 Budget Act included $400 million for the Adaptive Reuse Program. Of that original amount, $127.5 million remains unallocated and the May Revision now proposes to revert that amount back to the General Fund.

- *Veterans Housing and Homeless Program (VHHP)* -- VHHP provides "long-term loans for the acquisition, construction, rehabilitation, and preservation of affordable multifamily housing for veterans and their families to allow veterans to access and maintain housing stability." Though VHHP was historically funded through bonds, the 2022 Budget Act included General Fund allocations of $50 million for VHHP in both 2022-23 and again in 2023-24. The Governor's January 2024 Budget proposed to revert all $50 million of the 2023-24 VHHP funds back to the General Fund. The May Revision now proposes to revert an additional $26.3 million left unallocated from the 2022-23 funds as well.

Staff Comments: The recently passed Behavioral Health Infrastructure Bond Act (Proposition One of 2024) provides a dedicated stream of funding to VHHP and should backfill the proposed cuts to that program if they become part of the final budget act. Some of the cuts outlined above could also be backfilled in the event that the Legislature passes a housing bond such as AB 1657 (Wicks, 2024) and the voters approve it at the November ballot. The Subcommittee may wish to inquire about the Administration's current level of interest in backing such a bond should the Legislature pass it.

In addition, the Subcommittee may wish to press the Administration to address how these proposals would impact the state's ability to leverage available federal Low Income Housing Tax Credits, given that the proposed cuts could cause developers to abandon projects for which they would otherwise obtain federal tax credits.

Staff Recommendation: Hold open.

Issue 30: Additional Staffing for Increased State Oversight of Homelessness-Related Grant Programs and Laws

Governor's Budget Proposal: The Governor's January 2024 budget requested authority for the Housing and Community Development Department (HCD) to hire four additional staff to help provide greater oversight over the homelessness-related grant programs being transferred from the California Interagency Council on Homelessness (Cal-ICH) to HCD on July 1, 2024. *The May Revision now seeks authority for HCD to hire an additional 13 staff for this purpose as well as in order to build out the Governor's proposed Housing and Homelessness Accountability and Results Partnership Unit (HHARP), an expansion of the existing Housing Accountability Unit.*

Background: Cal-ICH currently administers three major homelessness-related grant programs: the Homeless Housing Assistance and Prevention (HHAP) program; the Encampment Resolution Fund (ERF); and the Family Homelessness Challenge (FHC) Grants. The 2023 Budget Act directed Cal-ICH to transfer management of these programs to HCD by July 1, 2024, both to take advantage of HCD's grant program management expertise and to allow Cal-ICH to focus on its core functions.

The Governor's January 2024 budget included a budget change proposal that implemented part of this transition by switching 22 existing grants management staff positions from Cal-ICH to HCD. At the same time, the budget change proposal requested the addition of four more staff to help HCD carry out its new homelessness-related grant management operations. The four new positions would be paid for as part of the existing administrative cost set-asides already included within each program.

Now, as part of the May Revision, HCD seeks to expand its request for additional personnel by a a further 13 positions, for a total of 17. The corresponding budget change proposal detailing this request was still forthcoming at the time this Agenda as being written. The Subcommittee may wish to seek greater detail about the proposal during the hearing.

Staff Comments: A recent examination of the state's homelessness-related programs by the State Auditor's Office concluded that in many instances, the state lacked sufficient oversight and data collection to know whether its homelessness-related programs are effective. That conclusion suggests that hiring some additional personnel to oversee the programs may be warranted. Still, the Subcommittee may wish to explore exactly how this staffing augmentation will address the problems identified.

The proposed staffing expansion will be paid for out of the administrative set-asides that are included with the funding for each homelessness-related grant program. As a result, the increased authority will not put any immediate new pressure on the General Fund. However, the Subcommittee may wish to inquire about the fiscal impacts of the augmentation in out years, when the grant programs may cease to exist.

Finally, the Subcommittee may want to utilize the opportunity to press the Administration for more details about its vision for the HHARP unit. What role will it play? How will it help to ensure that homelessness-related grant recipients are using the resources effectively? What homelessness-related laws will the HHARP unit enforce and how will it go about that?

Staff Recommendation: Hold open.

Issue 31: Staffing Increases for Implementation and Administration of the Behavioral Health Infrastructure Bond Act (Proposition One of 2024)

Governor's Budget Proposal: As part of the May Revision, the Housing and Community Development Department (HCD) requests authority to hire 39 new ongoing positions over the next several years in order to implement and administer the Behavioral Health Infrastructure Bond Act (BHIBA), also known as Proposition One of 2024, recently passed by the voters.

Background: In March 2024, California voters approved Proposition One by a narrow margin. The Proposition consisted of two components: the Behavioral Health Services Act and BHIBA. The BHIBA portion is a $6.38 billion general obligation bond the proceeds from which will go toward funding for development of a variety of behavioral health treatment, residential care settings, and supportive housing. The intent is to provide appropriate care facilities for Californians experiencing mental health conditions and substance use disorders, a significant fraction of whom are currently unhoused.

This budget request provides the necessary administrative personnel at HCD to administer the funding made available through BHIBA. As all of these new positions would be funded through the bond proceeds, this proposal would not place any new pressure on the General Fund. Relatedly, the May Revision also includes placeholder trailer bill language authorizing the use of up to three percent of the bond proceeds for administration of the program.

Staff Comments: At the time this Agenda was written, the Administration had not yet provided details about this proposal. The Subcommittee may wish to use the hearing as an opportunity to press for further specifics about the proposed positions and the work that will be performed.

Staff Recommendation: Hold open.