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 9, 2024
9:30 a.m. or upon adjournment of session
State Capitol – Room 113

Consultant: Elisa Wynne

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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 This proposal is technical clean-up to remove the outdated transfer authority.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.

7600 DEPARTMENT OF TAX AND FEE ADMINISTRATION (CDTFA)

Issue 4: 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.

ITEMS FOR DISCUSSION

7600 DEPARTMENT OF TAX AND FEE ADMINISTRATION (CDTFA)

Issue 5: 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.

Background. The CDTFA administers California's sales and use, fuel, tobacco, alcohol, and cannabis taxes, as well as a variety of other taxes and fees that fund specific state programs. CDTFA has also administered the Tire Program since its inception in 1989. Chapter 974, Statutes of 1989 (AB 1843) enacted the California Tire Fee, which imposed a fee of $1 per tire on every consumer purchasing a new tire and created the Tire Fund where monies collected are deposited.

The Tire Fee is collected by the retailer at the time of sale. Retailers are allowed to deduct 1.5 percent of the total fees as reimbursement for costs associated with the collection of the fee and remit the remaining fees to CDTFA. All fees are collected according to the Fee Collection Procedure Act of the Revenue and Taxation Code (RTC, §§ 55001-55381) and deposited into the Tire Fund, then 75 cents per tire sold is transferred to the Air Pollution Control Fund.

CDTFA administers the Tire Program in coordination with CalRecycle and CARB through annual reimbursement contracts, as the law does not currently assign Budget Act appropriations to CDTFA for program administration expenditures. CDTFA's administrative responsibilities for the Tire Program include, but are not limited to, the following:

- Identifying and registering tire sellers to establish an account.
- Maintaining and updating the account information.
- Reviewing returns.
- Processing payments.
- Providing customer service.
- Collecting tax, penalty, and interest not paid.
- Issuing determinations.
- Handling appeals.
- Analyzing and processing refund requests.

- Auditing accounts to insure proper reporting.

Currently, the Tire Program has 13,876 registered fee payers that generated $61.6 million in revenue in 2022-23. Program costs over the last three fiscal years have averaged $2.2 million annually and are expected to remain stable.

Staff Recommendation. Hold Open.

Issue 6: 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 7: Enterprise Data to Revenue Project 2

Budget. 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.

Background.

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

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

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

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

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

System	Date Implemented	System Age in Years (as of 2023)
ARCS	1999	24
INC	2001	22
PASS	1997	26

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

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

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. Hold Open.

Issue 8: Net Operating Loss Conformity

Budget Proposal. The Governor's budget includes a proposal to conform to federal law and limit the use of Net Operating Loss (NOL) deductions to 80 percent of a business's taxable income in the year it is applied. The Administration anticipates this will result in revenue gains of $300 million in 2024-25 and ongoing gains of $200 million in subsequent years.

Background.

A NOL occurs when a business has deductions that exceed taxable income in a given year. Under both state and federal law, these NOLs can be carried forward and applied to offset tax payments in future years. The rationale is to provide more equitable tax treatment between businesses with volatile income and businesses with steady income.

As part of the Tax Cuts & Jobs Act (TCJA, 2017), the federal government limited the use of NOLs generated beginning in 2018 to 80 percent of a business's taxable income, reducing the allowable amount from 100 percent. TCJA also allowed unlimited carryforwards, up from the previously allowed 20 years, and barred the use of carrybacks, which allowed NOLs to be applied to earlier tax years to receive a refund. Most states conformed to these provisions, either in part or in full.

California has not conformed to the limit on NOLs, allowing businesses to use NOLs up to 100 percent of their taxable income, while continuing to cap carryforwards at 20 years. In 2019, California conformed to the federal elimination of carrybacks, which had been allowed for up to the two preceding years under prior law. In 2020, when the state expected a revenue shortfall resulting from the COVID-19 Pandemic, California put temporary restrictions on NOLs, suspending the use of NOLs for businesses with more than $1 million in net income. Those restrictions were in place for tax years 2020 and 2021, before being lifted for tax year 2022. The temporary suspension on NOLs is expected to lead to increased utilization after their restoration because businesses continued to generate and amass NOLs during the suspension.

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

The LAO released their analysis on February 22, 2024, and recommends rejecting the proposal to limit NOL deductions. Their analysis notes the proposal would result in a less equitable tax system as it would create limits on the use of NOL deductions that are intended to smooth profits and losses for business activity where profits fluctuate due to the nature of the business.

In addition, the LAO points out that the proposal does not conform to federal law in several ways. Specifically, federal law applies the 80 percent limit only to losses experienced after 2017, whereas the Administration proposes to apply the limit to losses from all prior years. In addition, federal law allows NOLs to be carried forward indefinitely, whereas California would maintain its 20 year limit. Given these differences, the LAO does not anticipate the proposal would provide meaningful administrative efficiencies.

The LAO acknowledges that rejecting this proposal would necessitate an additional $300 million in budget solutions for 2024-25.

Staff Recommendation. Hold Open.

Issue 9: 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 10: 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 11: 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 Comments. Staff also notes that stakeholders have raised concerns that there are technical errors in statute which would misalign the maximum income thresholds between the CalEITC, YCTC, and FYTC, Staff is working with the Assembly and the Administration to review language for a potential correction.

Staff Recommendation. Information Only

Issue 12: 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

9210 LOCAL GOVERNMENT FINANCING

Issue 13: 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.