

**AGENDA****ASSEMBLY BUDGET SUBCOMMITTEE NO. 4 STATE ADMINISTRATION****ASSEMBLYMEMBER JOAN BUCHANAN, CHAIR****WEDNESDAY, MAY 9, 2012  
1:30 P.M. - STATE CAPITOL ROOM 437**

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## CONSENT

### 0840 STATE CONTROLLER'S OFFICE

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<b>CONSENT ISSUE 1: REIMBURSEMENTS FOR INCREASED AUDIT WORKLOAD</b>
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The State Controller's Office (SCO) has requested additional reimbursement authority for increased audit workload associated with mandated federal requirements. The increased resources are associated with the Disproportionate Share Hospital Program (DSHP) audits and the Women, Infants and Children (WIC) audits.

#### **Disproportionate Share Hospital (DSH) Program**

The DSH program is a federal program that provides assistance to a hospital that serves a large number of Medicaid (MediCal in California) patients relative to other hospitals. Through the program, the federal government pays eligible hospitals an amount in addition to the patient-related MediCal payments that are made. In 2007-08, California received in excess of \$1 billion in such DSH payments. As part of the program, federal regulations provide that federal matching payments are contingent on the state's submission of an annual DSH report and an independent certified audit. The Department of Health Care Services (DHCS) has contracted with the SCO to provide the audit plan. This contract will expire at the end of this fiscal year and DHCS has indicated that it renew the contract through the budget year. (The audits are completed three years after the close of the fiscal year.)

In a 2010-11 approved BCP, the SCO was provided 10.5 positions and \$1.1 million for limited-term positions to perform the audits through the current year. This request is for reimbursement authority from DHCS of \$856,000 and the continuation for one more year of 8.0 positions. The audit requirements include an independent certification that each DSH participant is qualified for the payment thorough an approved methodology, the state submits its audit in a timely fashion, and the audit is independent. This funding would assure compliance with these requirements and provide for the timely completion of the 2008-09 audit.

#### **Women, Infants and Children (WIC) Audits**

The federally funded WIC program is administered as a pass-through program by the California Department of Health Services (DHS). The program requires that five percent of the vendors participating in WIC be subject to compliance investigations. DHS does not have the expertise to provide these audits and review services and has contracted with the SCO to provide these services for the last 20 some years.

Due to changes in USDA vendor audit requirements, the number of annual audits was increased from 65 to 200 beginning in 2010-11. The SCO requested and received additional resources in 2011-12 for a related workload increase and requested that these positions become permanent through a 2012-13 BCP. This request is for an additional 7.4 positions for a five-year, limited term duration. 5.4 of the positions will be for audit and review services for vendors and two positions for audits of providers.

Based in part on the results of the 200 audits DHS has requested that SCO perform more extensive audits than previously including extensive procedures in high-risk areas and special request audits. These are to be undertaken to achieve a higher confidence level related to the validity of the vendor supporting documents. The special audits can be comprised of 5 to 25 independent vendor locations. In addition, DHS has indicated to SCO additional audit

requirements beginning in 2012-13. This additional workload revealed by the results of the expended audits was not included in the January request.

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**Staff Recommendation: Approve as Budgeted.**

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**1730 FRANCHISE TAX BOARD**

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<b>CONSENT ISSUE 2: VOLUNTARY CONTRIBUTION CHECK-OFF FUNDS</b>
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The Franchise Tax Board (FTB) administers a program whereby personal income taxpayers can choose to contribute to various organizations by checking-off a designated box on the personal income tax return. The taxpayer remits the corresponding payment along with any tax liability due, or subtracts the corresponding contribution from any refund due. The costs incurred by FTB for administering the program are derived from the contributions to each of the organizations. The organizations are placed on the personal income tax return through statute. This item appropriates \$18,000 (\$6,000 each from the ALS/Lou Gehrig's Disease Research Fund, Municipal Shelter Spay-Neuter Fund and Child Victims of Human Trafficking Fund) for payment of administrative expenses.

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**Staff Recommendation: Approve as Budgeted.**

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**VOTE-ONLY****0845 AND 0860 DEPARTMENT OF INSURANCE AND BOARD OF EQUALIZATION****VOTE-ONLY ISSUE 1: CHANGE IN PAYMENT DATES FOR SALES TAX AND INSURANCE TAX**

The Administration has proposed Trailer Bill Language that would make modest alterations in the due dates and related dates for certain sales tax and insurance tax payments. The sales tax is administered by and remittances made to the Board of Equalization. Currently quarterly payments are due and payable on the last day of the month next succeeding each quarterly period.

The change would require that such payments be made on the 24<sup>th</sup> day of the month next succeeding each quarterly period. The insurance premiums tax, administered by the Department of Insurance with remittances made to the State Controller, is levied on insurance companies in lieu of the corporation income tax. Currently, tax due dates, notification of deficiency assessments and approval of credits or refunds of overpayments are made on the first day of each calendar quarter or the first day of April (for annual returns). The proposal would change the date to the 15<sup>th</sup> day of the specified month. The purpose of the change is to minimize differences in and ease reconciliation of agency and Controller remittances. The result will facilitate an accurate accounting of the state's cash position. The adjustments in the dates could result in changing the cash flow procedures for various businesses.

**STAFF COMMENTS/QUESTIONS**

Staff has no concerns with this proposal.

**Staff Recommendation: Approve proposed TBL.**

**0860 BOARD OF EQUALIZATION****VOTE-ONLY ISSUE 2: DELL COMPUTERS SETTLEMENT**

This issue was initially heard at the committee's March 20 meeting and was held open. The budget requests \$3.1 million (\$2.1 General Fund) and 14.5 positions in 2012-13 and \$905,000 (\$593,000 General Fund) and 10 positions in 2013-14 in order to process refund requests related to the miscollection of sales tax on computer warranty contracts. The 2012-13 requests include \$2.1 million for OE&E, including consulting and professional services. From 2000 to 2008, Dell incorrectly collected use tax on the cost of optional extended warranty service contracts. Such purchases of optional extended warrantees (as opposed to cost of mandatory service contracts) are treated under law as nontaxable transactions. The tax was collected by Dell and remitted to the BOE.

The BOE was named as a cross-defendant in a class action suit against Dell Computers, based on the erroneous collection of use tax by Dell on the cost of optional extended warranty service contracts. An estimated \$200-\$250 million in use tax was erroneously collected from 10 million customers, 20 percent of whom are expected to file a claim for refund. BOE is now responsible

for refunding the taxes erroneously collected by Dell, resulting in this resource request. BOE indicates that the final amount of refunds to be made is unknown at this point. As a result, the estimates for the amount of resources necessary to make such refunds are still approximate. Final resource estimates will be updated with the understanding that BOE may submit a Spring Finance Letter once negotiations are finalized.

<b>STAFF COMMENTS/QUESTIONS</b>
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BOE had a similar request last year, which was not funded because the costs were preliminary. The costs for this exercise now appear to be final. The summary of the request identifies only limited-term positions (as is fitting for a program with a finite existence) while the detail identifies two positions classified as permanent. To the extent, the committee approves a version of this request it should approve on the basis of limited-term positions.

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**Staff Recommendation: Approve as budgeted with three year limited-term positions.**

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## **0950 STATE TREASURER'S OFFICE**

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<b>VOTE-ONLY ISSUE 3: PERCENTAGE CAP ON CREDIT ENHANCEMENT FEES</b>
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The Budget requests approval of trailer bill language (TBL) repealing the sunset date that allows credit enhancement fees paid to third parties to not exceed three percent of the principal amount borrowed. This change would allow credit enhancement fees to be permanently capped at three percent. Under current law, the three percent cap would sunset on June 30, 2013, and revert to the previously imposed cap of two percent. The two percent cap was initially imposed in 2003 to limit the amount of payment for credit enhancements. During the financial crisis, the cap was temporarily increased to three percent, with a sunset date of 2013. The cap was expanded as a result of banks imposing suboptimal terms with the lower rate caps or terminating existing credit arrangements.

The circumstances that led to the initial increase in the percentage cap relate integrally to the financial turmoil that began in 2008. Credit became increasingly scarce and increasingly expensive across numerous markets. In particular, the ability of state and local governments to secure credit enhancements (letters of credit or liquidity support) was restricted by a decline in the number of banks with adequate credit standing, an increase capital and reserve requirements, and a decline in the credit standing of state and local governments due to economic and budgetary stress. All of these factors have combined to push up the cost of credit support for the state.

While some of the factors that led to this change in the market have abated, other factors remain. In fact, the cost of credit enhancements remains substantially elevated from pre-2009 levels. The State Treasurer's Office (STO) is responsible for managing the state's substantial portfolio of credit-enhanced debt. Currently, the state has outstanding \$3.3 billion of variable rate bonds and \$1.6 billion of commercial paper. The state enters into credit enhancement agreements for both its bonds and commercial paper on an ongoing basis, generally for one to three years depending on the terms, conditions, and pricing offered by a particular bank.

In the absence of the an expanded cap, it is likely that banks and other issuers of credit enhancements would revert to practices that led to the original increase in the cap from two to three percent. This would require that the short-term debt be converted into long-term debt.

Assuming current interest rates, this conversion would result in additional interest costs of \$1 billion over the term of the bonds. In addition, the state would need to discontinue the commercial paper program, eliminating interim financing mechanism. Maintaining the existing three percent fee cap will help ensure the STO can maintain the current variable rate program and take advantage of short term rates that are substantially below long-term interest rates.

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**Staff Recommendation: Approve proposed TBL.**

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## ITEMS TO BE HEARD

### **CS 3.60 AND CS 3.61 CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM/CALIFORNIA STATE UNIVERSITY**

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#### **ISSUE 1: FUNDING PROCESS FOR RETIREMENT COSTS**

Retirement costs associated with California State University (CSU) employees are currently budgeted outside of the CSU budget, with adjustments made based on funding requirements. As part of the budget, the Governor proposes to no longer make base adjustments to reflect changing retirement costs and expects that state-related retirement costs be funded entirely from CSU's unrestricted base budget. The Administration's proposal removes the CSU from the budget bill Code Section 3.60 that allows the Director of Finance to adjust any appropriation affected by changes to employer contributions for 2012-13 fiscal year and creates a new Code Section 3.61, which states that CSU employer retirement contributions are to be paid out of their base budget item 6610-001-0001.

#### **BACKGROUND**

CSU employees are members of the California Public Employees Retirement System (CalPERS), the same retirement system to which most state employees belong. Funding for this system comes from both employer contributions and employee contributions. Each year, CSU's employer contributions to CalPERS are charged against its main General Fund appropriation, as is the case with other state departments. The employer contribution is based on a percent of employee salaries and wages as determined by CalPERS and specified in the annual budget act. The Governor's budget annually adjusts CSU's main appropriation to reflect any estimated changes in the employer contribution. For example, the Governor's Budget reduces CSU's main appropriation by \$38 million due to a lower employer rate and lower payroll costs in the current year. The CSU is expected to contribute \$400 million in CalPERS in 2012-13.

State law requires that CSU be part of CalPERS and specifies the benefit structure for CalPERS members, including payment rates at various ages and the minimum retirement age. State law protects these benefits as contracts under the State and U.S. Constitutions. This means that the university has virtually no control over the pension benefits that its employees earn. As a result, there are strict legal limits on even the state's ability to change these benefits for current employees in order to reduce government costs. In addition, employee contribution rate for CSU is also set in state law (similar to contribution rates for other state employees). As a result, CSU is not able to change this rate without Legislative approval.

The only way that the LAO could identify for the CSU to reduce its pension costs would be through managing its payroll costs, either by reducing the number of employees or their salaries. These are blunt tools at best and unlikely to have a significant impact on reducing pension costs for the university. Given the statutory and other constraints that CSU faces, the LAO finds that overall the Governor's proposal would place on CSU a level of responsibility for funding pension costs that is out of proportion with its ability to control those costs. For this reason, the LAO recommends that the Legislature reject the Governor's approach. Specifically, the LAO recommends that the Legislature adopt intent language in the budget specifying that future budget adjustments shall be provided to CSU to reflect its pension costs.

**STAFF COMMENTS/QUESTIONS**

Assembly Budget Subcommittee #2 took action on the item in its consideration of the CSU budget on April 11.

The Subcommittee rejected the Governor's proposal to include CalPERs retirement costs into the CSU base budget and reinstated budget bill language (BBL) that specifies that future budget adjustments shall be provided to CSU to reflect its pension costs.

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**Staff Recommendation: Conform to Action of Subcommittee #2 and Reject proposed change in retirement funding for CSU and reinstate BBL that specifies that budget adjustments be provided to CSU to reflect its pension costs.**

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**0840 STATE CONTROLLER'S OFFICE****ISSUE 1: INDEPENDENT REVIEW OF AIRPORT FACILITY FEE AUDITS**

The Governor's Budget proposes trailer bill language (TBL) that would eliminate the requirement that the Controller's Office independently review and report to the Legislature regarding the results of audits required to be conducted by airports with respect to the collection of fees to fund consolidated rental car and other transportation facilities. Under SB 1192 (Oropeza), Chapter 642, Statutes of 2010, the Legislature expanded the definition of customer facility charge to include a fee to be collected for the purpose of financing common-use transportation facilities and thus allowed the collection of an alternative fee, if necessary, for funding purposes. The bill also requires that airports that collect the fee to report certain information to the Legislature and complete a specified independent audit at particular intervals. The Controller's Office is to independently examine the audits and substantiate the necessity for the customer facility charge. The Controller is to report the finding to the Legislature and expenses of the review are paid by the airports.

The authority to collect the customer facility fee began in 1999 with special approval for such collection granted to international airports at San Jose, San Francisco and San Diego. The legislature expanded this to other public airports in 2001 and 2007. Under the program, each airport is required to complete an independent audit to ensure the aggregate amount of fee revenue does not exceed the reasonable costs paid by the airport to finance the design and construction of consolidated car rental facilities and common-use transportation systems. In 2010, the Legislature required that SCO review the audits and independently examine and substantiate the necessity of the customer facility fee. Thus, the audits will ensure that the fee (not to exceed \$10 per contract) charged to airport car renters is not excessive.

One two-year, limited term position was funded, resulting in \$140,000 in reimbursement authority for 2010-11 and \$134,000 for 2011-12 to conduct mandated independent reviews of the audits. The limited-term position expires at the end of this fiscal year. The SCO proposed to continue the funding in order to fulfill the independent review required by statute. The Administration has proposed TBL to eliminate the review requirement.

To date, the SCO has conducted an independent review of three independent CPA audits of the charges. The reviews reviewed undercharges and overcharges. For the Burbank-Glen Dale-Pasadena Airport Authority Audit, the review revealed that the Authority could have charged \$4.4 million more than it actually did. Two other reviews—San Jose Intonation Airport and Fresno-Yosemite International Airport—reveal overcharges of \$19.5 million and \$7.0 million, respectively. The overcharges were the result of unrecognized income and overstated costs.

**STAFF COMMENTS/QUESTIONS**

The results of the SCO's independent review of the independent audits indicates the presence of discrepancies between justifiable charges and fees actually collected. Given that over \$25 million was collected that should not have been, it would seem premature that the statute be changed and the SCO no longer given a role in the program. Staff recommends that the trailer bill language be rejected and the SCO provide information and proposal for continued funding of the oversight on a limited-term basis. The SCO has provided information regarding the audit program that would call for \$80,000 in reimbursement authority and 0.5 positions and provide sufficient resources for continuing the program. This could be continued on a limited-term basis upon direction of the committee.

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**Staff Recommendation: Reject proposed TBL and authorize reimbursement authority of \$80,000 and 0.5 positions for the continued funding of airport facility fee audit independent reviews as required by SB 1192.**

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**ISSUE 2: UNCLAIMED PROPERTY INSURANCE AND HOLDER REMIT REPORTS**

The SCO has requested \$1.3 million from the Unclaimed Property Fund and 13.7 positions in the budget year, and \$1.1 million from the Unclaimed Property Fund and 11.6 positions for 2013-14. For 2012-13, this will consist of 11.6 two-year, limited term positions and 2.1, one-year, limited term positions. The SCO states that the augmentation is necessary to address increased workloads resulting from non-compliant businesses, which fail to meet requirements necessary to restore property to lawful property owners. The additional positions will be used to evaluate and address issues related to owners not receiving death benefits and annuities to which they are entitled from the insurance industry, and property that has been remitted to the SCO without a Holder Remit Report. This issue was heard by the committee on March 20 and held open based on concerns with certain operational aspects of the program.

With respect to the life insurance-related proposal, the request is for 11.6 two-year, limited-term positions for additional audits and increased audit activity on an on-going basis, cross-matching of commercial data bases with owners/beneficiaries, and additional notifications to owners. The issue related to noncompliance with Holder Remit Report requirements would be addressed by 2.1 one-year, limited term positions to conduct research related to the unclaimed property, process the property for purposes of posting information, contact the holder for additional information, as well as other related activities. The positions consist of program analysts, program technicians and a manager.

**BACKGROUND**

Under current law, the SCO is responsible for safeguarding unclaimed property until it is returned to the lawful owner. After a period of time, generally three years, property escheats to the state. The property owner may file a claim for the return of the property at any time in the future. There are several ways, both before and after the property is escheated to the state, for property owners to be notified of property being held including mailed notifications, website information regarding property held, and a toll free number. However, the success of the program is also dependent on the compliance of businesses with unclaimed property law. In recent years, there have been legislative and system changes which have increased the workload in the areas of financial accountability, corporate actions, and the collection of securities. The goal of the program and the resource enhancement is to expedite the return of property to owners by increasing the ability of the SCO to preserve the integrity of the ownership trail.

The current proposal will seek to address two identified problems with the program:

- **Insurance Companies.** The SCO has conducted audits related to insurance companies that reveal practices that have prevented owners from receiving certain benefits to which they are entitled. Specifically, audits have indicated that rights to certain property (death benefits and annuities) have not been deemed to be unclaimed property and insurance companies have not gone through the required notification process. Owners of such benefits have not been notified nor has the SCO. Since notice has not been given and the SCO does not have the property on file, the property is seldom conveyed to the lawful owner.
- **Holder Remit Reports.** Some holders of property have submitted unclaimed property to the SCO without a Holder Remit Report that details information about the individual owners and property amounts. In the most recent three-year period, 1,582 remittances valued at \$116 million have been made without the required report. Without such a

report, the SCO is unable to take effective and necessary steps to locate the owner. The reporting requirement was further clarified in legislation last year.

<b>STAFF COMMENTS/QUESTIONS</b>
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The insurance company related portion of the proposal is constructed based on workload, and arrives at the resources necessary to process and complete an estimated number of cases. The proposal uses the average number of under-reported properties from the audit results, and then applies percentages of property owners who would be contacted pre-escheat, as well as other assumptions regarding other insurance companies not included in the audit. Given the number of assumptions and estimated parameters, the results of the program could vary from the estimate provided. Assuming the program is up and running with sufficient result, the committee may request that the SCO report the results to the Legislature next year with suggestions for improvements. Questions raised regarding the operational aspects of the program, in particular, those related to insurance policy holders and the process of escheatment, have been addressed by the SCO.

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**Staff Recommendation: Approve as budgeted.**

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**ISSUE 3: REDEVELOPMENT DISSOLUTION-RELATED WORKLOAD**

Through a Spring Finance Letter, the SCO indicates that additional on-going funding for Redevelopment Agency (RDA) dissolution activities will be required through the end of the 2012-13 budget year and ongoing. The request is for \$3.0 million in reimbursement authority and 27 permanent positions. Through the Section 28.00 process, the SCO requested current year funding to address increased responsibilities associated with the dissolution of RDAs across the state. The request was for \$640,000 increase in reimbursement authority and 25 audit, one accounting and one legal position, and was approved by the committee on March 20.

The audit staff will review the financial activities of roughly 400 RDAs that occurred between January 1, 2011 and February 1, 2012; the accounting staff will review the collection activities of the RDAs; the legal staff will ensure compliance with judicial orders. The annualized cost of the request would be roughly \$3.8 million). Funds required from the augmentation would be categorized as administrative costs under the legislation and would be payable from the property tax increment. The workload is based on audit review of each of the RDAs and the Successor Agencies.

This request also includes proposed budget bill language (BBL) that would require the SCO to report to Department of Finance (DOF) on its RDA dissolution-related activities and allow DOF to reduce reimbursement expenditure authority beginning in 2014-15, after a 30 day notice to the Legislature. The BBL would add Provision 17 to the Item 0840-001-0001 as follows:

*"The Controller shall report to the Department of Finance, not later than mid-September of each year, starting with September 2014, on the level of activity and workload associated with Controller's responsibility on Redevelopment Agency asset transfers, recognized obligation payment schedules, and oversight of auditor-controller actions, per Chapter 5, First Extraordinary Session, Statutes of 2011, (ABX1 26), including all necessary justification to continue positions and funding for the remainder of fiscal year 2014-15 and ongoing. Based on the information, Department of Finance may reduce reimbursement expenditure authority and related positions to reflect a lower level of activity and workload starting in 2014-15. No adjustments shall be made pursuant to this provision prior to a 30-day notification in writing to the Chairperson of the Joint Legislative Budget Committee and the chairpersons of the committees of each house of the legislature that consider appropriations."*

**BACKGROUND**

As a result of legislation adopted last year, and subsequent decisions by the State Supreme Court, RDAs were dissolved as of February 1, 2012. Between the time the Governor proposed the elimination of RDAs as part of his 2011-12 Governor's Budget, RDAs engaged in activities including the transfer of assets that need to be reviewed. The SCO is responsible for ascertaining the validity of such transactions and preserving public assets. In addition, as a result of this dissolution, extensive measures need to be undertaken by the Successor Agencies to the RDAs and the county auditor-controllers, including the disposal of assets and establishing account for payments due on RDAs debts. The SCO is responsible for oversight and guidance regarding numerous aspects of this process.

**STAFF COMMENTS/QUESTIONS**

Former RDAs maintained substantial resources and assets that have been conveyed to the Successor Agencies. During the period between the Governor's proposal to dissolve agencies and the actual date of dissolution, some real property and other assets may have been disposed of, even though the RDAs were under a freeze. The purpose of the legislation was to redirect property taxes to local governments and convey assets in a manner to maximize the value for purposes of schools, counties, cities and special districts. Given this, and the magnitude of the assets at stake, the positions requested are reasonable. However, even with the complex nature of the audits to be undertaken and the magnitude of the assets involved, permanent positions should not be required. One option would be to authorize three-year, limited-term positions with BBL giving DOF authority to reduce the authorization in the third year (2014-15) upon 30 days' notice to the Legislature. The BBL reporting required in the BBL could also be amended to begin in 2013 instead of waiting until 2014.

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**Staff Recommendation: Approve request as three-year, limited-term positions. Adopt amended BBL with required Controller's reports beginning in 2013 provided to DOF and the Legislature and provide DOF the ability to reduce budget authority in year three, upon 30 days' notice to the Legislature.**

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**0860 BOARD OF EQUALIZATION****ISSUE 1: SALES AND USE TAX—TAX GAP II**

The budget provides for additional activities to address the continuing tax gap for the sales and use tax and other taxes administered by the BOE. The initiative funded by the additional resources consists of an educational campaign regarding the use tax, additional desk audits of registered taxpayers, and expanded bankruptcy collections. The budget provides \$4.4 million (\$2.9 General Fund and \$1.5 million Reimbursements) and an additional 18 positions as part of this program in 2012-13 and \$1.7 million (\$1.2 million General Fund) for 2013-14. The efforts in this area are expected to result in additional General Fund revenues in the budget year of \$10 million, plus added special fund and local government revenues, for a total of approximately \$15 million.

The proposal consists of the following program that address tax gap issues related to the use tax and registered taxpayers:

- **Use Tax Educational Outreach Campaign.** This element addresses voluntary compliance with the use tax and requests \$3.1 million (\$2.1 General Fund) and 5.5 permanent positions to provide on-going outreach and education efforts to generate additional compliance and generate additional revenues of \$9.7 million, based on an increase in tax filings. The positions were approved as two-year, limited-term at the committee's March 20 hearing. In addition to the positions, the request includes \$2.5 million for one time funding of statewide media/marketing campaign. This component was held open by the committee at its March 20 hearing.
- **Registered Taxpayers.** This element is targeted at registered taxpayers that either under-report their sales or use tax or report the tax but fail to pay the amounts due, and consists of two components, desk audits and bankruptcy initiative. This was approved by the committee at its March 20 meeting.

**BACKGROUND**

As part of the 2010-11 Budget, BOE received additional resources for the Tax Gap I initiative. This initiative encompassed five components: in-state service business compliance, internet sellers, audit improvement, compliance improvements, and expanded bankruptcy/out-of-state collection. The benefit: cost ratio of this effort of the last three years was roughly 3:1. In the most recent full year—2010-11, costs were \$21.4 million with additional revenues of \$84 million, for a benefit cost ratio of 3.9:1.

**STAFF COMMENTS/QUESTIONS**

The proposal was approved at the committee's March 20 hearing except for the contract portion of the educational outreach and media campaign. The nature of the activities of the firm to be retained for this exercise, and the likelihood that it will meet with success, is at best unclear in the material provided. The department recently provided information regarding the name of the firm to be hired to do an initial survey and study to determine the effectiveness of a paid media campaign. Staff suggests that the results of this survey and study be provided to the Legislature for review before approving any funding of this proposal.

On May 3, 2012, the Senate took action on this issue. The Senate rejected the media contract, and approved the balance of the proposal, except it made the 5.5 positions related to internal education and outreach effort two-year limited-term limited-term and require reporting by January 10, 2014 on efforts undertaken by these positions and performance metrics, including benefit cost ratio of this investment.

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**Staff Recommendation: Conform to Senate Action**

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**ISSUE 2: AB 155 USE TAX NEXUS**

The budget proposes additional resources of \$3.2 million (\$2.1 million General Fund and \$1.1 million special funds) and 28 positions to implement the expanded collection of the use tax by out-of-state business pursuant to AB 155. These additional resources will be used to identify out-of-state business required to collect the use tax and institute compliance programs for the initiative. The Legislature passed and the Governor signed as part of the 2011-12 budget, AB 28 X1 (Blumenfeld), Chapter 7, Statutes of 2011, which required that out-of-state businesses with certain connections to California —such as sales using affiliates or the presence in the state of related companies—be required to collect the use tax on behalf of the state. Subsequently, the operative date of this bill was delayed until fiscal year 2012-13 through the passage of AB 155 (Charles Calderon and Skinner), Chapter 313, Statutes of 2011, with the date of implementation dependent on the outcome of certain federal actions.

For the purposes of the funding request, BOE has used an implementation date of September 15, 2012. The program is expected to generate an additional \$107 million in General Fund revenues in 2012-13. BOE expects an additional 2,000 new use tax accounts to be registered under the provisions of the bill. Resources required for these activities include positions to participate in discussions with federal officials regarding potential legislation, draft regulations, address incoming inquiries from retailers, taxpayers, tax practitioners and other interested parties, and provide outreach services. Resources in the subsequent years are expected to increase as a result of litigation, appeals and settlements.

As a means of preparing for additional use tax remittances, the BOE has The Department completed a series of interested parties meetings regarding AB 155 and recommended amendments to Regulation 1684 to incorporate the bill's provisions. The Board Members will discuss the amendments during the Board's Business Taxes Committee Meeting on February 28, 2012, and may authorize staff to publish the amendments at that time. BOE is also updating the questionnaire it sends to retailers to request information regarding their California activities so that the updated questionnaire will request the additional information the Department needs to determine whether a retailer is required to collect California use tax in accordance with the new provisions of AB 155 when AB 155 becomes operative.

Since retailers are free to change the way they do business at any time, BOE is not assuming that any retailer that is not currently registered to collect California use tax will or will not have affiliate nexus with California and thereby be required to register to collect California use tax when the provisions of AB 155 become operative. BOE will have to gather information to determine whether any specific unregistered retailer is required to register to collect California use tax after AB 155 becomes operative. BOE will also be looking at all types of traditional and non-traditional soliciting activities when determining whether the affiliate nexus provisions of AB 155 apply to a particular retailer after the new provisions of AB 155 become operative.

**STAFF COMMENTS/QUESTIONS**

The most significant portion of the new use tax nexus legislation is the component related to affiliate nexus. Providing resources necessary to effectively implement this legislation are addressed in this BCP. In addition, however, the legislation also included provisions related to nexus based on corporate ownership. Certain retailers are members of a commonly controlled group and members of a combined reporting group that includes another member of the retailer's commonly controlled group that pursuant to an agreement with or in cooperation with the retailer, performs services in this state in connection with sales of tangible personal property

sold by the retailer. These retailers would also be considered to be doing business in this state and subject to the use tax collection requirement.

The resources necessary to implement this part of the law are not addressed in this BCP. In addition, BOE reports that it has contacted the Franchise Tax Board (FTB), which is apparently unable to provide information related to commonly controlled and combined reporting groups. The committee may want to ask departmental staff regarding its approach to enforcing this aspect of the tax law, including whether additional resources from this BCP should be devoted to this effort. If FTB records are insufficient, for example, they could be supplemented with additional third-party data that would facilitate a matching process. Staff recently received additional documentation regarding the implementation of this law, which the department should present to the committee.

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**Staff Recommendation: Approve as budgeted.**

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### ISSUE 3: MANDATORY USE TAX REPORTING AND REMITTANCE

This proposal is to make mandatory use tax reporting on the income tax return if the use tax was not paid to the BOE by the end of the prior year. Among BOE's various tax compliance efforts, some have been instituted at little cost, such as the use tax line on income tax return forms. The line on the income tax return allows businesses and consumers to self-report use tax owed on out-of-state purchases and was originally put in place by SB 1009 (Alpert), Chapter 718, Statutes of 2003. Since that time, revenue generated from this policy has increased steadily. Costs associated for this program are approximately \$100,000. As part of last year's budget, this program was retained and granted permanent status.

Last year the Legislature adopted SB 86 (Budget and Fiscal Review) Chapter 14, Statutes of 2011, that required the BOE to develop a "look-up" table that would provide a safe harbor for taxpayers who had not kept track of purchases subject to the use tax. The look-up table provides an estimated amount of use tax owed based on a taxpayer's filing and income characteristics. Similar look-up tables were formerly provided at the federal level with respect to interest on consumer debt when such amounts were deductible from taxable income. The 'look-up' table appears as part of the tax year 2011 instructions, and remitted taxes are first applied to outstanding income tax or corporation tax liability.

There were also proposals last year to make the reporting and remittance of any use tax mandatory on the income tax return if the taxpayer had not remitted such taxes directly to BOE by the prior January 31. This TBL is similar to the proposal initially included in last year's legislation in that it would require:

- Every person who is not otherwise required to file a sales or use tax return with the BOE to report qualified use tax on the income tax return filed with FTB (but not any person that is not otherwise required to file an income tax return with the FTB, such as charitable organizations).
- A paid tax preparer or certified public accountant to make an inquiry with their client as to whether or not that client has a use tax liability, due to the fiduciary responsibility a paid tax preparer or CPA has in accurately preparing a tax return.
- Payments received on the FTB returns would to be first allocated to cover use tax liabilities reported on the income tax return, and then to FTB liabilities.

**STAFF COMMENTS/QUESTIONS**

The committee heard this issue at its March 20 hearing and held it open, partly due to member's questions raised regarding taxpayer audits. The department has provided information indicating that an audit of taxes reported on the Franchise Tax Board use tax line would only be made if BOE received other external data indicating an audit would be warranted and cost effective. BOE performs use tax audits of service industry businesses, and it is therefore possible that a service business reporting use tax on their income tax return could be audited under the BOE audit program. In addition, BOE might perform a use tax audit of an individual (as opposed to the service business) based on information obtained from our US Customs program or through some other third party lead. The department should discuss this topic at hearing. Making use tax reporting mandatory would provide an appropriate counterpart to previous statutory measures to increase tax compliance and a very cost effective means of increasing taxpayer compliance with the state's use tax law. The Subcommittee could approve trailer bill language to accomplish this goal.

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**Staff Recommendation: Approve placeholder Trailer Bill Language that would make use tax reporting mandatory.**

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