AGENDA
ASSEMBLY BUDGET SUBCOMMITTEE NO. 4 ON STATE ADMINISTRATION

Assemblymember Joan Buchanan, Chair

TUESDAY, FEBRUARY 1, 1:30 PM
STATE CAPITOL, ROOM 447

ITEMS TO BE HEARD

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ITEM 1730 FRANCHISE TAX BOARD

The Franchise Tax Board (FTB) administers the personal income tax and the corporation tax programs, the largest and third-largest contributors to the state's revenue, respectively. The department also performs some non-tax collection activities, such as the collection of court-ordered payments, delinquent vehicle license fees, and political reform audits. The FTB is governed by a three-member board, consisting of the Director Finance, the Chair of the Board of Equalization, and the State Controller. An executive officer, appointed by the board, manages the daily functions of the department.

The Governor's Budget proposed expenditures of $586.5 million ($551.1 million General Fund) and 5,260 positions for FTB. This represents a continuation of substantial increase in support for the agency compared to the 2009-10 fiscal year. Most of the current year and budget year increase is due to addressing negative revenue impacts of the prior administration's three-day furlough program in 2009-10, a policy which included the state's tax collection agencies. In addition, the budget calls for augmentations for specific tax compliance programs and technology improvements related to the department's revenue collection activities.

Franchise Tax Board

	2009-10 (actual)	2010-11 (estimated)	2011-12 (proposed)
Expenditures	$474.7 million	$577.0 million	$586.5 million
Personnel Years	5,431.5	5,434.1	5,259.9

As a result of the furlough program for FTB, there was a significant impact on revenues collected during the 2009-10 fiscal year. FTB took a number of steps to reduce this impact, including redeploying staff to direct revenue production activity, reducing or eliminating long-term strategic efforts, and limiting vacation use by staff. One of the negative impacts of furloughs and budget reductions was in the area of strategic activities related to tax gap initiatives and abusive tax shelter enforcement. In reallocating staff to the most direct and highest return revenue producing activities, FTB shifted resources away from strategic activities, weakening the effectiveness of these efforts in the short-term.

ISSUE 1: MAINFRAME REPLACEMENT FOR WORKLOAD GROWTH

The Governor's Budget requests $4.7 million for replacement of the mainframe's central processing unit, additional data storage space, and software upgrades. FTB indicates that the upgrades are needed to maintain service levels required to support critical business programs and processes. The request is supported by a Feasibility Study Report (FSR) as approved by the State and Consumer Services Agency in June 2010 and the California Technology Agency in January 2011.

FTB relies on the full use of its service data center for mainframe and distributed systems. The system is integral to the department's tax processing capabilities. For example, as part of its tax return processing, the FTB data center processes approximately 16.5 million online transactions and 195,000 batch jobs per month. FTB relies on the completion of batch jobs in order to provide system updates to all of its taxpayer information files.

Industry guidelines recommend operating at less than 90 percent of available general processor capacity in order to maintain acceptable demand levels on critical systems and maintain an efficient information systems network. During the 2010 peak tax season, the FTB system was at 94.5 percent of capacity. Based on current estimates, the 2011 peak tax season, system capacity would be exceeded by 4 percent. FTB processes tens of billions of tax payments during this period.

FTB indicates that there a number of negative impacts that could result if the system is not upgraded. The most serious of these is a failure of the system and disruption of FTB processing capabilities. This would cause delays in processing time, delays in the receipt of revenues, and increases in taxpayer dissatisfaction.

STAFF COMMENTS

Delaying the implementation of this important project is not a prudent approach. The mainframe system provides vital system support for the state's largest tax collection agency. The project will provide risk avoidance for the FTB's Taxpayer Information, Business Entities Tax, Court Ordered Debt Expansion system, as well as all other FTB stakeholders using data storage and mainframe processing resources. Nevertheless, there is an alternative that would rely on three-year financing and reduce the initial year cost by over $3 million. The financing cost of this alternative represents a roughly 6 percent premium.

ISSUE 2: AUDIT WORKLOAD GROWTH

The Governor's 2011-12 Budget requests funding of $3.2 million and 34 positions to work on discretionary audits that will generate additional revenue for the state. The funding would result in an additional number of audit assessments and generate General Fund revenues of $6.5 million in the budget year and $13 million annually thereafter. Once the hiring and training of auditors has been completed, the enhanced audit program would result in a benefit/cost ratio of roughly 4/1.

The audit program's discretionary workloads are prioritized by benefit/cost, with the high benefit/cost audits being worked on first. FTB constantly reevaluates its audit workload and shifts available resources to those activities that will generate the largest revenue relative to cost. The tax agencies (BOE and FTB) are typically funded to the 4/1 benefit/cost ratio. As part of the 2008-09 budget, FTB was funded to the 4/1 level; however, since that time audit model evaluations have revealed additional work at the higher levels, to which staff has been shifted. As a consequence, there is additional audit work that could be funded down to the 4/1 level.

STAFF COMMENTS

In general, both tax agencies prefer to have permanent positions rather than limited-term. This is largely due to the investment required to recruit and train suitable staff. Given the current employment landscape, however, it may be feasible to offer limited-term positions without jeopardizing the investment by FTB in the employee. FTB has not indicated whether it expects the workload to be a permanent increase or a short-term development. FTB should report to the Subcommittee on this issue and the feasibility of limited-term positions.

ISSUE 3: FINANCIAL INSTITUTIONS RECORDS MATCH

The Governor's Budget requests funding of $1.3 million and 3 positions in 2011-12 and $5.1 million and 40 positions in 2012-13 and on-going for establishing the Financial Institutions Records Match (FIRM). The project is expected to result in additional revenues of $3.0 million in 2010-11 (because existing systems are already in place), increasing to $40 million in 2011-12 and dropping to $30 million in 2012-13 and annually thereafter.

The FIRM project would establish a record match process between financial institutions customer records and tax debtor records. FTB would use the match information to collect delinquent state income tax debts using existing laws and collection methods. FIRM would, in a timely manner, permit FTB to identify previously unknown deposit accounts held by delinquent income tax debtors, collect outstanding income tax debts, and help narrow the tax gap. The proposed data match is similar to one used by existing Financial Institution Data Match (FIDM) program mandated by federal law for the collection of delinquent child support payments.

Current state law allows FTB to use several collection tools in order to collect delinquent tax liabilities, one of which is the Order to Withhold (OTW). An OTW can be issued to any third person in possession of funds or properties belonging to the debtor. Upon receipt of an OTW, the recipient notified is required to freeze the debtor's assets in their possession and hold those assets for 10 days, then remit to FTB all cash or cash equivalents held that would satisfy the amount of the OTW. The proposal requires changes to the Revenue & Taxation Code that would require financial institutions doing business in California to conduct records matches on delinquent taxpayers.

STAFF COMMENTS

This proposal has been discussed in the Legislature over the last several years, including 2010-11 when it was a part of the Assembly budget package. The program imposes costs on financial institutions, but they would be compensated with $2,500 per institution in start-up costs and $250 per calendar quarter for reimbursement of data matching costs. Additionally, financial institutions can impose fees up to $125 on customers for the costs of processing levies. FTB already has access to information on interest-bearing accounts and the ability to issue OTWs. This proposal would not expand its authority but rather simply give it access to more information regarding non-interest bearing accounts.

ISSUE 4: VOLUNTARY COMPLIANCE INITIATIVE II

The Governor's Budget requests funding of $513,000 and 5.5 positions to administer a new narrowly-constructed amnesty program for those taxpayers that either utilized an abusive tax avoidance transaction (ATAT) or have unreported income from the use of an off-shore financial arrangement. The 91 day amnesty period would run from August 1, 2011 through October 31, 2011 and would apply to taxpayers subject to the state's personal income tax (PIT) laws and corporation tax (CT) laws. This proposal is expected to generate accelerated revenues of $270 million in the current year, with revenue reductions of $50 million in 2011-12 and $28 million in 2012-13. The revenue reductions are the result of acceleration on revenues that would otherwise have been received at a later time.

California and the federal government generally deny claimed tax benefits of an ATAT if the transaction that gives rise to such benefits lacks economic substance independent of income tax considerations. The proposed limited amnesty program, termed Voluntary Compliance Initiative II (VCI II) is modeled after the department's highly successful tax shelter amnesty in 2004. VCI II is designed to collect taxes previously unpaid but otherwise due to the state's General Fund. VCI II creates an opportunity for qualifying individuals and businesses to remit back taxes with reduced penalties and avoid criminal prosecution. It would apply to tax years beginning prior to January 1, 2011.The program would be available to PIT and CT taxpayers who have

- ATATs currently under audit;
- ATAT cases in protest;
- Unknown ATATs; and
- Unreported income from the use of an offshore financial arrangement.

VCI II is designed in a manner that incorporates both "carrots" and "sticks." The carrots include a waiver of all penalties other than the Large Corporate Understatement Penalty (LCUP) and the Amnesty Penalty as well as protection from any criminal action against any qualified VCI II participant (who is not the subject of an existing criminal complaint or investigation). The "sticks" would include an increase from 8 to 12 years in the statute of limitations for FTB to issue a tax assessment for an ATAT activity; enactment of a uniform definition of ATAT; establishment of a 50 percent penalty for the filing of an amended return after being contacted by FTB but prior to FTB issuing a deficiency notice; and amendment of the California non-economic transaction penalty to include any transaction determined by the IRS to lack economic substance.

STAFF COMMENTS

There is always a double-edge sword quality to tax amnesties. While the short-term goal may be to accelerate revenues or realize tax payments that otherwise might not be remitted, the strategic goal of any amnesty to draw out noncompliant taxpayers and incorporate them into the compliant taxpayer population. However, if amnesties are over-used, taxpayers can develop behavioral responses based on expectations that amnesties will continue to occur in the future. The specific behavioral response adopted by taxpayers is that they may continue to engage illegal tax avoidance based on expectations that they can avoid penalties due to the enactment of a future amnesty. Fortunately, unlike many states, California's use of amnesties has been quite limited, and thus the state does not run much risk of encouraging additional future taxpayer noncompliance. In addition, this proposal increases penalties which should provide additional disincentives to noncompliance.

ISSUE 5: IMPACT OF PERSONAL LEAVE PROGRAM

The Governor's Budget calls for carrying-forward the statewide Personal Leave Program (PLP) to achieve overall savings during the budget year of $71.6 million. The 13 bargaining units that signed contracts in 2010, as well as the compensation package in place for most excluded employees, included a 12-month, one-day-per-month, unpaid personal leave program. This program affects FTB employees, including those engaged in revenue-producing activities.

FTB's preliminary estimate is that the loss due to the PLP program would approach $122 million over multiple years due to the reduction in hours, as indicated in the chart below. FTB's revenue estimates are based on a less aggressive use of the PLP days than the furlough days that were in place under the prior administration. FTB does not have sufficient information regarding how staff will use these PLP days, and the chart below represents a preliminary estimate. Staff may simply switch-out these days for planned vacation days. In the event staff primarily switches these days for vacation days, there would be an increase in vacation days which would hinder FTB from backfilling that vacancy upon retirement until the retiree's vacation runs out. That would mean this loss would be incurred over a number of years.

Distribution of PLP Revenue Impact (in Millions)					
Total		**2010-11**	**2011-12**	**2012-13**	**2013-14**
Personal Income Tax	($85)	($22)	($31)	($20)	($10)
Bank & Corp Tax	($37)	($9)	($13)	($8)	($5)
TOTAL	($122)**	($31)	($44)	($28)	($15)

**The remaining $4 million is distributed over later fiscal year periods.

STAFF COMMENTS

FTB staff should be asked to comment on the impact of the PLP and how they have approached using resources they have available to them to maximize revenues to the state. They should also be asked as to what alternatives may be available to revenue agencies to avoid revenue losses due to the statewide imposition of the program, such as through the use of temporary employees.

ISSUE 6: MANDATORY SINGLE SALES FACTOR APPORTIONMENT

Proposal

The Governor's Budget proposes to eliminate the election that multistate and multinational corporations have under current law in apportioning income to California for tax purposes, and instead would make mandatory a single sales factor apportionment. Current law allows such corporations to elect either the traditional four-factor apportionment method or single sales factor apportionment. The proposal would also require taxpayers to source the sale of services and intangibles using a market approach rather than cost of performance.

Background

Single Sales Factor. Under California's corporation tax law, businesses that are multistate or multinational in their operations must apportion their income among the jurisdictions in which they do business. Until this year, for most corporations, California required the use of a four-factor formula to determine how much income is attributable to California and subject to tax in this state. The factors are payroll, property and sales, with the sales factor double-weighted. Certain agricultural, extractive and financial establishments use a simple three-factor formula, without double–weighting sales. Each factor represents the ratio of the California share of each measure to the total amount. The average of the ratios is applied to the corporation's total net income to compute income apportionable to California.

A component of the 2009-10 budget package permanently gave multistate and multinational corporations an additional option for determining the proportion of income that is subject to taxation in California. The legislation allows companies the option to use only a sales factor to determine the amount of income attributable to California. This so-called "single sales factor" (SSF) option becomes effective for the 2011 tax year. When it becomes effective, the change is expected to reduce revenues by approximately $200 million in 2011-12, and reaching in the neighborhood of $1 billion in the long term.

Many states have changed their apportionment method to reflect a SSF formulation. Although there is a range of opinion as to the effect of such a change, the argument for adopting such an apportionment method is that it encourages businesses to locate or expand property and payroll in the state, since these activities are not factors in the ultimate taxation of any income. Other states that allow for a SSF apportionment do not generally allow an election of such a method. California's only other filing election for corporations is an option to include either its worldwide or water's edge income in the reporting group. Unlike the annual option for SSF, water's-edge/worldwide election is for a seven-year period.

Technical Changes. Along with the adopting elective SSF, the Legislature approved certain technical changes to various components of the corporation tax. These changes were necessary to prevent abuses from occurring in the new apportionment method and prevent additional revenue losses from occurring. The changes involved moving to an economic nexus standard, redefining what constitutes gross receipts, broadening the definition of sales assigned to unitary groups, and requiring that the sale of services and intangibles be assigned on a market basis.

As part of last year's budget package, the Legislature approved a change to the assignment of sales of services and intangible. Specifically, the change provides that taxpayers who do not elect (or are not eligible to elect) SSF would use cost of performance in the assignment of sales of other than tangible personal property. Thus, corporations remaining on the three-factor or four-factor income apportionment method would assign these sales to the state where the income-producing activity is performed. In cases where the income-producing activity occurs in more than one state, such sales would be assigned to the state where the greater proportion of the income-producing activity is performed, based on costs of performance. This provision was estimated to result in reduced revenues of roughly $100 million annually.

STAFF COMMENTS

There are some valid economic policy arguments for instituting mandatory SSF in California, particularly with respect to tax competitiveness if other states have such an apportionment method. In contrast, there are no strong economic policy arguments for making such an apportionment method “elective.” Instituting mandatory SSF could remove a disincentive for in-state and out-of state companies, compared to the three-factor formula, from locating additional capital and employment in California. On the other hand, allowing an apportionment election would remove any incentive effects for out-of-state companies to locate additional activity in California. The optional SSF also results in a divergent treatment of businesses located solely in California (whose income is entirely subject to California tax) and out-of-state companies which are allowed to choose the lower of the two apportionment methods.

The perverse incentives of the optional SSF are of particular detriment to the state. If the goal of single-sales factor apportionment is to encourage location and expansion of business in California, the "option" of using such a formula would—to some extent—appear to work against this goal. Under a mandatory SSF, an out-of-state company would be taxed on income relating to California sales, and an in-state company would not have its property and payroll included in determining California income. By adding the option of the three factor formula, the out-of-state company could reduce its level of taxation to the extent that it expanded its property and payroll outside the state. Thus, for these companies, the optional component removes any incentive to locate or expand in California.

Tax planning and manipulation activities are inherent in an optional SSF apportionment. A notable example is when a company has losses one year and income the next. During a loss year, it would choose to maximize the loss apportionable to California by using which ever apportionment method resulted in the greatest loss. In the subsequent year, if it had positive income, it would use the formula that minimizes its taxable income in California. The corporation could then use the losses from the prior year to offset any or all of its income in the positive income year. The provision for allowing credit-sharing among members of a combined group expands further the opportunities for tax planning.

With respect to the sourcing of sales of services and intangibles, the policy merits of assigning sales of services and intangibles based on cost of performance under sales factor apportionment are quite slim. Under either a four-factor (double-weighted sales) or SSF, the emphasis is on the market, not where production occurs. Thus, assigning sales based on cost of production rather than where the services or intangibles are consumed runs directly counter to the market or sales based apportionment method. Under either apportionment method, assigning sales based on market is wholly consistent with the apportionment method. Since the sales factor can be manipulated, adopting a consistent market approach to the assignment of services and intangibles will help minimize these manipulation opportunities.

Mandatory SSF would put California in line with many other states and is consistent with the conclusion of the LAO recommendation.

ISSUE 7: OVERSIGHT—TAX GAP ENFORCEMENT

The tax gap is defined as the difference between what taxpayers should pay according to law and what is actually remitted. The tax gap is the result of non-compliance with the state's tax law, either through intentional disregard or unintentional means. The FTB has identified an annual tax gap related to the personal income tax and the corporation tax of $6.5 billion. The presence of the tax gap puts an additional strain and burden on compliant taxpayers since, if all individuals and businesses complied, taxes for compliant taxpayers could decline and still result in generating the same amount of revenue for the state. While estimates of California's tax gap place it above $6.5 billion, in reality, the tax gap is complicated and dynamic, thus virtually impossible to measure. Numerous factors influence it significantly—including, tax law changes, technological advancements, the economy, and the number, behavior, and attitudes of taxpayers, among other factors.

FTB's accounts receivable is the culmination of a portion of the tax gap collected over several years. FTB'S accounts receivable is not equal to the tax gap, but merely represents the portion identified and validated as currently due and payable. It is, in essence, the portion of the tax gap that can be accurately measure. The other immeasurable portion of the tax gap is estimated (as opposed to actively measured) based on federal data' This represents the portion of taxes due and payable that is owed to the state, but the income and/or transactions have been hidden successfully.

California's tax gap is attributable to the following four general categories:

- **Non-Filing** – People or businesses who earned or derived California income, but did not file a state income tax return.
- **Under-Reporting** – Taxpayers who file state income tax returns and underreport (or over deduct) income. Under-reporters also include third parties that fail to file information returns and individuals or businesses that engage in abusive tax shelters.
- **Under-Paying** – Taxpayers who fail to pay a balance due with a tax return, minimize their withholding of required taxes through their employer, claim to be a resident of another state while residing in California, avoid making estimate payments, and make false withholding claims.
- **Fraud** – Taxpayers who intentionally misrepresent information in order to pay less tax than they owe or get a refund of a refundable credit. In some instances the fraud is committed by a tax preparer and the taxpayer is unaware of the violation of the law.

FTB pursues various programs to narrow the tax gap. Some of these programs focus on taxpayer education and seek additional compliance from those who may not be aware of certain tax requirements. Other measures relate to enforcement efforts to improve compliance among individuals and businesses that chose not to comply with the state's tax laws. These measures result in additional revenue for the state that would otherwise not be received. Equally central to the core value of good tax collection practices is that such efforts make the tax system fairer to everyone by distributing the burden according adopted laws.

FTB has on-going audit and collections activities that ensure a certain level of tax compliance. Its tax gap activities, on the other hand, are designed to address particular problem areas where noncompliance is particularly acute and raises significant revenue issues for the state. The FTB should report to the Subcommittee the overall design of its tax gap program, the various component programs associated with narrowing the tax gap, and the extent to which its effort have been successful. FTB should also outline what it sees as further challenges in tax compliance and enforcement and how it is planning on meeting those challenges.

ITEM 0860 BOARD OF EQUALIZATION

The Board of Equalization (BOE) administers and collects state and local sales and use taxes, administers a variety of business and excise taxes and fees (including motor fuel taxes, cigarette taxes, and alcoholic beverage taxes), and oversees the administration of the property tax by county assessors. The BOE is governed by a five-member board, consisting of four regionally elected members and the State Controller. The Board is the final administrative appellate body for the taxes and fees it administers, as well as the personal income and corporation taxes, administered by the Franchise Tax Board (FTB). Currently, BOE's tax and fee administration programs result in the collection of approximately one-third of the state's annual revenues, as well as substantial revenues for local governments and special programs.

BOE administers taxes benefiting the state General Fund, various special funds, and local governments. The source of its support is allocated among the various funds on a benefits-received basis. The Governor proposes expenditures of $496.4 million ($283.3 million General Fund) and 4,485.2 PYs of staffing for BOE in 2011-12—an increase of $16.3 million or 3.4 percent ($11.7 million, or 4.3 percent, General Fund) and an increase of 15.3 PYs (less than 1 percent).

Board of Equalization

	2009-10 (actual)	2010-11 (estimated)	2011-12 (proposed)
Expenditures	$408.8 million	$480.1 million	$496.4 million
Personnel Years	3,882.8	4,469.9	4,485.2

A large proportion of the increase in funding in the current year was a result of proposals to restore the 2009-10 baseline reduction of $13.5 million, and the one-time reduction of $28 million. These reductions were applied to BOE's budget based on the Board's decision not to participate in the previous administration’s furlough program. BOE was able to absorb the base-line and one-time reductions through a hard hiring freeze and voluntary work reductions. While the agency was able to direct staff to the most productive revenue–related activities, delays in the receipt of revenue as well as permanent revenue losses occurred. These continue to be addressed in the budget year.

ISSUE 1: PERMANENT ESTABLISHMENT OF THE STATEWIDE COMPLIANCE AND OUTREACH PROGRAM

The Governor's Budget requests funding of $14.2 million ($10.2 million General Fund) in the budget year and $14.1 million ($10.2 million General Fund) in 2012-13 and annually thereafter, for the permanent establishment of the Statewide Compliance and Outreach Program (SCOP). The project would require the conversion of 147.0 limited-term positions to permanent status. The SCOP initiative is a component of the BOE's ongoing tax gap efforts (as discussed in Item 5 below) and is expected to generate ongoing revenue of $68.2 million annually. The benefit/cost ratio of the initiative is 4.8/1.

The SCOP initiative began with a 3-year pilot in 2008-09 and has been a highly successful component of the BOE's tax gap efforts. The tax gap is defined as the difference between the statutory amount of taxes owed and the amount actually remitted by the taxpayer. Efforts to narrow the tax gap are based on increased taxpayer compliance and enforcement of the tax laws. The tax gap for sales tax purposes is identified as being well in excess of $1 billion. SCOP focuses on identifying and registering entities which are actively engaged in business in California and selling tangible personal property without a seller's permit. The SCOP program works to educate businesses about the legal requirements of tax collection, provides for follow-up with businesses to ensure compliance, and captures tax revenue that would otherwise go uncollected.

In the pilot project, BOE teams were disbursed to various areas throughout the state—Oakland, Sacramento, San Jose, Van Nuys, Norwalk, Irvine and Riverside. The pilot project was then broadened and since that time, the project has contacted almost 150,000 businesses, identified 3,400 businesses operating without a sellers' permit, updated 37,900 taxpayer information registrations, and referred 1,200 businesses for audit. By 2009-10, SCOP efforts resulted in the collection of $55 million in taxes. Data indicate that almost 95 percent of businesses determined by SCOP to be operating without a seller's permit voluntarily obtained the required permit. Through June 2010, the non-compliance rate for contacted businesses was 3.6 percent. After contact by BOE, businesses which continue to be non-compliant are referred to BOE's investigations division for follow-up. SCOP also refers information for other taxes administered by the BOE as well as to the Franchise Tax Board (FTB) and to local governments. On average, 12 percent of the SCOP referrals to local governments have resulted in new business license registrations.

STAFF COMMENTS

The value of the SCOP has been amply demonstrated by its success during the pilot phase of the project. This period allowed BOE to shift and change SCOP appropriately on a small scale before making the program a statewide part of BOE's tax gap activities. Permanent funding for the program would allow for full integration into BOE's on-going enforcement and compliance activities. The current benefit/cost of the initiative is 4.8/1. BOE annually reports to the Legislature on the status of its compliance and enforcement activities. The Subcommittee may want to direct the BOE to include in the report the viability of expanding this program such that the benefit/cost is 4/1.

ISSUE 2: HEADQUARTERS BUILDING RENT INCREASE

The Governor's Budget includes a request for $2.1 million ($1.1 million General Fund) to cover the additional rental costs associated with the planned effort to sell bonds to refinance the agency's headquarters building in downtown Sacramento.

The BOE headquarters building has a long and expensive history of problems. Construction was completed in 1993. The original owner was CalPERS, and the state leased the building on behalf of BOE. The state purchased the building several years ago because financing a purchase appeared more cost-effective than the ongoing lease payments. The state pooled money investment board (PMIB) advanced BOE $88 million from Pooled Money Investment Account (PMIA) to purchase the building from CalPERS. The PMIA was to be repaid with a lease revenue bond sale, which has not yet occurred. According to BOE, bond financing for the purchase has not been completed due to the ongoing problems with the building. As a result, temporary financing from the PMIA remains in place.

In November of last year, the State Public Works Board determined that the State Treasurer would sell bonds to pay off the loan. It is expected once the bonds are issued, the outstanding loan amount will be $91 million. This would result in an increase in annual rental cost to the agency over its current payments.

STAFF COMMENTS

The issuance of bonds to pay off the outstanding loan for the headquarters building has been discussed and planned for some time. Periodic delays have occurred as a result of both ongoing remediation's to the building and prevailing conditions in the credit markets. The remediation is near completion and market conditions are more stable than they have been in recent times. Nevertheless, credit markets for municipal debt are still uncertain and the issuance of bonds is far from assured. This budget authorization could be accomplished when the issuance on debt (and calculation of resulting rent) is more certain.

ISSUE 3: DELL COMPUTERS SETTLEMENT

The Governor's Budget requests placeholder approval for $4.2 million ($2.8 million General Fund) and 8 limited-term positions for the administrative costs associated with settling the Dell Computers use tax over-collection case. 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. According to initial records received from Dell, approximately 10 million transactions were affected, with excess use tax collected of from $200 million to $250 million. BOE would be responsible for refunding the use tax to consumers who paid the tax and filed a claim for refund with the BOE. 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.

STAFF COMMENTS

Negotiations with the class action attorneys are apparently ongoing and the administrative costs associated with this activity are still preliminary. There appear to be no convincing reasons why approval of this item is necessary at this time. The Subcommittee may inquire as to the apparent agreement regarding the payment of administrative costs associated with the tax over-collection by Dell.

ISSUE 4: IMPACT OF PERSONAL LEAVE PROGRAM

The Governor's Budget calls for carrying-forward the statewide Personal Leave Program (PLP) to achieve overall savings during the budget year of $71.6 million. The 13 bargaining units that signed contracts in 2010, as well as the compensation package in place for most excluded employees, included a 12-month, one-day-per-month, unpaid personal leave program. This program affects BOE employees, including those engaged in revenue-producing activities. BOE estimates that the PLP will result in a loss or delay in revenues of $57.4 million ($34.3 million General Fund) in 2010-11 and $29.9 million ($17 million General Fund). Thus, the 12-month program (8 months in 2010-11 and 4 months in 2011-12) would result in a loss or delay of a total of $87.4 million ($50.8 million General Fund). Total estimated savings would be $11.0 million.

The estimate of revenue loss or delay is based largely on a decline in the work hours devoted to collection efforts for non-voluntarily remitted taxes. There could also be some delay in the processing of voluntary payments if staff is unable to process such remittances with existing resources. The largest component of the estimated loss is the delay in collection efforts. This would be reflected in a build-up of uncollected accounts and accounts receivable. To the extent that additional resources are received in the future, this inventory buildup could be worked down and the state would eventually receive the taxes owed. A portion of the revenue impact is lost revenues, due either to accounts that cannot be collected because the taxpayer can no longer be contacted or the statute of limitations has expired.

STAFF COMMENTS

BOE staff should be asked to comment on the impact of the PLP and how they have approached using resources they have available to them to maximize revenues to the state. They should also be asked as to what alternatives may be available to revenue agencies to avoid revenue losses due to the statewide imposition of the program, such as temporary help or limited-term positions.

ISSUE 5: USE TAX LINE ON INCOME TAX RETURNS

Among BOE 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) in 2003. Since that time, revenue generated from this policy has increased to an estimated $10.2 million in state and local revenue for tax year 2008. 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 there were discussions about whether statutes should require the development by BOE of 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 would provide 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. In addition, there have also been proposals as part of legislation 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.

BOE reports that the addition of these two components (mandatory reporting and the look-up table) would result in additional revenues of $10 million ($6.5 million General Fund) in the budget year and ongoing.

STAFF COMMENTS

Making use tax reporting mandatory and instituting a look-up table would be a very cost effective means of increasing taxpayer compliance with the state's use tax law. The Subcommittee may request that trailer bill language be developed to accomplish this goal.

ISSUE 6: OVERSIGHT—TAX GAP INITIATIVES

The tax gap is defined as the difference between the amount of tax lawfully owed and the amount actually collected. BOE estimates the current gap for taxes that it administers at approximately $2 billion in lost revenues annually due to noncompliance, with General Fund reductions in excess of $1 billion annually. The major components of the tax gap are:

- use tax liabilities of businesses and individual consumers;
- tax evasion by non-filers; and
- under-reporting and nonpayment by registered taxpayers.

BOE has a number of programs—largely through the sales and use tax program—that are aimed at reducing the size of the tax gap. Some of these are designed to increase voluntary compliance and focus on education and outreach efforts to inform consumers and businesses regarding their tax collection and remittance obligations. In other cases, tax gap efforts are focused more on the compliance and enforcement activities, such as the Statewide Compliance and Outreach Program discussed under Issue 1 in this document.

BOE has a number of additional tax gap initiatives currently in place. These programs (in addition to SCOP discussed earlier) include more effective use of software applications, utilizing North American Industry Classification System (NAICS) codes, investigating miss-use of resale certificates, and conducting special audits of auto auctions and gas stations. These programs are generally outlined in BOE's report to the Legislature on compliance and audit activities provided in December of each year. In addition, this report is to include information regarding BOE's Enhancing Tax Compliance Proposal approved as part of the current year budget. Due to a delay in the adoption of the budget, this initiative was postponed and the information provided about this initiative in the December 2010 report is incomplete.

STAFF COMMENTS

BOE has had a tax gap strategic plan in place since 2007. In bringing the components of the plan into operation, BOE has initiated a number of specific programs—including those outlined above. BOE staff should describe for the Subcommittee the results of its tax gap initiatives to date, the overall success of the program, and any impact of budget reductions on strategic planning for its Tax Gap initiatives, including the impact of the personal leave program. BOE should also comment on the progress of its Enhancing Tax Compliance initiative.

ITEM 8885 COMMISSION ON STATE MANDATES

The Commission on State Mandates (COSM) is charged with the duties of examining claims and determining if local agencies and school districts are entitled to reimbursement for increased costs for carrying out activities mandated by the state. COSM was created as a quasi-judicial body and made up of the Director of Finance, the State Controller, the State Treasurer, the Director of the Office of Planning and Research, a public member with experience in public finance, and two additional members of local public bodies appointed by the Governor and approved by the Senate. This budget item appropriates the funding for staff and operations costs of COSM and appropriates non-education mandate payments to local governments. The Governors' Budget calls for expenditures of $57 million, representing a decline of $28 million from the current year. The number of personnel years would remain stable at 11.0.

Commission on State Mandates

	2009-10 (actual)	2010-11 (estimated)	2011-12 (proposed)
Expenditures	$76.8 million	$84.6 million	$56.7 million
Personnel Years	10.3	11.0	11.0

The Governor's Budget achieves substantial savings by continuing to suspend numerous mandates, including most mandates not related to law enforcement of property taxes. The savings are made up of $271.2 million in suspended mandates, $26.7 in deferred mandates, $55.1 million in expired mandates and $94.0 million in continued deferment of the pre-2004 mandate claims. Proposed mandates to be funded are shown below and amount to $52.3 million in costs. LAO notes that because of delays in the posting of claims, the amount of the funded mandates is likely to be higher by 50 percent in the spring.

Proposed Mandate Funding in Governor's Budget—General Fund

Title	Amount (000s)
Allocation of Property Tax Revenue	596
Crime Victim's Domestic Violence Incident Reports	188
Custody of Minors-Child Abduction and Recovery	13,999
Domestic Violence Arrests and Victim's Assistance	2,565
Domestic Violence Arrest Policies	7,412
Domestic Violence Treatment Services	2,345
Health Benefits for Survivors of Public Safety Officers	1,526
In-Home Support Services II	491
Medical Beneficiary Death Notices	27
Peace Officer Personnel Records	543
Rape Victim Counseling	376
Sexually Violent Predators	21,908
Threats Against Police Officers	40
Unitary Countywide Tax Rates	244
Total	$52,259

ISSUE 1: SUSPENSION LIST INCLUDES ELECTION MANDATES

The mandates scheduled for suspension by the administration include several new mandates that were not suspended in past years, A number of these mandates relate to election actives and include Absentee Ballots (permanent absentee); Absentee Ballots (tabulation by precinct); Absent Ballots (disabled) and Voter Registration Procedures. The funding of these mandates by the state ensures additional access to the polls and greater participation in elections. Even if some counties chose to fund these activities to a greater or lesser degree, there would be significant unevenness in the treatment of prospective voters through the state. The administration indicates that the cost of funding these mandates is approximately $33 million; however, LAO indicates that the cost is likely to be closer to $50 million by the time the final tally is posted.

COMMENTS

The Subcommittee may wish to have DOF comment on the reasoning behind including these mandates in the suspension list and what they see as the potential ramifications if these were suspended. LAO should comment on potential options for continuing the funding of these mandates.

ISSUE 2: SUSPENSION LIST INCLUDES OPEN MEETINGS ACT REFORM MANDATE

One of the suspended mandates is the Open Meetings Act/Brown Act Reform. The core provisions of the act are not mandates subject to reimbursement by the state, since their adoption occurred in 1953 as part of the Brown Act, and prior to mandate law. These core provisions require that all meetings of a legislative body of a local agency be open and public and all persons be permitted to attend any meeting of the legislative body. Because this act preceded mandate law, its provisions are not state-reimbursable mandates.

In 1986, the Brown Act was modified to require local agencies to prepare and post agendas for public meetings. In 1993, the legislature added provisions regarding closed sessions. These more recent provisions are referred to as Open Meetings/Brown Act Reform mandate, with associated costs reimbursable by the state. Typically, the annual cost of this mandate is $20 million to $25 million annually for local agencies and education. Due to a quirk in timing and the delay in processing and approving claims, however, the savings associated with suspending this mandate in the budget is $63.3 million. According to LAO, the cost by spring is likely to be approximately $75 million.

As part of the budget process last year, the LAO proposed recasting the mandate provisions of the law as “best practices.” LAO’s position is based on the argument that Proposition 59, adopted by the voters in 2004) “could” require local agencies to post agendas and disclose actions taken in closed sessions—even in the absence of the Open Meeting Act mandate. The LAO proposal was not adopted last year.

COMMENTS

The Subcommittee may wish to have the LAO comment on and update its approach to the Brown Act/Open meetings Act Reform as well as discuss other options to addressing mandate savings, if the Legislature chooses not to approve some of the administration’s proposals.

ITEM 9620 CASH MANAGEMENT AND BUDGETARY LOANS

Cash Management and Budgetary Loans account for interest costs and related expense to the General Fund for internal and external borrowing used to deal with normal cash flow shortfalls during the fiscal year. Because receipts and disbursements occur unevenly throughout the fiscal year, the state avails itself of internal funds and external borrowing to address these periodic shortfalls. Interest is paid on internal borrowing, for example for cash flow loans from special funds, and on external borrowing, for example, on Revenue Anticipation Notes (RANs). This item additionally pays for interest costs on internal budgetary borrowing by the General Fund from special funds. Unlike cash flow borrowing that occurs within the fiscal year, budgetary borrowing occurs across fiscal years and as a result helps address any budgetary shortfall.

The Governor's Budget calls for the payment of $300 million in interest cost for internal and external cash borrowing. This includes payment of interest on an anticipated RAN borrowing of $10 billion in August of the budget year with anticipated interest costs of $200 million. The remaining $100 million would be interest costs paid by the General Fund to special funds. This item also includes $62 million for the payment of interest on budgetary borrowing from state special funds for the benefit of the General Fund.

ISSUE 1: PAYMENT DEFERRALS TO CERTAIN ENTITIES

In addition to external borrowing on the capital markets and internal borrowing from other funds for cash flow purposes, the state has also deferred payments to certain entities in order to maintain an acceptable cash balance. These payments are then made when the cash balance returns to an acceptable level. This deferral plan was put into effect for the current year. Existing law through September 1, 2011 enacted a cash management plan for the 2010-11 fiscal year that authorized the Controller, Treasurer, and Director of Finance to defer General Fund payments for up 60 or 90 days, as specified, beginning July 2010 for specific entities including various public school entities, higher education, and local governments.

The 2011-12 cash management plan would be effective through September 2012 and is basically a continuation of the current year plan, except that the borrowing of funds from the Highway Uses tax Account within the Transportation Tax Fund has been excluded, pursuant to Proposition 22, approved last year. Proposition 22 significantly reduced the flexibility of the state to use internal short-term borrowing for the benefit of the General Fund. The cash management plan adopted last year was developed in concert with the affected parties to minimize uncertainty for those entities. The plan includes triggers such that the borrowing would be curtailed if state cash balances maintain a certain level.

The proposed plan allows: up to 3 deferrals of not to exceed $2.5 billion at any given time to school districts, charter schools and county offices of education; 2 deferrals totaling $300 million to community colleges, up to $250 million in cumulative deferrals to California State University System; and limited and program specific deferrals to cities, counties and special districts. The state also has structured payments to the University of California and CSUS that preserve cash resources.

COMMENTS

The payment deferment plan is basically the same as the current year plan, with the addition of certain limitations imposed by Proposition 22. The Subcommittee may want to request that DOF and LAO comment on cash needs throughout the year and how the deferrals work in tandem with internal and external borrowing.

ISSUE 2: RECLASSIFYING CERTAIN FUNDS AS BORROWABLE RESOURCES

The Governor's Budget also calls for adding two additional funds to the borrowable classification as part of the cash management Trailer Bill Language (TBL). Existing law establishes the Immediate and Critical Needs Account of the State Court Facilities Construction Fund (3138) and the Hospital Quality Assurance Revenue Fund (3158). These two funds support the planning, financing and construction of court facilities and the enhancement of hospital quality respectively. These two funds would be added to the list of internally borrowable resources pursuant to the TBL. A third fund that the administration proposes to be a borrowable fund is the Children's Health and Human Services Special Fund (3156). Borrowing from this fund is being proposed as part of the Health and Human Services TBL. These three funds will add about an average of $400m cash balance.

COMMENTS

The Subcommittee may want to ask DOF to address the issue of timing of expected deferrals and how they would avoid having an impact on the activities of the two funds.

ISSUE 3: PAYMENT OF INTEREST ON SPECIAL FUND LOANS

Interest on loans from special funds accrues at the rate of the Pooled Money Investment Account (PMIA) unless otherwise specified in statute. The Governor's Budget calls for the payment of interest on such budgetary borrowing, totaling $62 million for all loans. The total amount of such borrowing that is expected in the budget year is $566 million.

COMMENTS

Staff has no issues with this item.

ITEM 9100 TAX RELIEF

This item provides specified tax relief pursuant to certain local tax programs. In previous years, funding was received by local governments to provide property tax relief for senior citizen property owners and renters. Funding for these programs was eliminated and currently there are just two programs funded by this item:

- **Homeowners Property Tax Relief** — This is a constitutionally-mandated program that exempts the first $7,000 of value from the assessment for property tax purposes. The value of this exemption for the taxpayer is approximately $70 annually (the amount would vary to the extent that the local tax rate exceeds 1%, for example due to debt service on outstanding bonds). The amount budgeted for this program is $442 million.

- **Williamson Act** — This program provides tax relief to property owners who sign contracts with local governments to retain property as open space or agricultural use. The program provides subvention funding for local governments that choose to participate in the program. The requested funding for the Williamson Act is a placeholder of $1,000. Full funding of the program is approximately $40 million.

ISSUE 1: WILLIAMSON ACT FUNDING

The Governor's Budget calls for elimination of funding for the Williamson Act. The program allows cities and counties to enter into 10 or 20 year evergreen contracts with property owners who agree to restrict their property to open space or agricultural use. In exchange for this agreement, the property is assessed at a below-market level resulting in reduced property taxes. The state portion of the program provides a partial subvention of lost revenues to local governments from the reduction in property taxes. Local governments receive $2 per acre for non-prime agricultural land and $5 per acre for prime agricultural land. Either party may decide to non-renew and let the contract run its course over the ensuing 9 year period. The property would then be reassessed to market value over the remaining term.

The last year that the Williamson Act was fully funded was in 2007-08. In the subsequent year, 2008-09, the funding was reduced by 10 percent to $34 million. In 2009-10, the program was suspended. Last year, as part of the adopted budget, the program was funded at $10 million, which would have provided a substantially reduced level of subvention. The Governor's budget proposal would eliminate this funding in the current year, for a savings of $10 million, and reduce funding to a placeholder level of $1,000 in the budget year. The LAO has called for the end of state funding for the Williamson Act. Eliminating funding would not prevent counties from entering into such agreements if they so choose to.

COMMENTS

There are substantial design flaws with the Williamson Act program that prevent it from operating as an effective open space conservation measure. Aside from issues related to instances of non-compliance with the contract by property owners (such as building or developing land under contract in violation of such agreement) the program is not an effective tool for permanent open space preservation. The program largely succeeds in providing tax relief for property owners of land that is not likely to be developed anyway. In such cases, if development appears to be an option, the property owner may choose to not renew the agreement, let the contract run its course for the remaining 9 years, and then proceed with development. At best, the program serves to delay development for a finite period of time. The overall costs to the state are substantial. In addition to the $40 million for subventions, the increase in Prop 98 General Fund obligation school funding due to the property tax reduction is on the order of at least $40 million, for a total state cost of approximately $80 million. There are additional costs related to amounts that local governments give up in property tax reductions that are not subvened by the state.