Senate Budget and Fiscal Review—Denise Moreno Ducheny, Chair

SUBCOMMITTEE NO. 5 Agenda

Senator Denise Moreno Ducheny, Chair
Senator Robert D. Dutton
Senator Alex Padilla

Agenda - Part B

Monday, May 24, 2010
1:30 a.m. (or upon adjournment of session)
Room 113

Consultant: Keely Martin Bosler

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Revenues and the Economy

0100 Legislature

Background. Under the terms of Proposition 140, the growth in the Legislature's budget is constitutionally limited to the growth in the state's appropriation limit (SAL).

May Revision. The Department of Finance has determined that the SAL is -1.77 percent.

Staff Recommendation. Staff recommends that the Subcommittee take the following actions:

- Adopt an adjustment to the Legislature's budget to reduce the Legislature's budget by the SAL amount, which equates to a $4.6 million reduction and General Fund savings.
- Adopt technical changes to the budget display to reflect the Legislator's salary reductions adopted by the Compensation Commission last year. These changes were not reflected in the budget bill, as introduced, by error.

0860 State Board of Equalization

Tax Gap Reduction Measures

Summary. The State Board of Equalization (BOE) estimates that the total tax gap for all its programs is about $1.8 billion. The tax gap is defined as the total tax receipts due to the state less the tax receipts collected by BOE. The tax gap for the sales and use tax, the board's largest tax program, is approximately $1.2 billion. The department has undertaken several initiatives to reduce this tax gap. However, many of those initiatives were thwarted in the current fiscal year given the Governor's baseline reductions to BOE's budget.

1. Agricultural Inspection Station Tax Leads

Previous Subcommittee Action. On May 6, the Subcommittee approved the Governor's budget proposal to expand the Agricultural Inspection Station Tax Leads pilot to three additional agriculture inspection stations. This proposal included converting 16 limited-term positions to permanent to continue supporting the Needles border inspection station and establishing 42.5 new permanent positions.

The Assembly also approved this proposal, except that the Assembly made the 42.5 new positions two-year limited-term. Staff finds that the modified action taken by the Assembly will require the BOE to come back to the Legislature with additional workload data before these positions are made permanent at the three additional border stations.

This proposal is expected to generate $36.9 million ($24.4 million General Fund) in the budget year and $44 million ($29.4 million General Fund) ongoing.

Staff Recommendation. Staff recommends that the Subcommittee conform to the Assembly action and make the new positions limited-term.

2. Use Tax Collection - Voluntary Disclosure Program

Previous Subcommittee Meeting. On May 6, the Subcommittee discussed the expiration of the line item on the state income tax for taxpayers to report use tax that was not paid on items purchased by out-of-state vendors. This line item is expiring with the 2009 tax year. The BOE has collected approximately $10 million in state and local revenue annually from this voluntary compliance program, which costs approximately $100,000 to operate.

The Subcommittee discussed recent legislation, AB 469 (Eng) that would have extended the program. In addition, this bill also provided a "look-up" table to assist taxpayers in calculating their tax liability, and a mandatory reporting requirement if the tax was not reported to BOE. The BOE estimated that this bill would have generated approximately $14 million annually. This bill was vetoed by the Governor in 2009.

Legislation (AB 2676, Ma) is currently pending in the Assembly that would extend the line item on the income tax form.

Staff Recommendation. Staff recommends that the Subcommittee adopt trailer bill language to: (1) extend the existing voluntary line for the sales and use tax on the income tax form, (2) direct BOE to develop a "look-up" table to assist taxpayers in compliance with current law, and (3) make this a mandatory reporting requirement.

This would safeguard $10 million in state and local revenue that would otherwise be lost and generate an additional $4 million in state and local revenue in the budget year.

3. Sales Tax Collection—Out-of-State Internet Retailers

Previous Subcommittee Meeting. On May 6, the Subcommittee discussed ABx8 8 (Budget) that was passed by the Senate in March of this year. It required certain out-of-state sellers that pay commissions to California firms or residents for sales referrals to collect use tax on their sales to California residents. Under current law, purchases made on the Internet by California residents are subject to the sales and use tax. However, certain retailers (Amazon.com, Overstock.com) that do not claim nexus in California, do not collect this sales and use tax. However, other Internet retailers that maintain brick and mortar in California do collect sales and use tax from California consumers on behalf of the State (for example, Walmart.com, Target.com, and many others).

The Subcommittee heard testimony from The Home Depot Corporation about the need to level the playing field for retailers that do not claim nexus in the State (Amazon.com, Overstock.com, and others) and do not collect use tax on goods that are sold to California customers. Furthermore, the Chair of the Subcommittee has received a letter from the Barnes and Noble Corporation further supporting this change in law.

The BOE estimates that this law change would generate approximately $107 million in the budget year.

Staff Comments. Staff finds that across the country different approaches have been taken by different states to address this issue. New York pursued a model similar to the compliance approach included in ABx8 8 that was passed by the Senate earlier this year. Currently, AB 2078 (Calderon) is pending in the Senate. This bill would require out-of-state Internet retailers and others that are not required to collect use tax on sales to California consumers to instead report on their Internet website or retail catalog that sales tax is imposed and owed. Earlier versions of this bill required every retailer selling taxable personal property to California residents file monthly the following information with BOE: name of purchasers, sales price of property, date of sale, and other information BOE may require. The earlier version of the bill would exempt retailers that sell less than $100,000 to California customers. This bill was similar to the approach taken by Colorado.

Staff Recommendation. Staff recommends that the Subcommittee adopt trailer bill language similar to the language contained in AB 2078 prior to the amendments made on April 27 of this year.

While FTB is uncertain of the fiscal impacts of this approach, staff assumes that this approach is likely to generate at least $100 million in additional revenue in the budget year similar to the nexus approach.

Other Issues

1. Fuel Tax Swap – Administration

Previous Subcommittee Meeting. On May 6, the Subcommittee discussed the BOE's Finance Letter requesting $1.5 million ($138,000 General Fund, $1.3 million Motor Vehicle Fuel Account, and $151,000 in Reimbursements from local government) in 2010-11 to implement the fuel tax swap. The funding would be slightly less ($1.4 million) in 2011-12 due to one-time costs associated with creating new forms, outreach, and data entry. The funding would support 11.5 new positions and overtime related to implementing the tax swap. At this time, the Subcommittee held these issues open pending additional information from BOE to justify the positions.

Since the May 6 meeting, the BOE has worked with staff to reduce the positions requested for this proposal.

Staff Comments. Staff finds that some activities identified in the original request appear to be short-run costs that would decline as taxpayers adjusted to the new tax scheme enacted as part of the fuel tax swap. In addition, staff finds that the original proposal overstated the amount of resources necessary for taxpayer information.

Staff Recommendation. Staff recommends that the Subcommittee approve the Finance Letter with the following modifications:

- Reduce the request by 1.5 positions.
- Delay the implementation of two audit positions to the 2011-12 fiscal year.
- Make three of the positions requested in the budget year two-year limited-term.

These changes will save the state approximately $400,000 in the budget year. This action conforms to an action already taken by the Assembly.

2. Cost Recovery Fee

Background. Chapter 23x4, Statutes of 2009 (SBx4 16, Ducheny) authorized agencies to impose a fee on past due liabilities. The statute requires that the fee is reasonable and does not exceed actual collection costs incurred. This statute does not provide BOE with the authority to obtain payment of the fee through involuntary collection methods (e.g., liens, wage garnishments). The Franchise Tax Board (FTB) currently has a cost recovery fee and the authority to collect through involuntary collection methods.

May Revision. The May Revision proposes $289,000 ($197,000 General Fund) to support 1.8 positions to implement a new collection cost recovery fee. The BOE is proposing trailer bill language that would allow for involuntary collection methods and a continuous appropriation for the fees collected. The BOE proposes that the fees collected in a separate, continuously appropriated account would annually offset (reduce) BOE’s operating budget.

The DOF indicates that this fee proposal would generate $20 million ($13 million General Fund) in savings in the budget year because fees would offset BOE’s operating budget.

Staff Comments. Staff finds that the FTB already has a similar cost recovery fee authority including the authority to collect through involuntary collection methods. Staff finds that currently the costs associated with collecting taxes due to the State from non-compliant taxpayers is supported by payments from other compliant taxpayers.

Staff Recommendation. Staff recommends that the Subcommittee approve the May Revision proposal and the proposed trailer bill language.

1730 Franchise Tax Board

Tax Gap Reduction Measures

Summary. The Franchise Tax Board (FTB) estimates that its total tax gap is about $6.5 billion. The tax gap is defined as the total tax receipts due to the state less the tax receipts collected by FTB. The department has undertaken several initiatives to reduce this tax gap. However, many of those initiatives were thwarted in the current fiscal year given the Governor's baseline reductions to FTB's budget.

1. Financial Institutions Records Match (FIRM)

Recent Subcommittee Meeting. On May 6, the Subcommittee heard the proposal to have FTB implement a Financial Institutions Records Match (FIRM) system to help reduce the tax gap. The FIRM is an information technology project that would require financial institutions doing business in California to match FTB information on delinquent tax and non-tax debtors against their customer records on a quarterly basis. The FIRM is patterned after the FTB's Financial Institution Data Match system, which is a project implemented as a result of federal legislation to identify the assets of delinquent child support debtors.

The Senate passed legislation (ABx8 8, Budget) earlier this year to authorize FTB to implement a FIRM system. The FTB would use the new data collection aid in the collection of debts under the authority of the existing Order to Withhold statutes. The proposal would not impact existing law that provides the applicable constitutional due process protections and appeal rights available in either the audit or collection processes. In addition, ABx8 8 required FTB to reimburse a financial institution for its actual costs incurred to implement FIRM, up to $2,500 for startup costs and no more than $250 per calendar quarter thereafter. This amendment removed bank opposition to this measure. A Feasibility Study Report (FSR) has been completed on this project.

Implementation of the FIRM system is estimated by FTB to generate approximately $35 million with first year implementation costs of approximately $3.2 million. The revenues are projected to grow to over $100 million at full implementation of this project.

Staff Recommendation. Staff recommends that the Subcommittee adopt trailer bill language similar to the language contained in ABx8 8 to direct FTB to implement the FIRM system and generate $32 million in General Fund revenues in the budget year.

2. Abusive Tax Shelters

Recent Subcommittee Meeting. On May 6, the Subcommittee heard a proposal to eliminate inconsistencies in the abusive tax shelter provisions of state law. Current law suffers from inconsistencies in definitions among various abusive tax shelter provisions, hampering the enforcement of these provisions.

The Senate passed ABx8 8 (Budget) in March of this year to eliminate inconsistencies by providing single, consistent definitions for abusive tax shelters. This language adopted the federal reportable transaction categories for “transactions of interest” for California purposes, and provided authority to the FTB to determine “transactions of interest” for California income tax purposes.

Furthermore, the language in ABx8 8 would have imposed a reduced penalty (50 percent of the full penalty) for taxpayers that file an amended return after FTB contacts them about their use of abusive tax shelters.

These statutory changes are estimated by FTB to generate $2 million in additional General Fund revenue in the budget year.

Staff Recommendation. Staff recommends that the Subcommittee adopt trailer bill language similar to the language contained in ABx8 8 (Budget) and generate $2 million in additional General Fund revenue in the budget year.

3. Professional License Suspension

Recent Subcommittee Meeting. On May 6, the Subcommittee discussed a proposal to allow FTB to suspend professional licenses only after all due process was exhausted and the taxpayer still does not agree to a payment plan to pay down their tax debt. Prior to the suspension, the taxpayer would be provided with additional notice and given 60 days to satisfy his or her obligation or enter into an installment agreement. The license suspension would be canceled upon compliance with tax obligations. The FTB indicates that there are approximately 25,000 delinquent taxpayers with a state-issued occupational or professional license.

The Senate passed legislation (ABx8 8, Budget) this past March to allow FTB to suspend professional licenses only after all due process provisions had been exhausted and the taxpayer still does not agree to a payment plan to pay down their tax debt. The FTB estimates that this would generate approximately $19 million in General Fund revenues to reduce the tax gap. There is similar legislation currently pending in the Assembly in AB 2038 (Eng).

Staff Recommendation. Staff recommends that the Senate adopt trailer bill language similar to the language in ABx8 8 that suspends professional licenses of delinquent taxpayers and generates approximately $19 million in General Fund revenues.

Tax Policy Changes

Governor's May Revision Approach to Solving the Budget Problem. The economic forecast in the Governor's May Revision shows that both the national and California economies have improved since January. Output from the national economy grew for the third consecutive quarter in the first quarter of 2010 and California payroll employment grew in four of the six months ending in March. The economic growth has occurred despite the tax increases adopted in February 2009. However, the recovery continues to be slow and the recent gains are small when compared to the loss of payroll jobs since the beginning of the recession.

Nevertheless, the Governor continues to identify a $19.1 billion budget deficit for 2010-11, due in part to the over $6 billion deficit projected for the current fiscal year. The Governor is proposing to close this gap primarily with program cuts and eliminations totaling $12.4 billion in the budget year.

Furthermore, the Department of Finance is still estimating that we will have a $6.3 billion shortfall in 2011-12 even if the Legislature adopts all of the Governor's budget solutions. These solutions include the complete elimination of the state's cash assistance program for the poorest families with children (CalWORKs).

LAO Approach to Solving the Budget Problem. The LAO, since January, has advocated that the Legislature consider selective revenue increases in conjunction with expenditure reductions to address the ongoing deficit. Specifically, the LAO has recommended fee increases and other non-tax revenues, changes to tax expenditure programs, delays in previously scheduled tax reductions or expirations, and targeted tax increases. The LAO recommends an approach and actions that seek to minimize negative consequences for the economy, jobs, and the Californian's directly affected.

Staff Recommendation. Staff finds that the size of the budget problem and structural deficit will require: (1) significant reductions in state programs, and (2) a re-evaluation and restructuring of government and the services that it delivers especially given the prospects of a multi-billion out-year deficit.

However, staff finds that solving this problem will also require some level of increased revenues. Similar to the LAO, staff recommends that the Legislature adopt revenue options that are focused on delaying tax cuts that have not already gone into effect and extending taxes that are set to expire in the budget year.

In total, the revenue options in the following pages would generate approximately $4.9 billion in additional revenues in the budget year when compared against current law. Under the proposal outlined below, corporate tax rates and income tax rates would remain at the same level and the sales tax rate would be cut, reflecting the expiration of the 1 percent temporary increase enacted in 2009.

1. Suspend/Reform Corporate Tax Cuts

Previous Subcommittee Meeting. On May 13, the Subcommittee discussed recent tax policy changes, LAO suggested tax policy changes, and others. The Subcommittee heard testimony on the pros and cons of these different tax policies. Specifically, the Subcommittee discussed recent corporate tax cuts that are scheduled to go into effect in the budget year:

- **Extend NOL Carry Forward Period and Allow for Carrybacks.** Beginning in 2010, taxpayers will again be able to carry forward Net Operating Losses (NOLs). The ability of corporations to use NOLs was suspended for the 2008 and 2009 tax years. However, recent law changes expanded the carry forward period from 10 to 20 years for losses incurred in 2008 and forward.

  Recent changes also authorized NOL carry backs for losses incurred in 2011 or later tax years. The carrybacks will be applicable to offset taxable income back to 2009. The carry back provision will phase in, with 50 percent of any 2011 NOLs available for carry back, 75 percent of any 2012 NOLs, and full carry back for NOLs in subsequent years.

- **Elective Single Sales Factor.** Recent law changes created an ***elective*** single sales factor for apportionment of business income to California starting in 2011. In contrast, current law averages a business's proportion of sales, property, and payroll in California (with the sales factor double-weighted) to apportion the California share of multi-state business income. Under this new tax policy, corporations can elect to allocate net income for California tax purposes under the old formula or 100 percent to sales. Businesses that proportionally have fewer sales in California relative to property and payroll will see their taxable income in California fall.

  This change will go into effect for the 2011 tax year and the State will lose $235 million in General Fund revenues in the budget year related to this corporate tax cut. The revenue losses related to this policy change are expected to grow to $1 billion.

- **Unitary Group Credit Sharing.** Beginning in the 2010 tax year, corporations that accumulate business tax credits would be able to assign all or a portion of any unused credit to an affiliated corporation that is a member of the same combined reporting group. With respect to credits earned in tax years beginning before July 1, 2008, the assignee corporation would have to have been a member of the group from at least June 30, 2008, through the year of assignment. For credits earned subsequently, the assignee corporation must be a member of the group in the year that the credit is earned through the year in which the assignment occurs. This tax policy change will result in a loss of General Fund revenues of approximately $315 million annually starting in the budget year.

Staff Recommendation. As mentioned already in this agenda, given the state's fiscal condition and the projected multi-year deficit, staff recommends that the Subcommittee delay for two years the implementation of the tax cuts summarized above with the following two changes:

- **Eliminate Carrybacks.** Staff recommends that the Subcommittee eliminate the policy of carrybacks enacted as part of the 2008-09 budget package. While this policy does conform to federal policy, there are unique circumstances in California that make this policy problematic. Specifically, the Proposition 98 guarantee that funds K-14 education depends on year-over-year growth in General Fund revenues. However, the premise of carrybacks is that corporations can go back and amend prior tax returns to lower tax liabilities and even trigger tax returns. However, the state has no ability to change the Proposition 98 guarantee retroactively to adjust for the amendments to revenues. Secondly, the carry forward policy allowed by current law essentially gets at the same public policy goal, which is to average a corporation's tax liability over a period of time in order to encourage investments that may take multiple years to recover.

- **Make Elective Single Sales Mandatory.** Staff recommends that the Subcommittee make the elective single sales factor policy mandatory. Allowing corporations to choose the formula they apportion income for tax purposes is not good tax policy and gives a comparative advantage to out-of-state corporations that have high sales, but low property and payroll invested in California. By allowing the corporation to elect the formula it uses to calculate tax owed, the corporation can then choose the calculation that is most advantageous to their situation.

The proposed recommendation and projected revenues are summarized below:

Delay Corporate Tax Cuts Two Additional Years: (dollars in millions)	**2010-11**	**2011-12**	**2012-13**
- (1) Suspend Net Operating Losses two additional years and continue with expansion from 10 years to 20 years the amount of time losses can be carried forward. (2) Eliminate ability to carryback losses for two years.	$1,500	$400	-$200
- Delay the ability for corporations to determine income/tax liability attributable to California solely on sales in California and make the determination mandatory and not elective.	235	800	1,000
- Delay the ability of corporations to share credits among similar companies.	315	260	32
Subtotal	**$2,050**	**$1,460**	**$832**

2. Extend Targeted Income Tax Provisions

Previous Subcommittee Meeting. On May 13, the Subcommittee discussed recent tax policy changes, LAO suggested tax policy changes, and others. The Subcommittee heard testimony on the pros and cons of these different tax policies. Specifically, the Subcommittee discussed the recent temporary increases in the personal income tax (PIT) that are scheduled to expire in the first half of the budget year. These increases are as follows:

- **Temporary 0.25 percent Surcharge.** A PIT surcharge of 0.25 percent was enacted effective with the 2009 tax year. The surcharge will sunset at the conclusion of the 2010 tax year. The Governor's budget estimates that this surcharge and the reduced dependent credit (next bullet) will result in \$4.2 billion in additional revenues in the current fiscal year, which fall to about half that amount in the budget year.

- **Temporary Reduction in Dependent Exemption Credit.** The dependent exemption credit was reduced from \$309 to \$99 per dependent effective with the 2009 tax year. The exemption credit will return to the higher value after the conclusion of the 2010 tax year.

Staff Recommendation. Given the state's fiscal condition, staff recommends that the Subcommittee continue the temporary PIT tax increases in effect in the 2009 and 2010 tax year for an additional two tax years. The proposed recommendation is summarized below:

Extend PIT Increases Two Additional Years: (dollars in millions)	**2010-11**	**2011-12**	**2012-13**
-Extend 0.25 Percent Surcharge	\$1,000	\$2,900	\$800
-Extend Reduced Dependent Credit	430	1,300	850
Subtotal	**\$1,430**	**\$4,200**	**\$1,650**

3. Vehicle License Fee

Previous Subcommittee Meeting. On May 13, the Subcommittee discussed recent tax policy changes, LAO suggested tax policy changes, and others. The Subcommittee heard testimony on the pros and cons of these different tax policies. Specifically, the Subcommittee discussed the recent temporary increases in the vehicle license fee (VLF). This increase was as follows:

- **Temporary 0.5 percent Increase.** The rate of VLF was increased from 0.65 to 1.15 percent of a vehicle's value. The increase became effective May 19, 2009 and will sunset on June 30, 2011. The increase from 0.65 to 1 percent went to benefit the General Fund and 0.15 of the increase was transferred to the Local Safety and Protection Account to fund local law enforcement programs. The Governor's budget estimates that revenues from this source to the General Fund will be $1.5 billion in the budget year.

Staff Comments. Staff finds that historically the VLF was 2 percent. The LAO has recommended aligning the VLF with local property tax rates, which are approximately 1 percent.

Staff Recommendation. Staff recommends that the Subcommittee take the following actions:

- Extend the VLF increase (0.35 to the General Fund and 0.15 to local law enforcement activities) for another two years through 2012-13.
- Increase the VLF by an additional 0.35 percent to a total of 1.5 percent effective July 1, 2010 and extend through June 30, 2013.
- Continue to dedicate 0.15 of the VLF to local law enforcement through 2012-13. This would be instead of the Governor's proposal, which is to allocate $502 million General Fund through a continuous appropriation starting in 2011-12.
- Reject the Governor's Emergency Response Initiative and instead fully fund fire protection with revenues from the VLF.

The proposed recommendation is summarized below:

Vehicle License Fee (dollars in millions)	**2010-11**	**2011-12**	**2012-13**
- Extend 0.35 increase for additional two years.	$0	$1,200	$1,200
- Extend 0.15 increase dedicated to law enforcement for an additional two years.	0	500	500
- Raise VLF an additional 0.35 percent for two years	1,200	1,200	1,200
Subtotal	**$1,200**	**$2,900**	**$2,900**

Increasing the VLF by an additional 0.35 would result in vehicle owners with a car valued at $30,000 paying an additional $100 a year. Vehicle owners with vehicles that are valued at $10,000 would end up paying approximately $35 more annually in VLF. Furthermore, the VLF adjusts annually based on the depreciated value of the vehicle and is deductible on federal income tax returns.

4. Alcohol Tax

Previous Subcommittee Meeting. On May 13, the Subcommittee discussed recent tax policy changes, LAO suggested tax policy changes, and others. The Subcommittee heard testimony on the pros and cons of these different tax policies. Specifically, the Subcommittee discussed the LAO option of increasing the alcohol tax to reflect inflation. The LAO's recommendation is summarized below:

- **Alcohol Tax.** The LAO recommends updating alcohol tax rates to reflect inflation since 1991, which is the last time the rates were updated. The LAO notes that there are considerable societal costs related with drinking and they believe it is reasonable to maintain the real value of these taxes.

Staff Recommendation. Staff recommends that the Subcommittee take the following actions:

- Adopt the LAO proposal to increase the alcohol tax to reflect inflation since 1991.
- Reject the Governor's red light camera proposal that would fund the courts and instead use these revenues to defray costs related to the courts.

The proposed recommendation is summarized below:

Alcohol Tax (dollars in millions)	**2010-11**	**2011-12**	**2012-13**
- Increase excise tax on alcohol to reflect inflation	$210	$210	$210