DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE ENROLLED BILL ANALYSIS

Date Amended:	**Chapter 49**	Bill No:	**AB 1809**
Tax:	**Sales and Use**	Author:	**Assembly Budget Committee**
Related Bills:	**AB 1933 (Coto)**		

BILL SUMMARY

This Budget trailer bill makes a number of revenue and taxation related changes necessary to implement the Budget Act of 2006. This Budget trailer bill, among other things unrelated to the Board, does the following:

1. Extends for one year the sunset date (from July 1, 2006 until July 1, 2007) of the sales and use tax provision that specifies that it shall be rebuttably presumed that, except as specified, a vehicle, vessel, or aircraft purchased outside this state and brought into California within 12 months from the date of purchase is purchased for use in California and is subject to California use tax *(Rev. and Tax. Code, § 6248)*.
2. Beginning fiscal year 2006-07, and each fiscal year thereafter, requires the Board's administrative costs associated with administering the sales and use tax on behalf of the state and local jurisdictions to be based on the methodology described in the November 2004 report by the State Board of Equalization entitled "Response to the Supplemental Report of the 2004 Budget Act" (*Rev. and Tax. Code, §§ 7204.3 and 7273).*
3. Beginning January 1, 2007, requires the Department of Finance to provide a report to the Legislature by September 15th of each year on tax expenditures exceeding $5 million annually and specifies the additional information that the report must contain on each tax expenditure, including, but not limited to, the statutory authority and description of the legislative intent, and information on sales and use tax expenditures, as specified. *(Government Code, §13305)*.

ANALYSIS

Vehicles, Vessels and Aircraft
Revenue and Taxation Code Section 6248

Current Law

Under existing law, Chapter 3 (commencing with Section 6201) of Part 1 of Division 2 of the Revenue and Taxation Code, a use tax is imposed on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer. The use tax is imposed on the purchaser, and unless that purchaser pays the use tax to a retailer registered to collect the California use tax, the purchaser is liable for the tax, unless the use of that property is specifically exempted or excluded from tax. The use tax is the same rate as the sales tax and is required to be remitted to the Board, or in the case of a vehicle or undocumented vessel, to the Department of Motor Vehicles.

Under the law, the California sales tax generally does not apply to a transaction when a California retailer sells an item and ships it directly to the purchaser at an out-of-state location for use outside California. The sale is regarded under the law as a sale in interstate commerce. In general, the sale is not taxable if the retailer:

- Ships the product directly to the purchaser, in another state or in a foreign country, using the retailer's own delivery vehicle or another means of transport that the retailer owns; or
- Ships the product to another state or to a foreign country by delivering it to a common carrier, contract carrier, customs broker, export packer, or forwarding agent.

Section 6248 of the Sales and Use Tax Law, as amended by SB 1100 (Stats. 2004, Ch. 226), provides that, for the period October 2, 2004, through and including June 30, 2006, shall be rebuttably presumed that a vehicle, vessel, or aircraft bought outside this state and brought into this state during the first 12 months of the date of purchase, was acquired for storage, use, or other consumption in this state and is subject to use tax if any of the following occur:

(a) The vehicle, vessel, or aircraft was purchased by a California resident as defined in Section 516 of the Vehicle Code.

(b) In the case of a vehicle, the vehicle was subject to registration under Chapter 1 (commencing with Section 4000) of Division 3 of the Vehicle Code during the first 12 months of ownership.

(c) In the case of a vessel or aircraft, the vessel or aircraft was subject to property tax in this state during the first 12 months of ownership.

(d) The vehicle, vessel, or aircraft was used or stored in this state more than one-half of the time during the first 12 months of ownership.

This section further provides that this presumption may be controverted by documentary evidence, that the vehicle, vessel, or aircraft was purchased for use outside of this state during the first 12 months of ownership. Such evidence includes, but is not limited to, proof of registration of that vehicle, vessel, or aircraft with the proper authority outside of this state. In addition, the law specifies that these provisions do not apply to any vehicle, vessel, or aircraft used in interstate or foreign commerce pursuant to regulations prescribed by the Board.

And, finally, Section 6248 specifies that an aircraft or vessel shall not be deemed to be purchased for use in this state if that aircraft or vessel is brought into this state for the purpose of repair, retrofit, or modification of the aircraft or vessel, provided that no more than 25 hours of airtime or sailing time are logged for that purpose, as specified.

Proposed Law

This provision extends for one additional year, until and including June 30, 2007, the 12-month rebuttable presumption contained in Section 6248 related to purchases of vehicles, vessels and aircraft.

The provisions became effective June 30, 2006.

Background

The amendments to Section 6248 that occurred by Stats. 2004, Ch. 226 (SB 1100), were part of the tax-related provisions of the 2004-05 budget package. The amendments were prompted by a perceived tax loophole with respect to the law at that time. Then, under the law and Board regulations, a vehicle, vessel, or aircraft purchased outside this state by a California resident was presumed to have been purchased for use in California and subject to the California use tax if the item was brought into California within 90 days of purchase. Also, a vehicle, vessel, or aircraft purchased outside this state by a nonresident was presumed to have been purchased for use in California if it entered this state within the first 90 days of ownership. These transactions were subject to the use tax unless all of the following occurred:

- The purchaser took title to and possession of the vehicle, vessel, or aircraft while it was out of state; and
- The purchaser made the first functional use of it outside the state; and
- The purchaser used it out of state for more than 90 days before the vehicle, vessel, or aircraft first entered California.

Under these provisions, there were instances in which, for example, California purchasers of yachts from California yacht retailers were arranging delivery of the yachts outside the territorial waters of California, leaving them in Mexico for the 90-day period, and bringing them into California and escaping the California sales or use tax.

The 12-month provisions incorporated into Section 6248 were intended to reduce the frequency of these sorts of arrangements.

COMMENTS

1. **Purpose.** This budget trailer bill has been introduced to extend the 12-month rebuttable presumption contained in Section 6248 to minimize the revenue losses associated with the 90-day rebuttable presumption provisions in prior law, thereby increasing the State's revenues.

2. **Why not extend the provisions indefinitely**. SB 1100 (Stats. 2004, Ch. 226) required the Legislative Analyst's Office (LAO) to examine the economic and fiscal impacts of the change to Section 6248. The LAO found that (1) the law change has resulted in a sharp reduction in out-of-state usage exemptions and an increase in sales and use tax revenues, and (2) the negative economic impacts arising from the measure do not appear to be particularly large. The LAO indicated that it would be preferable to permanently extend these provisions. The report states that the year-to-year extension of this tax law change would likely create behavioral incentives having negative consequences for both the industries involved and the state. The report points out that there is some evidence that the July 2006 sunset date is starting to encourage the postponement of purchases (as some prospective customers wait for the potential return of the 90-day test). This type of behavioral effect would likely continue if the expectation is that the one-year test will be in effect for just one additional year. The LAO believes that it would be preferable to settle the policy issues now and put in place a permanent set of standards so that buyers and sellers will know what the "ground rules" will be in the future.

COST ESTIMATE

Some costs would be incurred in notifying affected retailers and answering inquiries. These costs are expected to be insignificant (less than $10,000).

REVENUE ESTIMATE

Based on the first year of the 12-month provisions, we expect a one-year extension will result in an annual increase in state and local sales and use tax revenue of $45.8 million.

	Revenue Effect
State General Fund Gain (4.75%)	$28.0 million
Fiscal Recovery Fund Gain (.25%)	1.4 million
Local Gain (2.25%)	12.6 million
Special District Gain (.67%)	3.8 million
Total	$45.8 million

Allocation of Sales and Use Tax Administrative Costs

Revenue and Taxation Code Sections 7204.3 and 7273

Current Law

Under current law, the Board charges the State, local governments, and local jurisdictions a fee for administering the state and local sales and use taxes on their behalf. Under current law, Section 7204.3 of the Bradley-Burns Uniform Local Sales and Use Tax Law requires the Board to charge a city, city and county, county, or redevelopment agency (hereinafter referred to as Bradley-Burns), an amount for the Board's services in administering the local sales and use tax ordinance. Under current law, Section 7273 of the Transactions and Use Tax Law requires the Board to charge an amount for its administration of the local transactions and use tax ordinance of each special taxing jurisdiction (STJ).

Under these statutes, the Board also is required to use a costing model for allocating its costs that is based on recommendations made in the March 1992 and January 1996 reports by the Office of the Auditor General (now the Bureau of State Audits). AB 102 (Ch. 75, Stats. 1993) amended Sections 7204.3 and 7273 to set the policy that controls the Board's current costing model and implemented the recommendations contained in the Auditor General's March 1992 report entitled "The Board of Equalization Needs To Adjust Its Model For Setting Reimbursement Rates For Special Tax Jurisdictions."

The 1996 Bureau of State Audits report titled "Board of Equalization: Policies and Cost Assessment Methods for Special Tax Jurisdictions Need Reconsideration," made additional recommendations regarding the costing model, as follows:

- State policy makers should examine whether STJs should bear a percentage of the infrastructure costs associated with administering sales taxes.
- The costing model should not charge STJs for the costs of administering the two statewide half-cent sales taxes.
- Workload factors that are based on workload studies should be used and periodically updated.
- Costs to individual STJs should be based on workload factors, rather than revenue.

In addition, AB 836 (Sweeney, Ch. 890, Stats. 1998) and SB 1302 (Senate Revenue and Taxation Committee, Ch. 865, Stats. 1999) required that the Board's administrative charges for STJs be capped at a percentage of revenue depending on the local jurisdiction's tax rate.

Proposed Law

This bill amends Section 7204.3 to, beginning with the 2006-07 fiscal year, and each fiscal year thereafter, require the Board to charge a city, city and county, county, or redevelopment agency an amount for the Board's services in administering the sales and use tax ordinance of the local entity based on the methodology described in Alternative 4C of the November 2004 report by the Board entitled "Response to the Supplemental Report of the 2004 Budget Act."

This bill also amends Section 7273 to, beginning with the 2006-07 fiscal year, and each fiscal year thereafter, require the Board to charge each STJ an amount for the Board's services in administering the sales and use tax ordinance of the STJ based on the methodology described in Alternative 4C of the same November 2004 report. With respect to allocating costs to each STJ, this bill:

- Provides that the amount charged each STJ be based on that STJ's proportional share of the revenue after weighting the revenue to equalize the differences in transactions and use tax rates; and,
- Eliminates the provisions that placed a limit on the amount (known as "The Cap") the Board could charge each STJ.

New costing methodology - Alternative 4C

This bill implements a new methodology known as Alternative 4C for allocating the Board's administrative costs among the State, Bradley Burns, and STJs. The following provides a brief description of how those costs are allocated under Alternative 4C.

As with the existing model, Alternative 4C begins with the four sales and use tax program elements as reflected in the approved Governor's Budget. Those elements are Registration, Returns, Audit, and Collections. Since central agency costs (i.e., costs incurred by the State's central service departments) are not reflected in the Governor's Budget, these costs are added based on the overall central agency percentage to each of the four elements.

Unlike the existing model, the new model makes no calculations to determine direct and shared costs. Rather, the new model applies a separate cost pattern to the cost of the Registration, Audit, and Collection elements based on a revenue pattern that represents the workload of that element.

- Registration cost is allocated on the revenue received through the normal returns process.
- Audit cost is allocated based on total tax change, including both over and under reporting of tax.
- Collections cost is allocated based on delinquent taxes billed by the Board's collection program including non-paid or underpaid taxes reported on returns filed and Board determinations for failure to file returns or additional taxes due in excess of reported amounts.

The Returns element is allocated using information from the sales and use tax return. A ratio is calculated based upon how many lines on the return are associated with the State, Bradley Burns, or STJs. Since some of the lines on the return relate to all three entities (subtotal lines or total lines), these generic lines are allocated based on total revenue.

In General

The following provides a summary of the main steps in allocating the administrative costs, including a description of the STJ cap adjustment, before the enactment of this bill.

Existing Cost Model

There are two distinct steps involved in allocating the Board's administrative costs. The first step is the allocation of the total cost of the sales and use tax program to the State, Bradley-Burns, and STJs. The second step is the allocation of the total Bradley-Burns cost and the total STJ cost to each Bradley-Burns entity and each STJ.

Allocating the sales tax program cost to the State, Bradley- Burns, and STJs:

The Board's administration of the sales and use tax program encompasses four basic service elements: 1) registering taxpayers, 2) processing returns and payments, 3) auditing taxpayers' records, and 4) collecting delinquent taxes. The existing model begins with the cost of each of the four sales and use tax program elements (Registration, Returns, Audit, and Collection) as reflected in the approved Governor's Budget.

The existing model identifies direct costs associated with Bradley-Burns and STJ workloads. Direct costs are the marginal costs that the Board would not incur if it were not for the local administered taxes. The State and the Bradley Burns incurs few direct costs because it is difficult to identify activities from which only they derive benefits. The STJs incur the most direct costs. For STJs, the direct costs are determined using workload indicators such as audit hours, number of permits, and number of returns.

From the total sales tax program cost, the model subtracts the direct costs to compute shared costs. Shared costs are those costs that benefit the state, Bradley Burns, and STJs individually and jointly but cannot be separately identified and associated with each entity. An adjustment is then made for costs that are related to counties that do not have STJs from costs that are shared between the State, Bradley Burns, and STJs. To calculate the amount of shared costs allocated to STJs, the model uses workload factors. The remaining shared cost, including the cost of the counties that do not have STJs, is allocated to the State and Bradley Burns based on revenue.

Next, the model allocates central agency costs, which are those costs incurred by the State's central service departments for activities that benefit all state departments (e.g. the State Controller's Office, the State Treasurer, and the Department of Finance). Central agency costs vary from year to year and are about 4 percent of the total sales and use tax program costs and are prorated to the State, Bradley Burns, and STJs based on their total direct and shared cost.

The model also allocates the costs the Board is charged by the Department of Motor Vehicles and the Housing and Community Development Agency for the work they perform in collecting State and local sales and use tax revenues.

Allocating the Bradley Burns and STJ cost to each jurisdiction:

After the total costs have been calculated for the State, Bradley Burns, and the STJs, the Bradley Burns amount and the STJ amount must be allocated to each Bradley Burns entity and each STJ. For Bradley Burns, the total cost is allocated to each Bradley Burns entity based on revenue. For STJs, the allocation uses complex workload factors as recommended by the Auditor General reports. Also, for STJs, the Board is limited on the amount it may charge STJs. This amount is capped at a percentage of revenue depending on the STJ's tax rate.

STJ Cap

The model includes a cap on the amount that the Board can charge individual STJs. The cap was put into place by legislation beginning with the 1998-99 fiscal year. The following table illustrates the maximum allowable fees the Board can charge an individual STJ:

STJ Tax Rate	Allowable Fee
0.50% or greater	1.50% of revenue
0.25% up to but less than 0.50%	3.00% of revenue
Less than 0.25%	5.00% of revenue

Beginning with the 1998-99 fiscal year, and each fiscal year thereafter, for any existing STJ, their permanent cap is based on the lesser of the statutory cap (see table above) or their cost as a percentage of revenue in the 1998-99 fiscal year. For STJs that came into existence after 1998-99, their permanent cap is the lesser of the statutory cap (see table above) or their cost as a percentage of revenue in their first full year of existence.

Background

Legislative Analyst's Office - Supplemental Report of the 2004 Budget Act

- During the 2004-05 Budget enactment process, the LAO considered removing the cap on the amount the Board can charge individual STJs to administer their transactions and use tax ordinance. However, the 2004 Budget Act retained the cap, while the LAO recommended that the Board provide an analysis of methodological approaches for allocating administrative costs.
- In its "Supplemental Report of the 2004 Budget Act," the LAO requested that the Board provide to the Chair of the Joint Legislative Budget Committee (JLBC) and chairs of the fiscal committees of the Legislature by December 1, 2004, a report of an analysis of methodological approaches to allocating the administrative costs of collecting the state and local sales and use taxes among the state General Fund, special funds, Bradley Burns, and transactions and use taxes. The analysis and report was to be prepared in consultation with the LAO, the DOF, and appropriate local government representatives and would contain detailed information regarding cost allocation methodologies for various activities based on workload or other factors, including their fiscal implications.

Board of Equalization - Response to the Supplemental Report of the 2004 Budget Act

- In November 2004, the Board provided to the Chair of the JLBC and chairs of the fiscal committees a report entitled, Response to the Supplemental Report of the 2004 Budget Act Response to the Supplemental Report of the 2004 Budget Act.doc. The report included four alternative approaches to the Board's existing cost model, each of which provided a simpler approach to calculating and allocating the various costs. A simpler approach was taken because the complexity of the existing model has made it more cumbersome to administer and difficult to explain to local entities. Most of the existing model complexity results from using complex workload factors (such as number of seller's permits, number of returns, and audit hours) that are cumbersome to administer and yet do not necessarily produce greater accuracy than other, simpler methods.

Legislative Analyst's Office - 2006-07 Analysis of the Governor's Budget

- In its analysis of the 2006-07 Governor's Budget, the LAO recommended the enactment of legislation implementing a simplified methodology for allocating the Board's administrative costs. The LAO recommended the adoption of the "modified revenue" model (Alternative 4C and referred also as the "revenue approach") for allocating costs. The LAO commented that the Board's costing model, due to various statutory requirements, has become increasingly complex and expensive to administer. In addition, as new STJs have been established, adjusting the model has become an expensive and resource-intensive undertaking.
- In addition, according to the LAO, the "modified revenue" model (Alternative 4C) is a more reasonable method to allocate costs than the one currently used. In developing the various alternatives, the Board, in consultation with the LAO, DOF, and STJ representatives, attempted to address specific goals and features. Those goals and features are: 1) relatively straightforward to determine; 2) methodology can be easily explained; 3) reasonably related to each tax component's cost; and 4) can readily incorporate additional STJs. According to the LAO, Alternative 4C best achieves these goals while also removing the current somewhat arbitrary cap on administrative costs as a percentage of revenue. The LAO noted that the adoption of the "modified revenue" model (Alternative 4C) would result in a reduction in costs borne by the state General Fund and the STJs, with an increase in costs borne by Bradley Burns. This reduction in the costs borne by the General Fund would translate to a General Fund savings of approximately $6 million annually, with an increase in Bradley Burns reimbursements by an identical amount.

COMMENTS

1. Purpose. As part of the 2006-07 Governors' Budget, the LAO recommended the enactment of legislation implementing a new simplified methodology for allocating administrative costs associated with the sales and use tax on behalf of the state and various local entities. The adoption of a new costing methodology would result in an estimated $6 million to the state General Fund with a corresponding increase in the amount of reimbursements from the Bradley Burns entities.

2. Technical amendments. Section 7204.3 incorrectly uses the term "district," rather than "local entity." Section 7204.3 requires the Board to charge each city, city and county, county or redevelopment agency for the services it provides in administering the local entity's tax ordinance. This statute covers a local entity (i.e., city, city and county, county, or redevelopment agency) but does not cover a district. The term "district" refers to tax districts under the Transactions and Use Tax Law, not local entities under Bradley-Burns Uniform Local Sales and Use Tax Law. To correct this error, the following amendment is suggested:

> 7204.3. (a)(2) The amount charged each ~~district~~<u>local entity</u> shall be adjusted to reflect the difference between the board's recovered costs and the actual costs incurred by the board during the fiscal year two years prior.

With respect to Section 7273 of the Transactions and Use Tax Law, subdivision (a)(1) of Section 7273 was amended to add “each district” to this provision. For consistency, it is suggested that the phrase “each district” be added to subdivision (a)(2) of Section 7273:

> 7273. (a)(2) The amount charged <u>each district</u> shall be adjusted to reflect the difference between the board’s recovered costs and the actual costs incurred by the board during the fiscal year two years prior.

3. Explanation of Alternatives 4A (shared approach), 4B (marginal approach), and 4C (revenue approach). As previously stated, the Board, in consultation with the LAO, DOF, and local government representatives, developed four proposed alternatives for allocating administrative costs to the State, Bradley Burns, and the STJs. The fourth alternative includes three sub-options. Alternatives 4A, 4B, and 4C all allocate Registration costs based on revenue from returns, Audit costs based on revenue from audit and investigative liabilities (including both over and under reported amounts), and Collections cost based on revenue from delinquent taxes billed. In each sub-option, the Returns element cost is allocated differently. In 4A (shared approach), the generic lines are allocated equally (1/3 each) to the State, Bradley Burns, and STJs. In 4B (marginal approach), the generic lines are allocated entirely to the state. In 4C (revenue approach also referred to as “modified revenue”) the generic lines are allocated to State, Bradley Burns, and STJs based on to total revenue.

COST ESTIMATE

As previously stated, current law specifies the method for the Board to charge an administrative fee to local entities for collecting the sales and use tax. This bill implements a simplified model for allocating the Board’s costs to administer the sales and use tax program among the State, Bradley Burns entities, and STJs. Even though this bill does not reduce or increase the Board’s administrative costs, the model results in a reduction in the share of those costs paid from the General Fund and the STJs, which is offset by increasing costs paid by the Bradley Burns entities. Under Alternative 4C, the General Fund savings is approximately $6 million annually, offset by increased Bradley Burns reimbursements.

REVENUE ESTIMATE

As previously stated, this bill implements a simplified methodology for allocating administrative costs among the State, Bradley Burns, and STJs. Assuming that the Legislature would like the Board to continue administering the sales and use tax program at the same efficient and effective level as currently authorized, this bill will have no impact on the state’s revenues.

Tax Expenditure Report
Government Code Section 13305

Current Law

Since 1971, pursuant to Section 13305 of the Government Code, the Department of Finance (DOF) has been required to provide a tax expenditure report to the Legislature. Chapter 1762, Statutes of 1971, required that the report be submitted to the Legislature once every two years. Chapter 268, Statutes of 1984, increased the reporting frequency to once a year. The required report includes each of the following:

- A comprehensive list of tax expenditures.
- Additional detail on individual categories of tax expenditures.
- Historical information on the enactment and repeal of tax expenditures.

Proposed Law

This bill repeals and adds Section 13305 of the Government Code to, beginning January 1, 2007, require the DOF to provide a report to the Legislature by September 15th of each year on each tax expenditure exceeding $5 million annually. The report shall include the following information for each tax expenditure:

- The statutory authority;
- A description of the legislative intent, where the act adding or amending the expenditure contains legislative findings and declarations of the intent, or such intent is otherwise expressed or specified by the act;
- The sunset date, if applicable;
- A brief description of the beneficiaries of the tax expenditure;
- An estimate or range of estimates for the state and local revenue loss for the current fiscal year and the two subsequent fiscal years. For sales and use tax expenditures, this would include partial year exemptions and all other tax expenditures when the Board has obtained such information;
- For sales and use tax and personal and corporation tax expenditures, the number of returns filed or taxpayers affected, as applicable, for the most recent tax year for which full year data is available; and
- A listing of any comparable federal tax benefit, if any, and;
- A description of any tax expenditure evaluation or compilation of information completed by any state agency since the last report made under this section.

This bill defines a "tax expenditure" as a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by state law.

The provisions became effective immediately upon enactment, but are operative on January 1, 2007.

Background

There have been several bills introduced during the last few years related to tax expenditure reports. These include:

AB 168 (Ridley-Thomas, 2005) would have required: (1) the Board and the Franchise Tax Board (FTB) to each provide to the Legislature, the DOF and the Legislative Analyst Office (LAO), a report, based on a static revenue analysis, of the estimated revenue losses attributable to each tax expenditure, to the extent feasible, that produced a revenue loss in excess of $25 million in the prior fiscal year; (2) the DOF to provide, biennially, to the Legislature and the LAO, a report, based on a dynamic revenue analysis, of the estimated revenue losses attributable to tax expenditures that produced revenue losses in excess of $25 million, as specified; (3) the LAO to review the reports and make recommendations to the Legislature as to which tax expenditures should be modified or repealed.

AB 168 was vetoed by Governor Schwarzenegger and the veto message states:

> "The Department of Finance and the Legislative Analysts Office currently have broad authority to review and report tax expenditures to the Legislature. This bills restatement of the existing tax reporting requirements is redundant and unnecessary."

AB 735 (Arambula, 2005) would have: (1) required the LAO to establish a process to review all tax exceptions, and submit a report to the Legislature by December 31, 2006; (2) required the LAO to review and analyze any relevant reports prepared by the DOF, and request assistance from the Board and the FTB in order to make the report as comprehensive as possible; and (3) directed the Assembly and Senate Revenue and Taxation Committees to review the report submitted by the LAO and authorize them to select a group of tax exceptions for deletion or modification, reporting their recommendations to the fiscal committees for consideration during the budget process. This bill was never heard by a committee.

SB 577 (Figueroa, 2005) would have, among other things, required the DOF, in consultation with the Board and the FTB, to report to the Legislature by January 1, 2008, on the effectiveness of "tax expenditures," as defined. This provision was amended out of the bill.

AB 2106 (Ridley-Thomas, 2004) would have, among other things, required the DOF, in conjunction with the Governor's Budget, to submit to the Legislature a report of tax expenditures currently in effect. The bill would have specified that, among other things, based on information provided by the Board to the extent feasible, the report include the number of tax returns or taxpayers affected by any sales or use tax expenditure, the distribution of that expenditure, and the size and type of business or industry to which that expenditure is made available.

AB 2106 was vetoed by Governor Schwarzenegger and the veto message states:

> "Under existing law, the Department of Finance already is required to provide an annual tax expenditure report to the Legislature containing specific information. This bill changes the type of information that is provided in the annual report. However, some of the information that Department of Finance would be required to report is not available. For example, the original intent of

a given tax expenditure is often not clearly defined in the enabling statute. In addition, the number and income distribution of taxpayers benefiting from sales tax exemptions would not be known because this information is not required to be reported by retailers when filing their tax returns. Furthermore, some of the information might not be available for reporting to the Legislature because of existing confidentiality requirements."

COMMENTS

1. **Purpose.** This budget trailer bill, among other things, revises and enhances the existing DOF statutory requirement to report on tax expenditures as specified in Government Code Section 13305. At the May 11, 2006 Senate Budget and Fiscal Review – Subcommittee No. 4 hearing, tax expenditures were discussed and committee staff recommended that the Legislature consider devoting greater attention to tax expenditures using the three following objectives: 1) understanding their intentions and implications, 2) gaining better access to information, and 3) revising and enhancing reporting. Objective 3 would be achieved by revising and enhancing the existing statutory reporting requirements related to the DOF's annual tax expenditure report.

2. **Should the term "partial year exemptions" be changed to "partial exemptions?"** This bill provides that the annual tax expenditure report include an estimate or range of estimates for the state and local revenue loss for the current fiscal year and the two subsequent fiscal years. This bill specifies that, for sales and use tax expenditures, the information would include *partial year exemptions* and all other tax expenditures when the Board has obtained such information.

   Would the term *partial year exemption* mean an exemption that has been operative for a partial fiscal year, or did the Legislature mean to include those partial exemptions for which the sale or purchase is exempt from a portion of the sales and use tax? The Board administers full exemptions and partial exemptions. There are currently five partial exemptions in effect (see Comment 3). These partial exemptions apply to the 5 percent state General Fund portion of the tax, but do not apply to the two 0.5 percent statewide taxes (i.e., Local Revenue Fund and Local Public Safety Fund), or the taxes imposed under the Bradley-Burns Uniform Local Sales and Use Tax Law and the Transactions and Use Tax Law.

   It appears that the intent of the bill is to state that the tax expenditure report would include information on *partial exemptions*, rather than an exemption that is operative for a *partial fiscal year*.

3. **The Board does not have specific data on tax expenditures.** This bill requires that the annual tax expenditure report include an estimate of the state and local revenue loss for a three-year period. This bill specifies that, with respect to sales and use tax expenditures, the information include partial year exemptions and all other tax expenditures when the Board has obtained such information. An explanation regarding the information obtained on the sales and use tax returns, including the differences between tax return data captured for state income tax purposes versus tax return data captured for sales and use tax purposes, is provided below:

- Sales and Use Tax Expenditure Reporting

  In general, revenue estimates and expenditure data for the Personal Income Tax and Corporation Tax Laws are easier to quantify than for the Sales and Use Tax Law. Personal income and corporation tax returns contain significant detail information regarding different sources of income and types of exemptions, exclusions, deductions, and credits claimed. Thus, tax return data are often available when estimating the fiscal impact of various income and corporate tax expenditure programs. In contrast, returns filed by taxpayers under the Sales and Use Tax Law www.boe.ca.gov/pdf/boe401a2.pdf contain little information regarding tax expenditures.

  As shown on the attached sales and use tax return, some of the more common tax expenditures allowed under the Sales and Use Tax Law are separately identified on the return itself for purposes of allowing taxpayers to claim the deduction. These include deductions for, but not limited to, sales of food products, sales to the U.S. Government, sales in interstate or foreign commerce, and nontaxable labor (note, the law contains numerous other tax exemptions and exclusions not separately identified on the return).

  However, instead of actually itemizing these deductions, many taxpayers simply report their taxable sales, netting out any exempt sales. Any attempt to capture the amount of exempt transactions would require a much more extensive tax return and would require a very large effort from taxpayers to detail these transactions.

  Consequently, return information does not capture specific data on the myriad of tax exemptions and exclusions provided under the law, and is not a reliable source to use in making estimates of revenue losses attributable to those exemptions and exclusions. As such, the Board generally relies on independent data sources when estimating the revenue impacts of various sales tax expenditure programs.

- Partial Sales and Use Tax Expenditure Reporting

  The exception to this is for partial exemptions. The Board currently requires the taxpayer to specify the amount of those exemptions that apply to only a portion of the combined state and local sales and use tax. There are currently five such exemptions in effect:

  - Teleproduction Equipment
  - Farm Equipment
  - Diesel Fuel Used in Farming and Food Processing
  - Timber Harvesting Equipment and Machinery
  - Racehorse Breeding Stock

  Sales of these items are exempt from a portion of the state sales and use tax. Local and special district sales and use taxes continue to apply. In order for a taxpayer to claim these partial exemptions, they must report the amount of the transactions that are subject to the partial exemption. For these partial exemptions, the Board knows how much is being claimed as well as how many retailers are claiming the partial exemption.

4. **The Board's Publication 61, *Sales and Use Taxes: Exemptions and Exclusions*, provides a detailed listing of various exemptions and exclusions from the sales and use tax.** The publication has two listings: one by category and another by alphabetical reference. The listings provide a brief general description of the exemption or exclusion, including the statutory authority. The listing by category also provides an estimate of the revenue loss of the exemption or exclusion, if available. As previously stated in Comment 3, a revenue loss of a particular tax expenditure is not always possible to quantify.

5. **Related legislation.** AB 1933 (Coto) would require the DOF to review, over a 10-year period, all tax expenditures in excess of $1 million that are in existence since January 1, 2007, and require any legislative measure creating a new tax expenditure, or extending the operation of an existing tax expenditure, to meet certain requirements, as specified. This bill failed passage in Senate Revenue and Taxation Committee on June 28, 2006; however, a reconsideration was granted. The Committee is considering holding a hearing in August. This bill could be taken up at that time.

COST ESTIMATE

This bill would require the DOF, beginning January 1, 2007, to provide an annual tax expenditure report to the Legislature by September 15th of each year. This bill specifies the information that the report must contain, including, but not limited to a three-year estimate of the revenue loss. This bill also specifies that, with respect to sales and use tax expenditures, the report would include only those tax expenditures where the Board has obtained such information. Thus, as long as the Board is only required to provide the DOF with information that it is currently obtaining from returns, any costs associated with this bill would be minor (i.e., under $50,000).

REVENUE ESTIMATE

To the extent that future reviews and evaluations result in the identification and termination of ineffective or inappropriate tax expenditures, enactment of this measure could result in unknown additional revenues.

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