

Date of Hearing: June 27, 2018

ASSEMBLY COMMITTEE ON EDUCATION

Patrick O'Donnell, Chair

SB 227 (De León) – As Amended June 4, 2018

[Note: This bill was doubled referred to the Revenue & Taxation Committee and was heard by that committee as it relates to issues under its jurisdiction.]

SENATE VOTE: 27-7

SUBJECT: Education finance: Local Schools and Colleges Voluntary Contribution Fund: personal income taxes: credits

SUMMARY: Establishes the Local Schools and Colleges Voluntary Contributions Fund Tax Credit program. Specifically, **this bill:**

- 1) Allows a tax credit, under the Personal Income Tax (PIT) Law, equal to the amount identified in the certification issued by the Fiscal Crisis and Management Assistance Team (FCMAT), as specified.
- 2) Allows the credit for taxable years beginning on or after January 1, 2018.
- 3) Allows this credit to reduce the regular tax below the tentative minimum tax.
- 4) Requires FCMAT to do all of the following:
 - a) Establish a procedure for a taxpayer who makes a monetary contribution to the Local Schools and Colleges Voluntary Contributions Fund (Contribution Fund) created by this bill to obtain from FCMAT a certification for the credit. The certification shall be issued in an amount equal to 85% of the amount contributed by the taxpayer to the Contribution Fund. This procedure shall meet the following requirements:
 - i) Beginning with fiscal year (FY) 2018-19, certifications shall be issued for contributions in the order that the monetary contributions are received. The amount identified in a certification issued for FY 2018-19 shall be allowed as a credit for taxable years beginning on or after January 1, 2018, but before January 1, 2019. The amount identified in a certification issued for every FY thereafter shall be allowed as a credit for taxable years beginning on or after January 1 of the previous FY, and before January 1 of the FY;
 - ii) FCMAT shall cease issuing certifications attributable to a FY once the credit threshold amount described below is reached for the FY. If the credit threshold amount is reached for a FY before the FY ends, FCMAT shall begin issuing certifications for the following FY; and,
 - iii) FCMAT shall certify the contribution amount eligible for credit and the FY to which the certification is attributable within 45 days following receipt of the contribution.

- b) Provide to the Franchise Tax Board (FTB) a copy of each credit certificate issued for the calendar year by January 31 of the calendar year immediately following the calendar year in which the credit certificate is issued.
- 5) Requires FCMAT to adopt any regulations necessary or appropriate to implement this credit program. The Administrative Procedure Act shall not apply to any regulation adopted by FCMAT pursuant to this authority.
- 6) Provides that if the credit amount exceeds the taxpayer's tax liability, the excess shall be credited against other amounts due, if any, and the balance paid, upon legislative appropriation, from an unspecified fund to the taxpayer.
- 7) Specifies that no deduction shall be allowed for amounts taken into account in calculating the credit.
- 8) Caps the aggregate amount of credits that may be allocated for a FY by FCMAT at \$45 billion for FY 2018-19 and each FY thereafter, plus any unallocated credit amount, if any, for the preceding FY.
- 9) Authorizes the FTB to prescribe any regulations necessary or appropriate to carry out this program. The Administrative Procedure Act shall not apply to any such rule, guideline, or procedure prescribed by the FTB.
- 10) Specifies that Revenue and Taxation Code (R&TC) Section 41 shall not apply to this credit.
- 11) Provides that if the Commission on State Mandates determines that this bill contains costs mandated by the state, reimbursement to local agencies and school districts shall be made.
- 12) Authorizes the governing board specified in Education Code Section 42127.8(b) (Governing Board) to receive voluntary contributions made by individuals to:
 - a) School districts;
 - b) Charter schools;
 - c) Child care centers operated by local educational agencies; and,
 - d) Community college districts.
- 13) Requires the Governing Board to deposit these contributions in the Contribution Fund, which this bill establishes in the county treasury of the county in which FCMAT has its principal office under the administration of FCMAT.
- 14) Requires the moneys deposited into the Contribution Fund to be allocated into two subaccounts as follows:
 - a) Beginning with FY 2018-19, 85% of the first \$54.5 billion deposited into the Contribution Fund in that FY shall be deposited into the Baseline Schools and Colleges Subaccount, which this bill establishes within the Contribution Fund. For FY 2019-20, and each FY thereafter, the \$54.5 billion amount shall be adjusted by the same percentage

as the adjustment of the appropriations limit made pursuant to Article XIII B of the California Constitution.

- i) Requires the Governing Board to do both of the following:
 - (1) On or before January 15 of each FY, transfer to the State Treasury all of the moneys that were deposited in the Baseline Schools and Colleges Subaccount from July 1 to December 31, inclusive, of that FY to reimburse the General Fund for the Baseline Schools and Colleges Subaccount's share of meeting the requirements of Section 8 of Article XVI of the California Constitution; and,
 - (2) On or before July 15 of each FY, transfer to the State Treasury all of the moneys that were deposited in the Baseline Schools and Colleges Subaccount from January 1 to June 30, inclusive, of the prior FY to reimburse the General Fund for the Baseline Schools and Colleges Subaccount's share of meeting the requirements of Section 8 of Article XVI of the California Constitution.
- b) Beginning with FY 2018-19, the contributions to the Contribution Fund *in excess* of 85% of the first \$54.5 billion (or the adjusted amount), shall be deposited into the Supplemental Schools and Colleges Subaccount, which this bill establishes within the Contribution Fund.
 - i) Requires the Governing Board to do all of the following:
 - (1) On or before January 15 of each FY, allocate 89% of the moneys deposited in the Supplemental Schools and Colleges Subaccount from July 1 to December 31, inclusive, of that FY to school districts, county offices of education, and charter schools on the basis of an equal amount per unit of regular average daily attendance, as those numbers are reported at the time of the second principal apportionment for the prior FY;
 - (2) On or before January 15 of each FY, allocate 11% of the moneys deposited in the Supplemental Schools and Colleges Subaccount from July 1 to December 31, inclusive, of that FY to community college districts on the basis of an equal amount per enrolled full-time equivalent student, as those numbers of students are reported at the time of the second principal apportionment for the prior FY;
 - (3) On or before July 15 of each FY, allocate 89% of the moneys deposited in the Supplemental Schools and Colleges Subaccount from January 1 to June 30, inclusive, of the prior FY to school districts, county offices of education, and charter schools on the basis of an equal amount per unit of regular average daily attendance, as those numbers are reported at the time of the second principal apportionment for the prior FY; and,
 - (4) On or before July 15 of each FY, allocate 11% of the moneys deposited in the Supplemental Schools and Colleges Subaccount from January 1 to June 30, inclusive, of the prior FY to community college districts on the basis of an equal amount per enrolled full-time equivalent student, as those numbers of students are reported at the time of the second principal apportionment for the prior FY.

EXISTING LAW:

- 1) Establishes a minimum funding guarantee for public schools and community colleges (Proposition 98), which is based on proceeds of taxes to the state General Fund.
- 2) Creates a Governing Board to establish and administer a unit known as FCMAT. Among other things, this unit provides fiscal management assistance, at the request of any school district, charter school, county office of education, or community college district.
- 3) Allows various tax credits under the PIT Law. These credits are generally designed to encourage socially beneficial behavior or to provide relief to taxpayers who incur specified expenses.
- 4) Provides for an alternative minimum tax and specifies that, except for certain credits, no credit shall reduce the regular tax, as defined, below the tentative minimum tax.
- 5) Allows a College Access Tax Credit in an amount equal to 50% of the amount contributed by a taxpayer to the College Access Tax Credit Fund, as allocated and certified by the California Educational Facilities Authority (Authority). The maximum aggregate amount of the College Access Tax Credit that may be allocated and certified by the Authority is \$500 million. Taxpayers are precluded from taking a deduction for amounts included in the calculation of the College Access Tax Credit. Any unused credits may be carried forward for up to six years. Finally, the College Access Tax Credit may reduce tax below the tentative minimum tax under both the PIT Law and the Corporation Tax Law.
- 6) Requires any bill authorizing a new credit to contain all of the following:
 - a) Specific goals, purposes, and objectives that the tax credit will achieve;
 - b) Detailed performance indicators for the Legislature to use when measuring whether the tax credit meets the goals, purposes, and objectives stated in the bill; and,
 - c) Data collection requirements to enable the Legislature to determine whether the tax credit is meeting, failing to meet, or exceeding those specific goals, purposes, and objectives. The requirements shall include the specific data and baseline measurements to be collected and remitted in each year the credit is in effect, for the Legislature to measure the change in performance indicators, and the specific taxpayers, state agencies, or other entities required to collect and remit data. (R&TC Section 41.)

FISCAL EFFECT: State-mandated local program. In addition, the FTB notes that "because taxpayers only receive an 85 percent credit for their contribution to the Fund, there would be a net gain to the State of 15 cents for every dollar contributed."

COMMENTS:

Background: Federal tax overhaul. On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 (the "Act"), which dramatically restructured the federal tax system for both individuals and businesses. For individuals, the Act adjusts tax rates, increases the standard deduction, and eliminates personal exemptions. The Act also imposes a new \$10,000 cap on the deductibility of state and local tax (SALT) payments. Critics of this provision note that

eliminating the full deductibility of SALT payments "rolls back a basic tenet of federal tax law that has been part of the modern federal income tax since it was created in 1913, more than a century ago."¹ Critics of the new \$10,000 cap on SALT deductions also note that this provision will negatively impact millions of California households currently claiming more than \$10,000 in SALT deductions on their federal tax returns. The Act's \$10,000 cap on SALT deductions raises the after-tax price of state- and local government-provided public goods and services for millions of Californians. This, in turn, could make it more difficult for state and local governments to raise future revenues. At the same time, the nearly \$1.5 trillion projected increase in the federal deficit caused by the Act will likely lead to reductions in federal funding for education and healthcare, along with other spending priorities. With the federal government poised to disinvest from the public sector, states such as California will be tasked with making up the difference at the very moment the new federal Act undermines state fiscal capacity.²

What would this bill do? The author has chosen to address this challenging national landscape by establishing the Local Schools and Colleges Voluntary Contributions Fund Tax Credit program. This program would allow, for taxable years beginning on or after January 1, 2018, a PIT credit equal to the amount certified by the Fiscal Crisis Management and Assistance Team (FCMAT). Certifications, in turn, would be issued in an amount equal to 85% of the amount contributed by the taxpayer to a newly established Contribution Fund. This bill caps the aggregate amount of credits that may be allocated for a FY by FCMAT at \$45 billion, plus any unallocated credit amount for the preceding FY.

What is FCMAT? FCMAT is funded through the Kern County Superintendent of Schools and it provides guidance to local educational agencies in the areas of business and financial management practices. Funding is appropriated each year in the Budget Act in support of FCMAT's activities and responsibilities, and the California Department of Education is then responsible for apportioning the funding to the Kern County Superintendent of Schools. By funding FCMAT through the Kern County Superintendent of Schools, the funds count towards meeting the state's minimum public school and community college funding requirements under Proposition 98.

What's in it for the taxpayer? This bill is designed to encourage taxpayers to make voluntary contributions to fund public education. If a taxpayer were to donate \$10,000 to the Contribution Fund, she would receive a state PIT credit equal to \$8,500. However, it is also envisioned that this donation would be fully deductible as a charitable contribution for federal purposes. Assuming a marginal federal tax rate of 24%, the taxpayer would see a \$2,400 reduction in his/her federal tax bill. When added to her \$8,500 state credit, the taxpayer would actually receive a benefit of \$10,900 for her \$10,000 contribution.

Federal deductibility. This bill's approach admittedly depends upon the premise that federal tax authorities will recognize the donating taxpayer's contribution as a charitable contribution

¹ "Preliminary Report on the Federal Tax Cuts and Jobs Act", New York State Department of Taxation and Finance, January 2018.

² The Act not only represents a potential threat to taxpayers and state and local governments; nonprofit charities will also likely feel the brunt. With fewer taxpayers itemizing their deductions because of the expanded standard deduction, millions of households in California and across the country will also see their tax incentive for charitable giving eliminated.

eligible for deduction under IRC Section 170. This premise enjoys robust support. Courts have consistently held that a donor's receipt of tax benefits in exchange for a charitable contribution "cannot be used as a basis for disallowing the deduction for that charitable contribution." (See *Allen v. Commissioner*, 92 T.C. 1, 7 (1989); *Skirpak v. Commissioner*, 84 T.C. 285, 319 (1985); see also *McLennan v. Commissioner*, 994 F.2d 839 (Fed. Cir. 1993) (holding that the receipt of tax benefits for charitable contributions does not undermine the "donative intent" required for a charitable contribution deduction under IRC Section 170).) These decisions are reflected in IRS Chief Counsel Advice 201105010, which concludes that a payment of cash to a state agency or charitable organization constitutes a charitable contribution under IRC Section 170 notwithstanding the fact that the payment entitles the donor to a transferable state tax credit.

It should be noted, however, that the IRS recently issued a notice informing taxpayers that it intends to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes. Specifically, the notice states:

In response to this new [SALT] limitation, some state legislatures are considering or have adopted legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities.

Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.

This bill would reduce the Proposition 98 minimum guarantee. The California Constitution establishes a minimum funding guarantee for public elementary and secondary schools and community colleges (K-14 education). The constitution establishes three methods, or "tests," for determining the minimum funding level. Test 1 requires K-14 allocations, as a percent of total General Fund revenue subject to the appropriations limit, to be no less than the percentage allocation from the General Fund to K-14 education in 1986-87 (the year before the adoption of Proposition 98), which is about 40%.

Test 2 requires the total allocation to K-14 education from the General Fund and local *ad valorem* property tax revenues to be no less than allocations from those sources in the prior year as adjusted for changes in K-12 average daily attendance (ADA) and a cost-of-living adjustment (COLA). For Test 2, the COLA is defined as the percent change in per capita personal income (PCPI).

Generally, the constitution requires K-14 funding to be the greater of Test 1 or Test 2. However, concerns that the increased funding required under Test 2 could exceed General Fund revenue growth in a slow or bad economy led to the approval of Proposition 111 in 1990. Proposition 111 added Test 3, which is identical to Test 2 except the COLA is defined as the percent growth in General Fund revenue instead of PCPI.

The calculation required by all three tests is based on General Fund revenues. The constitution specifies "proceeds of taxes" for Tests 2 and 3, but only "revenues" for Test 1. However, statute defines Test 1 revenues also to mean proceeds of taxes. Under existing law, therefore, this bill would reduce the minimum guarantee by reducing proceeds of taxes to the General Fund. Depending on the amount of contributions to the Local Schools and Colleges Voluntary Contribution Fund, and the subsequent transfers from the Baseline Schools and Colleges Subaccount, the minimum funding guarantee could be significantly reduced and far lower than what is necessary to maintain existing K-14 programs. If so, it is unlikely that actual funding would be reduced to the minimum. However, it could be less than what would be required under existing law.

Proposition 98 funds would be used to administer a tax credit program. This bill imposes several duties on FCMAT, which is funded through the Kern County Office of Education, which is a local education agency. Accordingly, any funds allocated to the Kern COE from the General Fund, whether a direct appropriation or a reimbursement for mandated costs, would count toward meeting the state's Proposition 98 minimum funding requirement. Therefore, Proposition 98 funds, which are intended to support public schools and community colleges, would be used to administer the tax credit program.

Arguments in support. According to the author:

Under the new Trump Tax cuts, an estimated three million California taxpayers will lose out on thousands of dollars of valuable deductions each year on their federal taxes. Senate Bill 227 gives California taxpayers the ability to direct a charitable contribution to improve vital state programs and services such as k-12 education, higher education, and state parks. This proposal is based in part on the College Access Tax Credit, which allows Californians to make charitable contributions to the Cal Grant program. And it builds on successful models already in place in 17 states across the nation. SB 227 gives taxpayers a measure of control over the tax dollars they invest in California and it also blunts the negative impact of the Republican tax plan on our state.

Arguments in opposition. This bill is opposed by the California Teachers Association, which notes the following:

SB 227 proposes a system of tax credits that will run on a tax year basis going forward and proposes that contributions to the newly established fund will flow to schools twice annually. Precisely when taxpayers will make contributions and in what quantity is unknown, and the amount of each twice-annual disbursement is not certain.

The Proposition 98 guarantee, however, is calculated on a fiscal year basis as part of the state budget. SB 227 is silent as to how moneys contributed to the Fund and disbursed twice annually will be reconciled with Proposition 98's fiscal year. Nor is there any consideration for how to handle partial year tax credits, or any true-up mechanism to correct errors in calculations or estimates. This creates significant uncertainty for school funding.

Related legislation. SCA 223 (De Leon), which is currently pending in the Senate, amends the California Constitution to add transfers from the Baseline Schools and Colleges Subaccount or

successor fund to the General Fund revenues for purposes of calculating the Proposition 98 minimum funding guarantee.

Amendment needed. During the hearing on this bill in the Revenue & Taxation Committee, the author agreed to amend the bill to add a five year sunset to its provisions. Due to time constraints, the author committed to amending the bill in this committee. Accordingly, **staff recommends** that the bill be amended to add a five year sunset.

REGISTERED SUPPORT / OPPOSITION:

Support

None received

Opposition

California Teachers Association

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