A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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CA Controller's May Cash Report Shows State Revenues Meeting Revised Estimates

With the legislature expected to pass the 2017-18 budget by June 15, State Controller Betty T. Yee reported that California revenues of $8.39 billion for May beat expectations in the revised budget proposal Governor Jerry Brown's released last month by $133.4 million.

Total fiscal year-to-date revenues of $105.27 billion are $1.29 billion below projections on which the 2016-17 Budget Act was based and $2.70 billion higher than total revenues for the same 11-month period in FY 2015-16.

May personal income tax (PIT) receipts of $4.12 billion were $35.2 million shy of expectations laid out in the governor's May Revision. For the current fiscal year, California has collected total PIT receipts of $71.78 billion, $265.7 million less than anticipated in the 2016-17 Budget Act.

Retail sales and use tax receipts of $3.41 billion for May were $69.5 million higher than projected in the May Revision. For the fiscal year to date, sales tax receipts are $992.0 million lower than 2016-17 Budget Act assumptions.

Corporation tax receipts of $529.5 million for May topped last month's revised budget estimates by $61.2 million. Fiscal year-to-date corporation tax receipts are $334.4 million below 2016-17 Budget Act projections.

The state ended May with unused borrowable resources of $29.41 billion, which was $3.07 billion more than predicted in the governor's May Revision and $5.08 billion more than anticipated in the 2016-17 Budget Act.

Outstanding loans of $11.71 billion were $1.17 billion lower than projected in May and $2.09 billion lower than projected in the 2016-17 Budget Act. This loan balance consists of borrowing from the state's internal special funds.

For more details, read the cash report.

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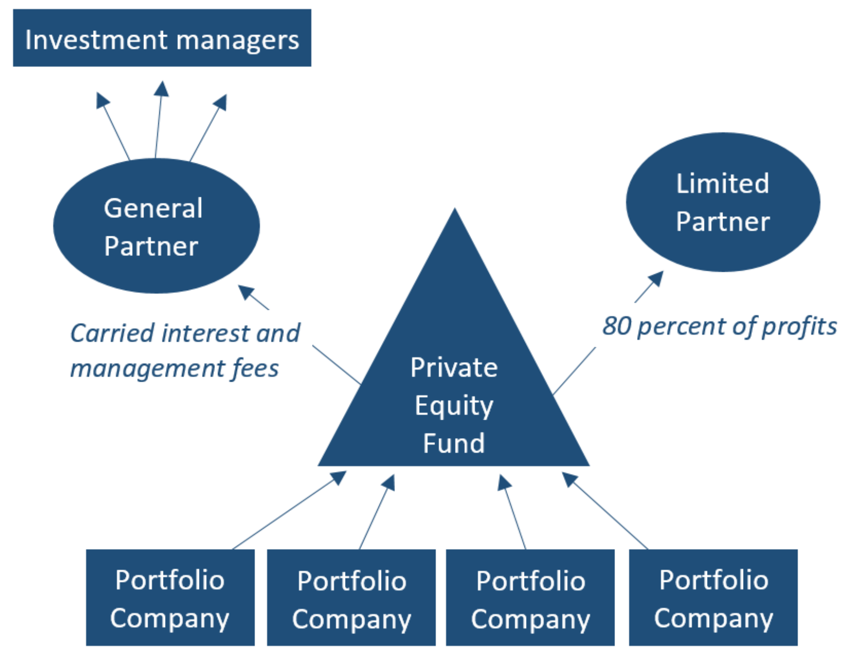
Favorable Taxation of Carried Interest Ignites Controversy and Change

The taxation of carried interest has been controversial since the mid-2000s. As the compensation earned by investment managers and general partners increased with the growth and success of private equity and hedge funds, some critics began to question the favorable tax treatment: Why should the investment manager or general partner receive capital gains treatment when little to none of their personal funds were invested into the equity fund?

Private Equity Industry Compensation Model



Capital Gains

For federal tax purposes, capital gains and losses are classified as long-term or short-term. A long-term capital asset is an item held for more than one year, and a short-term capital asset is an item held for one year or less. When there is a net capital gain, a lower federal tax rate may apply to the gain than the tax rate that applies to ordinary income. The federal tax rate on most net capital gains is 15 percent. However, for those individuals with ordinary income of $415,000 or more the net capital tax rate is generally 20 percent.

Net short-term capital gains are subject to taxation as ordinary income at graduated tax rates. The highest graduated federal tax rate is 39.6 percent. Considering that net capital gains are taxed at a lower rate, some taxpayers try to find ways to convert ordinary income into capital gains.

Carried Interest

Private equity and other investment managers are compensated with "carried interest." Carried interest is a share of the profits of an investment paid to the investment manager or general partner in excess of the amount that the manager contributed to the partnership. For tax purposes, the carried interest is taxed as capital gains. An investment manager or general partner is also paid a management fee of 1 to 2 percent taxed as ordinary income.

Carried Interest Allocation

The carried interest allocation to an investment manager or general partner varies based on the type of investment fund and the demand for the fund from investors. In private equity, the standard carried interest allocation has historically been 20 percent.

To receive carried interest in a private equity fund, an investment manager or general partner must first return all capital contributed by the investors and limited partners and, in certain cases, a previously agreed-upon rate of return to the investors.

The private equity industry has argued this is a fair compensation model *(see diagram)* because general partners invest a great deal of time and resources toward building a company's portfolio and profitability. In a hedge fund

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Pension Funds Work to Advance Long-Term Sustainability and Profit

Pension funds must stay vigilant and protect their shareholder rights to safeguard public employees' investments.

Exercising shareholder rights is critical to protecting pension fund investments. Each year, the California Public Employees' Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTRS) vote on thousands of proposals at annual meetings of the public companies in which they invest. Corporate governance teams at both funds review management and shareholder proposals carefully, to ensure the funds support resolutions and directors focused on long-term sustainability and profitability of the companies.

In 2016, CalPERS voted on 107,276 proposals at 11,673 annual meetings of foreign and domestic corporations. That same year, CalSTRS voted on 76,258 proposals at 7,818 annual meetings. CalPERS and CalSTRS also work with other institutional investors throughout the country to secure proxy access at public corporations, giving shareholders the right to nominate members of corporate boards. This helps improve corporate governance and ensures boards are more diverse in terms of gender, race, age, and skill sets, including climate competency.

In addition to the election of board directors, CalPERS and CalSTRS vote on issues such as executive compensation, independent chairs, and environmental and sustainability proposals. They work with other like-minded institutional investors on select issues, introducing and/or generating support for shareholder proposals. For example, CalPERS co-filed a shareholder proposal with other investors at Exxon Mobil that requires the company to report on environmental risks and opportunities associated with climate change. Specifically, the proposal requests an assessment of the company's sustainability under the 2 degrees warming scenario to determine the resiliency and financial risk of the company's portfolio through 2040 and beyond.

This will help investors in Exxon Mobil—one of CalPERS' largest investments—evaluate the long-term sustainability of returns, which is critical to providing members their expected retirement benefits. The proposal was approved with 62 percent of the vote in late May. A similar proposal filed in 2016 received just 38 percent support.

In addition to voting for the Exxon Mobil proposal, CalSTRS has teamed with other investors to encourage shareholders to vote against management's executive compensation proposal at pharmaceutical company Mylan N.V. later this month. Given the outrage surrounding huge price spikes for their EpiPens—which are used to stop severe allergic reactions and anaphylactic shock and are required to be stocked at all California schools—CalSTRS is hoping to send a message to management and protect their investment by ensuring consumer outrage does not impact the firm's sustainability.

The ability of investors to file shareholder proposals to protect their investments is critical. Controller Yee recently joined comptrollers and treasurers across the country in urging Congress to revise provisions in the Financial CHOICE Act that would severely limit this ability. As proposed, the bill would require a single shareholder to own a least

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1 percent of a company's stock for three years before filing a proposal. Even for large investors like CalPERS and CalSTRS this is a prohibitive change from the current rule requiring an investment of $2,000 be held for one year. For frame of reference, a 1 percent ownership stake in Exxon Mobil is $3.4 billion. This bill would limit when shareholders can participate in an advisory vote on executive compensation and restrict the right of shareholders to vote for directors in contested elections. It would also increase the amount of support required to refile a failed proposal the following year.

In the past 10 years, CalPERS and CalSTRS— along with other public pension funds and institutional investors—have made a difference through their corporate engagement and shareholder votes. This work has paid dividends, as studies show a correlation with improved bottom line returns. Controller Yee believes the pension funds must stay vigilant and protect their shareholder rights to safeguard public employees' investments.

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environment, carried interest is usually referred to as a "performance fee." Due to the liquidity of a hedge fund's investments, it is often able to pay carried interest annually if the fund has generated a profit. Historically, the carried interest allocation has been 20 percent.

Taxation

Some argue the carried interest should be treated as compensation to the general partner and taxed as ordinary income. This could result in taxing the carried interest at 39.6 percent as opposed to 20 percent. There have been many proposals to change the tax treatment of carried interest, including the Carried Interest Fairness Act of 2015 (H.R. 2889), which would have taxed investment advisers at ordinary income tax rates. In a recent interview, President Donald Trump said federal tax reform will target the carried interest tax loophole.

Given the current federal tax treatment, some states have taken steps to impose an additional tax on carried interest earned by investment managers. For example, the Illinois state senate passed a bill that would impose a privilege tax of 20 percent on fees earned by managers of private equity and hedge funds. New York, New Jersey, Connecticut, Rhode Island, Massachusetts, and Maryland have all introduced or are considering bills that would target carried interest. California's legislature has not introduced similar legislation.

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