

SAM - BUDGETING

CAPITAL OUTLAY VERSUS STATE OPERATIONS AND LOCAL ASSISTANCE

6806

(Revised 5/1998)

The state appropriates funds in three broad classifications—state operations (support), local assistance, and capital outlay—referred to as the *character of appropriation*. Unless statutory language specifically allows otherwise, once budgeted as one of the three characters, a program or activity must follow that classification's expenditure rules.

Infrastructure management uses all three characters of appropriation, depending on the activity. The general rule is that the acquisition/creation/renovation of real assets is classified as capital outlay if the state holds ownership. Operation and maintenance of state real assets is classified as state operations. State-funded but locally-owned infrastructure is classified as local assistance.

Certain types of leasing activities—called capitalized leasing—which are funded as state operations can also result in a capital acquisition. As used in this chapter, the term *capitalized assets* covers both traditional capital outlay as well as capitalized leasing. (Reminder: Capitalized assets are to be reported to the DGS Statewide Property Inventory [SPI] Unit for inclusion in the SPI.)

Exception to the prohibition against using support funds for capital outlay:

Section 6.00 of the Budget Act provides a limited exception to the rule that support funds may not be used for capital outlay purposes. This section allows up to \$35,000 of support funds to be encumbered for preliminary plans, working drawings, or construction of any project for the *alteration of a state-owned facility* (Section 6.00 does not apply to leased facilities). This amount may be exceeded only if:

1. DOF determines the proposed alteration is critical and the use of a higher level of support funds is necessary; *and*
2. The maximum cost of the project does not exceed \$250,000.

DOF must notify the Legislature not less than 30 days in advance when approving more than \$35,000 in support funding for a capital project. Section 6807 on minor capital outlay describes the approval process for projects of more than \$35,000.

Guidelines for determining character of appropriation: The following discussion and table are intended as a guide to assist departments in determining whether an activity should be budgeted as capital outlay, support, or local assistance.

Capital outlay: Section 3.00 of the Budget Act defines capital outlay as “acquisition of land or other real property, major construction, improvements, equipment, designs, working plans, specifications, repairs, and equipment *necessary in connection with a construction or improvement project*” (emphasis added). Administratively, capital outlay is defined as:

1. Any real property acquisition or new construction.

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2. Any alteration, renovation, addition or betterment (including interior asbestos removal/remodeling) which extends the design life or alters/upgrades the function of a structure.
 - a. This does not include repairs and maintenance, which are intended to keep a facility functional at its *designed* level of services and life expectancy.
 - b. "Alteration" means any modification of existing space (buildings, structures or other facilities) that changes the use as to function, layout, capacity, or quality. Typical alterations include demolition of fixed partitions and/or construction of new fixed partitions or initial installation of carpeting and movable partitions. *However, there are two instances in which alterations may be done with state operations funding:*
 - (1) In a leased space situation, the landlord generally makes the alterations and amortizes them through the lease. The lease, including increases for amortized alterations or lump-sum payment for alterations, is a state operations expense subject to the support budget review process; and
 - (2) As noted in preceding text, Section 6.00 of the Budget Act allows the use of the support appropriation for alterations, within specified limits.

"Betterment" means any modification that increases the designed level of services or life expectancy of a facility or other state infrastructure (e.g. seismic improvements, upgrades, etc.).

3. Fixed and movable equipment needed for initial occupancy of a new facility or space, but usually only if the new facility is not replacing an existing facility (see 6806 Illustration). Fixed equipment is referred to as *Group 1* equipment, and movable equipment is referred to as *Group 2* equipment (Section 6855).

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4. A lease-purchase (installment payment) agreement because equity is built as payments are made. Although the actual lease payments will be budgeted in state operations, the transaction is a capitalized assets acquisition.

All planned lease-purchases, whether authorized through the budget or special legislation, must be included in the department's five-year capitalized assets plan. If the lease-purchase will be authorized through the Budget Act, a COBCP is required to verify economic benefits, *whether or not there is a related support BCP for lease costs*. (For lease-purchase agreements authorized through special legislation, DOF may require information similar in content to a COBCP at the proposed legislation stage.) These requirements apply to lease-purchases for state infrastructure financed through a joint powers authority, another level of government, or a private developer (Sections 6818 and 6820).

5. Both the *request* for, and the *exercise* of, a purchase option. A lease with a purchase option gives the state the right, during the course of the lease, to purchase the asset for a predetermined price, if desired, which is a capital outlay acquisition. Adding a purchase option in a lease agreement is considered initiating a *potential* capital outlay acquisition. Although the lease payments prior to the exercise of the option are classified as state operations, the potential acquisition must be tracked as part of the department's overall capitalized asset plan. Therefore, if authorization is sought through the Budget Act, *anticipated purchase options and their exercise* must both be presented for review as COBCPs, subject to dollar thresholds noted in Sections 6818 and 6820. Regardless of method of authorization, the planned use of purchase options must be included in the department's five-year capitalized assets plan.
6. Generally, the following are not considered as capital outlay: relocation (including temporary "swing space" while a project is under construction) and moving expenses, although DOF may authorize moving expenses as a capital outlay cost on an exception basis.

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State operations: The following facility-related expenses are classified as state operations:

1. Equipment not included in the complement necessary for initial operation of a new construction or renovation project.
2. Movable equipment for new employees or new programs that are not part of a capital outlay project. (Such equipment is budgeted as an operating expense in the department's support budget when the positions or programs are authorized.)
3. Replacement equipment items (regardless of amount).
4. Repair projects, including special repairs, not connected with a construction or improvement project. Examples of special repair projects include repainting, re-roofing, electrical rewiring, plumbing repairs, dredging of river or stream beds to restore original flow capacity, replacing old equipment items, and road repairs. (Regardless of amount, "special repairs" are budgeted in the client department's state operations appropriation.)
5. Maintenance, including deferred maintenance. Maintenance is budgeted as "facilities operations" in the client department's operating expense schedule.
6. Relocation—including temporary "swing" space—and moving expenses, whether or not related to a capital outlay project. (However, DOF may authorize exceptions to this rule.)
7. Lease or rental costs, and any associated budget requests. (However, as noted in the preceding text, capitalized leasing must be reflected in the five-year capitalized asset plan and COBCPs are required under specified conditions per Section 6818.)
8. Generally NOT alterations in state-owned buildings, except as provided in Section 6.00 of the Budget (see preceding). In leased facilities, support funds may be used for alterations.

Local assistance is: The following infrastructure-related expense is classified as local assistance:

1. Grants to local agencies for the operation, maintenance, and acquisition or development of facilities or land, provided the local entity retains ownership after completion of the project.

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ILLUSTRATION DISTINCTION BETWEEN CAPITAL OUTLAY AND STATE OPERATIONS

DESCRIPTION OF PROJECT ^{1/}	STATE OPERATIONS	CAPITAL OUTLAY	
	OPERATING EXPENSES AND EQUIPMENT	PROJECT LEVEL MINOR PROJECTS	PROJECT LEVEL MAJOR PROJECTS
<p>Construction projects: New construction, alteration ^{2/}, extension or betterment of existing structure. <i>(Construction projects include necessary Group I fixed equipment.)</i></p>		If \$250,000 or less and scheduled as minor projects in Budget Act ^{3/}	In excess of \$250,000 ^{3/}
<p>Repair and maintenance projects: Repair and maintenance projects that continue the usability of a facility at its designed level of services</p>	Irrespective of amount		
<p>Equipment (Group II, movable) projects <i>(Section 6855):</i></p> <ul style="list-style-type: none"> • If related to a specific construction project. • New equipment to meet program needs and not related to a construction project; replacement of existing equipment even though the new equipment is to be used in a new facility. 	Irrespective of amount		Irrespective of amount or time of purchase

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ILLUSTRATION DISTINCTION BETWEEN CAPITAL OUTLAY AND STATE OPERATIONS

	STATE OPERATIONS	CAPITAL OUTLAY	
DESCRIPTION OF PROJECT ^{1/}	OPERATING EXPENSES AND EQUIPMENT	PROJECT LEVEL MINOR PROJECTS	PROJECT LEVEL MAJOR PROJECTS
<p>Purchase of land and/or facility/structure: Including related costs such as condemnation and court costs, legal fees, and title reports etc.</p>			Irrespective of amount
<p>Capitalized leases of real property: All leases which build equity as payments are made. (<i>Section 6818</i>):</p> <ul style="list-style-type: none"> • Lease-purchase • A lease with purchase option agreement or amend an existing lease to add a purchase option • Any other capitalized lease per Section 6818 	<p>The lease payments are budgeted in support appropriation. Use a support BCP to request a budget increase. However, a coordinated capital outlay review is also required.</p>		<p>Transaction is reviewed for infrastructure cost/benefits because the property is acquired—or may be acquired—as a result of the lease. <i>Submit a COBCP when requesting authority through the Budget Act, per Section 6818.</i></p>
<p>Operating leases of real property: Pure leases that do not build up equity as payments are made (<i>Section 6876</i>).</p>	Irrespective of amount		

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ILLUSTRATION DISTINCTION BETWEEN CAPITAL OUTLAY AND STATE OPERATIONS

	STATE OPERATIONS	CAPITAL OUTLAY	
DESCRIPTION OF PROJECT ^{1/}	OPERATING EXPENSES AND EQUIPMENT	PROJECT LEVEL MINOR PROJECTS	PROJECT LEVEL MAJOR PROJECTS
Exercise of purchase option for currently rented or leased space (Section 6820)			Irrespective of amount
Relocation and moving costs <ul style="list-style-type: none"> • Unrelated to a specific construction project. • Related to a specific construction project. 	Irrespective of amount Irrespective of amount ^{4/}		
Technical assistance/consultants This may include studies, master planning, feasibility studies, program management, and budget packages.	Depends on timing and nature/scope of activities.		Budget packages are generally capital outlay; other studies and assistance depend on timing and nature/scope of activities.

^{1/} State-funded but locally-owned infrastructure is classified as local assistance.

^{2/} Control Section 6.00 allows the use of limited support appropriations for the alterations of state-owned facility.

^{3/} See Public Contract Code Section 10108.5 for exceptions.

^{4/} DOF may authorize exceptions to this rule.