

# **SUBCOMMITTEE NO. 4**

# **Agenda**

---

**Senator Richard D. Roth, Chair**  
**Senator Steven M. Glazer**  
**Senator Scott Wilk**



**Thursday, April 12, 2018**  
**9:30 a.m. or upon adjournment of session**  
**State Capitol - Room 2040**

Consultants: Joe Stephenshaw

### **Items Proposed for Discussion**

<b>Item</b>	<b>Department</b>	
	<b>0860 Board of Equalization</b> <b>0870 Office of Tax Appeals</b> <b>7600 Department of Tax and Fee Administration</b>	
Issue 1	State Tax Agencies Reorganization	2
	<b>7600 Department of Tax and Fee Administration</b>	
Issue 1	Centralized Revenue Opportunity System Project	6
	<b>7730 Franchise Tax Board</b>	
Issue 1	Earned Income Tax Credit	8
Issue 2	New Employment Credit	12
Issue 3	Audit Staffing Increase	14
Issue 4	Enterprise Data to Revenue Project	17
Issue 5	Information Technology Security Enhancements	18
Issue 6	Information Technology Classification Consolidation	19

Public Comment

---

*Pursuant to the Americans with Disabilities Act, individuals who, because of a disability, need special assistance to attend or participate in a Senate Committee hearing, or in connection with other Senate services, may request assistance at the Senate Rules Committee, 1020 N Street, Suite 255 or by calling (916) 651-1505. Requests should be made one week in advance whenever possible.*

---

---

## ISSUES PROPOSED FOR DISCUSSION AND VOTE

**0860 STATE BOARD OF EQUALIZATION**  
**0870 OFFICE OF TAX APPEALS**  
**7600 DEPARTMENT OF TAX AND FEE ADMINISTRATION**

**Issue 1: State Tax Agencies Reorganization**

**Governor's Proposal.** The Governor's budget proposes \$713.9 million in total funds (\$404.1 million General Fund) and 4,553.1 positions to support the Board of Equalization (BOE), Office of Tax Appeals (OTA), and the California Department of Tax and Fee Administration (CDTFA) in 2018-19, as follows:

**State Tax Agencies  
Program Expenditure  
(dollars in thousands)**

Department	Actual 2016-17	Estimated 2017-18	Proposed 2018-19
Board of Equalization	\$555,274	\$30,826	\$30,445
Office of Tax Appeals	-	7,554	19,951
Department of Tax and Fee Administration	-	624,358	663,538
<b>Total Expenditures</b>	<b>\$555,274</b>	<b>\$662,738</b>	<b>\$713,934</b>

**State Tax Agencies  
Position Authority**

Program	Actual 2016-17	Estimated 2017-18	Proposed 2018-19
Board of Equalization	4,229.5	207.6	203.6
Office of Tax Appeals	-	80.0	80.0
Department of Tax and Fee Administration	-	4,287.0	4,269.5
<b>Total Positions</b>	<b>4,229.5</b>	<b>4,574.6</b>	<b>4,553.1</b>

**Background.** In 2017, the Legislature passed two bills (AB 102 (Committee on Budget), Chapter 16, Statutes of 2017, and AB 131 (Committee on Budget), Chapter 252, Statutes of 2017) that made major changes to tax administration and appeals in California. The bills created two new departments, the CDTFA and OTA, and transferred most of the BOE's duties to these departments. Specifically, the OTA was established for purposes of adjudicating tax disputes related to state taxes and fees, administrative activities of the BOE were shifted to CDTFA, and the BOE was rededicated to its core tax administration responsibilities as set forth in the California Constitution.

BOE is headed by a five-member board, with four members elected directly by district, and the fifth, the State Controller, elected on a statewide basis. Prior to the new laws, BOE's primary responsibility was to administer the sales and use tax. It also administered dozens of smaller tax and fee programs, including alcoholic beverages, insurance and some programs related to property taxes. Additionally, BOE was the quasi-judicial body that heard appeals for state tax programs. The five-member board presided over appeals hearings and ruled on appeals by a majority vote of the board. Taxpayers who disagreed with the board's decisions could have their appeals heard in the trial courts.

Under the new laws, CDTFA administers most of the tax and fee programs formerly administered by BOE. Accordingly, the new laws transferred most of BOE's budget, staff, facilities, and other resources to CDTFA. CDTFA is a department within the Government Operations Agency. The head of the department is a director appointed by the Governor and confirmed by the Senate. AB 102 and AB 131 did not amend the State Constitution, so BOE maintained its constitutional authority over taxes on alcoholic beverages, insurance, and property. However, under a memorandum of understanding, CDTFA administers the alcoholic beverage tax and the insurance tax on behalf of BOE. The Department of Finance (DOF) is currently conducting a mission-based review of CDTFA's administration of the sales and use tax.

OTA is now responsible for hearing tax appeal cases formerly assigned by statute to BOE, including personal income, franchise, and sales tax appeals. OTA is to hear cases in tax appeals panels, each consisting of three administrative law judges (ALJs). These panels are to hear cases in three locations: Sacramento, Fresno, and Los Angeles. Unlike CDTFA, OTA is not part of a state agency. Like CDTFA, however, the head of the department is a director appointed by the Governor and confirmed by the Senate. OTA's director reports directly to the Governor.

As noticed above, due to the enactment of AB 102 and AB 131, BOE's budget has gone from \$555.3 million and 4,229.5 positions in 2016-17 to \$30.4 million and 203.6 positions in 2018-19. The 2017 budget act required the DOF to evaluate the ongoing personal staffing needs of BOE's Board Members, and to report any recommended changes to the Legislature by April 1, 2018. DOF's report, dated March 28, 2018, provides recommendations on staffing of the four Board Members who represent equalization districts (the State Controller is not assigned staff for BOE duties).

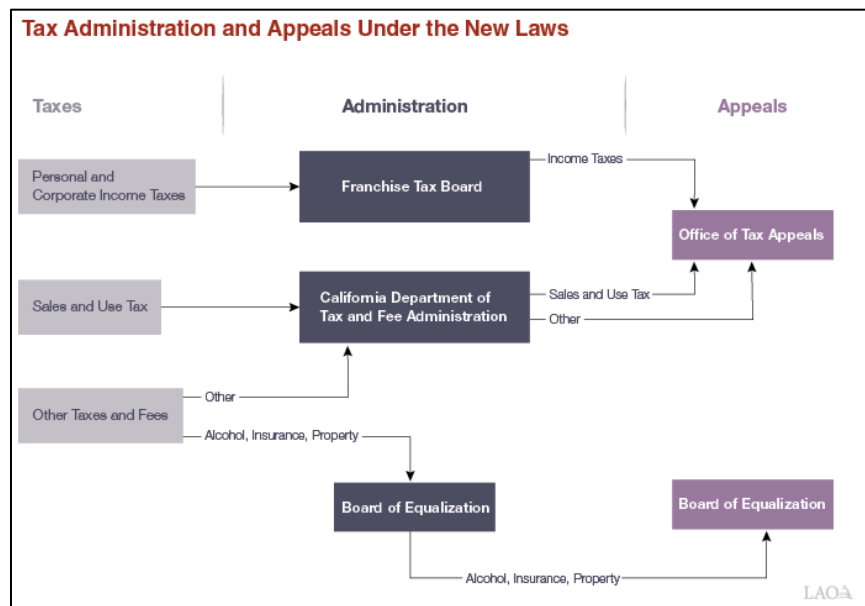
Since 2006-07, Board Members each have had 12 total staff (six exempt and six civil service positions). While the classifications of the six civil service positions has varied, the six exempt staff are: 1) Deputy to the Board Member, 2) CEA Level A (two positions), 3) Tax Consultant Expert II, 4) Assistant to the Board Member, and 5) Administrative Assistant to Board Member.

Two of the Board Member's exempt positions are authorized in the State Constitution and two were authorized by statute (Government Code (GC) Sections 15605.5 (a) and 15623 (a)). DOF's report notes that the legal authority for the remaining two exempt positions is unclear and that they were added in the 1998-99 and 2006-07 state budgets. AB 102 deleted GC Sections 15605.5 (a) and 15623 (a).

In order to provide flexibility to transition staff, the current budget act provides Board Members with authority to employ the same level in the 2017-18 fiscal year as they employed on June 15, 2017. DOF notes that, as of February 2018, Board Members had not yet begun to reduce their exempt staffing levels. Beginning July 1, 2018 each Board Member will have legal authority for only two exempt positions.

Based on DOF’s analysis of workload, they estimated an overall workload reduction of approximately 30 percent, suggesting a need for eight positions to support each Board Member. DOF recommends that each Board Member retain six civil service staff, in addition to the two exempt staff authorized by the State Constitution, to address the workload need that they identified.

**Legislative Analyst’s Office (LAO) Comments.** The LAO published a recent overview of the changes to California’s tax agencies pursuant to AB 102 and AB 131. Their report included the following chart, which displays tax administration under the new law (including those administered by the Franchise Tax Board, which have not changed).



The LAO has also provided comments and recommendations regarding BOE Board Member staffing. They note that Board Members and their personal staff account for \$12 million and 52 positions, 39 percent and 25 percent of the respective totals, of BOE’s total budget for 2017-18 (\$30.8 million and 208 positions).

The LAO noted that DOF’s method for assessing Board Members’ staffing needs - they surveyed board members’ offices regarding their staff’s work activities in 2017; then they identified specific, readily quantifiable workload reductions associated with AB 102 - likely overestimates the board’s staffing requirements for the following reasons:

- It does not consider whether board members' existing staffing was necessary for its pre-AB 102 duties, which was one of the questions that led the Legislature to place this requirement in the budget act.
- It makes a variety of assumptions that are highly deferential toward the status quo. For example, it assumes that one-third of "business tax" appeals are still under BOE's jurisdiction. The LAO's review of 2016-17 board meeting agendas suggests that the actual share is much closer to zero.
- It assumes no fundamental changes in the structure of board member offices. In particular, it assumes that all four board members will continue to have separate, individual offices in Sacramento in addition to their district offices.

Based on the LAO's review of DOF's report, they believe that the appropriate staffing level is significantly lower than eight positions per board member. They note that some of the additional savings, however, would involve major changes to the structure of board members' offices - changes that could not be implemented immediately. The LAO presented the following recommendations:

- **Short-Term Recommendation: Reduce Board Members' Staff by One-Half.** Within the current office structure, the Legislature could achieve further savings by reducing staffing to six positions per board member.
- **Long-Term Recommendation: Consolidate Sacramento Offices.** Instead of having four separate offices in Sacramento, the four district-elected board members should share a single office. Under this structure, board members could share some staff (such as administrative assistants and attorneys), resulting in additional savings.

**Staff Comment.** The changes to our tax administration and appeals made by AB 102 and AB 131 are significant and, although they have made tremendous progress to this point, BOE, CDTFA and OTA are still in the process of transitioning to the new structure. In particular, as noted above, BOE is adjusting to a significant downsizing, while CDTFA and OTA have had to bring new state departments online and subsume significant responsibility in a short period of time. The Legislature should continue to monitor progress on these fronts to ensure that the intent of the reorganization is realized and that, particularly from a budget perspective, it is done in a responsible and efficient manner.

Lastly, in regards to BOE member staffing, staff notes that Board Member offices have raised concern with reductions in staff pursuant to DOF's report.

**Staff Recommendation.** Hold open.

---

**7600 DEPARTMENT OF TAX AND FEE ADMINISTRATION****Issue 1: Centralized Revenue Opportunity System Project**

**Governor's Proposal.** The Governor's budget proposes \$70.1 million (\$39.8 million General Fund), the redirection of two permanent positions, and 6.15 temporary position in 2018-19 to ensure that the Centralized Revenue Opportunity System (CROS) Project has the resources required to continue the implementation phase. This request includes the continuation of funding authorized in 2017-18 and the reclassification of select, prior approved permanent positions.

**Background.** The CROS Project is an information technology modernization effort designed to expand tax and fee payer services, improve the efficiency and effectiveness of the operation and enhance its ability to generate increased revenues. The CROS Project's objective is to establish an integrated, responsive and effective tax and fee payer centric solution that will use up-to-date tax collection, storage, account management, and data retrieval technologies to maximize effectiveness of CDTFA's operations through the following activities:

- Replacing legacy mainframe-based revenue and collection information systems with an integrated and automated tax and fee system;
- Providing an enterprise data warehouse;
- Enhancing eServices services to tax and fee payers and other stakeholders;
- Improving case and contact management;
- Reengineering and improving program processes;
- Improving data sharing capability and real-time data access, especially to field staff;
- Enhancing the department's capability to quickly implement legislative, judicial or electoral changes to tax/revenue codes.

The project scope includes:

- Integrating registration, reporting obligations, cashiering, refunds, collections, audits, appeals, accounting and General Ledger functions for all sales and use and special tax and fee programs, and timber tax functional areas into the CROS Solution;
- Replacing the Integrated Revenue Information System and Automated Compliance Management System, as well as Timber Tax legacy systems;
- Integrating enterprise software including Avaya (call center) and Documentum (enterprise content management) software.

On August 30, 2016 the department approved selection of the CROS Contractor (Fast Enterprises, Inc.) as the contractor responsible for implementing the CROS Solution. The resources requested in this proposal are necessary to support the implementation phase of the project and are derived from the roles and responsibilities of the department as defined in the Request for Proposal; the milestones, deliverables, and resource needs defined in the Integrated Master Schedule; the contractor's schedule submitted in the proposal; and discussions between California Department of Technology, the CROS contractor, and the department's program and technical management.

The next major project rollout – the development and implementation of the CROS solution that includes sales and use tax, lumber, cigarette, retail license fee, tire, and electronic waste tax programs - is expected to go live in the first couple of weeks of May 2018. The total project costs are estimated at \$281.4 million. The CROS project is projected to generate \$334.8 million in revenue between 2017-18 and 2022-23.

**Legislative Analyst’s Office comments.** The Legislative Analyst’s Office (LAO) has noted that the CROS project has experienced high vacancy rates, which has led to a lot of staff overtime. However, they also noted that CDTFA has recently filled two vacancies of particular concern: a Contract Manager and an Organizational Change Management consultant.

The LAO also reports that projected costs in most areas have remained roughly the same or decreased since Special Project Report (SPR) 4 (February 2017). The data conversion contract is an exception: it is currently projected to cost \$1.7 million total over the next three years, up from \$1.3 million in the SPR. According to CDTFA, design sessions in spring 2017 brought to light data conversion requirements that exceeded the assumptions made in the SPR.

**Staff Comments.** As noted last year, the CROS project is a necessary undertaking for the state, given the age and status of the legacy mainframe-based revenue and collection information systems. The budget proposal for continued funding of the CROS project appears reasonable with respect to anticipated workload during the implementation phase. In addition, the benefits-based funding approach has been used successfully by the Franchise Tax Board.

**Staff Recommendation.** Hold open.

## 7730 FRANCHISE TAX BOARD

**Department Overview.** The Franchise Tax Board (FTB) is one of the state's two major tax collection agencies and administers the personal income tax and the corporation tax programs, the largest and third-largest contributors to the state's revenue, respectively. The department also performs some non-tax collection activities, such as the collection of court-ordered payments, delinquent vehicle license fees, and political reform audits. The FTB is governed by a three member board, consisting of the Director of Finance, the chair of the Board of Equalization, and the State Controller. An executive officer, appointed by the board, manages the daily functions of the department.

**Budget Overview.** The Governor's budget proposes \$793.2 million (\$759.5 General Fund) and 5,742.8 positions for FTB in 2018-19. The following display from the Governor's budget shows positions and expenditures for FTB over the prior, current, and proposed budget years.

### 3-YR EXPENDITURES AND POSITIONS

		Positions			Expenditures		
		2016-17	2017-18	2018-19	2016-17*	2017-18*	2018-19*
6280	Tax Programs	5,404.8	5,145.3	5,189.7	\$737,642	\$761,914	\$757,288
6285	Political Reform Audit	14.2	13.0	13.0	1,767	1,932	-
6290	Department of Motor Vehicles Collections Program	64.9	81.1	81.1	7,724	9,079	9,102
6295	Court Collection Program	101.0	111.2	112.2	11,543	13,057	13,009
6300	Legal Services Program	-	-	-	1,311	2,489	2,489
6305	Contract Work	59.0	62.2	62.2	8,499	11,296	11,303
9900100	Administration	262.3	284.6	284.6	27,515	28,506	28,506
9900200	Administration - Distributed	-	-	-	-27,515	-28,506	-28,506
<b>TOTALS, POSITIONS AND EXPENDITURES (All Programs)</b>		<b>5,906.2</b>	<b>5,697.4</b>	<b>5,742.8</b>	<b>\$768,486</b>	<b>\$799,767</b>	<b>\$793,191</b>

### Issue 1: Earned Income Tax Credit

**Governor's Proposal.** The Governor does not have a new proposal related to this item.

**Background.** In SB 80 (Committee on Budget and Fiscal Review), Chapter 21, Statutes of 2015, the Legislature created the Earned Income Tax Credit (EITC), a state refundable tax credit for wage income that is intended to benefit very low-income households. Specifically, the program builds off the federal EITC and established a refundable credit for tax years beginning on or after January 1, 2015. The credit is applied to personal income tax liabilities associated with earned wage income. The program provides for a credit amount during a phase-in range of earned wage income according to specified percentages based on the number of qualifying children.



SB 106 (Committee on Budget and Fiscal Review), Chapter 96, Statutes of 2017, among other things, expanded California's EITC. This legislation expanded the state EITC to allow previously ineligible self-employed workers to qualify for the CalEITC, and raised the credit's income eligibility limits so that workers higher up the income scale can qualify for it. This change better aligns California's EITC with the federal EITC and ensures that the state credit incentivizes all types of paid work.

Prior to the expansion, many workers who struggled to get by were not eligible for the CalEITC because the income limits to qualify for the credit were extremely low. SB 106 raised these limits in order to allow additional low-earning workers to qualify for the credit. For workers with qualifying children, the new income limit is \$22,300. This is more than double the previous income limit for parents with one child and more than one-and-a-half times the previous limit for parents with two or more children. The budget agreement also more than doubles the income limit for workers without qualifying children, from about \$6,700 in tax year 2016 to roughly \$15,000 in tax year 2017.

According to research by the California Budget and Policy Center, State EITCs, like California's, are important tools for boosting economic security among working families. By piggybacking on the federal EITC, these state credits further boost families' incomes, helping them to better make ends meet. In addition, state EITCs may enhance the federal EITC's well-documented benefits to children, families, and communities. Decades of research shows that the federal EITC reduces poverty, encourages work, may improve families' health, may boost children's school achievement, may increase children's future earnings, and boosts California-based businesses and the state's economy. The following charts from the California Budget and Policy Center show California EITC claims and credits for the last three years.

## CalEITC Claims and Credit Amounts

Tax Year 2015 (As of August 20, 2016)					
Filers With:	Total Claims	Percentage of Total Claims	Total Credit Paid	Percentage of Total Credit Paid	Average Credit
3+ Dependents	35,212	9%	\$39,284,908	20%	\$1,116
2 Dependents	77,885	21%	\$76,533,374	39%	\$983
1 Dependent	101,287	27%	\$61,954,210	32%	\$612
0 Dependents	158,915	43%	\$17,717,082	9%	\$111
All Filers	373,299	100%	\$195,489,574	100%	\$524

Tax Year 2016 (As of August 19, 2017)					
Filers With:	Total Claims	Percentage of Total Claims	Total Credit Paid	Percentage of Total Credit Paid	Average Credit
3+ Dependents	35,124	10%	\$39,970,185	20%	\$1,138
2 Dependents	77,339	21%	\$78,154,657	40%	\$1,011
1 Dependent	96,039	26%	\$59,073,215	30%	\$615
0 Dependents	159,841	43%	\$18,897,260	10%	\$118
All Filers	368,343	100%	\$196,095,317	100%	\$532

Tax Year 2017 (As of March 17, 2018)					
Filers With:	Total Claims	Percentage of Total Claims	Total Credit Paid	Percentage of Total Credit Paid	Average Credit
3+ Dependents	83,069	10%	\$39,728,823	19%	\$478
2 Dependents	169,977	21%	\$76,204,623	37%	\$448
1 Dependent	270,771	34%	\$68,851,517	34%	\$254
0 Dependents	268,118	34%	\$19,756,820	10%	\$74
All Filers	791,935	100%	\$204,541,783	100%	\$258

Note: Tax year 2017 data are not comparable to prior years because California extended the CalEITC to self-employed workers who otherwise qualify for the credit and raised the income limit to qualify for the credit for all workers.

Source: California Budget & Policy Center analysis of Franchise Tax Board data

**Outreach Efforts.** The Legislature and the Governor provided \$2 million in 2016-17 and 2017-18, for a CalEITC outreach grant program to reach the 10 target counties with the estimated highest potentially eligible number of households, as well as one small rural and one statewide grant pool. In total, there are 15 grantees with grants ranging from \$55,000 to \$300,000.

In its outreach efforts, FTB collaborated with a wide breadth of government and nongovernment agencies to develop a detailed communication plan to reach California taxpayers who might qualify for both the federal and state credits. Efforts included compilation and analysis of demographic information regarding the targeted population, web support activities, a direct mailer campaign to California taxpayers who did not have a state filing requirement but may qualify for the new California EITC credit, and educational outreach to taxpayers, tax professionals, legislative staff, and other groups.

According to advocates, increased outreach is essential because of the following reasons:

- Current state funding only covers portions of California (10 Counties), despite EITC eligible people living everywhere.
- Eligibility for the CalEITC has expanded greatly with addition of self-employed workers and higher income eligibility, while public funding for outreach has not.
- Increased state EITC outreach draws down untapped federal dollars for low-income areas by increasing Federal EITC uptake (according to UC Irvine research) and boosting state economy.
- EITC outreach needs to be a year-round activity, focused on those who are NOT currently filing their taxes, therefore not impacted by “tax-season”.
- Increased and continued funding, with evaluation of best practices, will allow for more effective outreach through list-building, data management, and effective targeting.

**Staff Comments.** In addition to an update of the program, the subcommittee members may want to ask the FTB, as well as Department of Finance (DOF), about the effectiveness of last year’s outreach resources and whether additional resources would be warranted this year.

Lastly, staff notes that in addition to additional outreach, a coalition of stakeholders has submitted the following recommendations to enhance CaEITC to the committee:

- Create a multi-year target for increasing the CalEITC, as proposed by the Assembly Budget Committee’s 2018-19 Budget Blueprint.
  - Increasing the size of the credit for the lowest-income working families, up to a total \$6,000 credit for a family with two children when combined with the federal EITC.
  - Increasing the size of the credit for workers without dependent children (including non-custodial parents and childless workers).
  - Raising the CalEITC income eligibility limit to \$31,000 to preserve eligibility for full-time workers as the minimum wage rises.
- Include low-income working young adults ages 18-24 in the CalEITC.
  - Currently, working young adults under age 25 without qualifying dependent children are not eligible for the CalEITC.
  - The age limit leaves out young adults who often lack financial security early in their careers, working students struggling to get by, and former foster youth.
- Include low-income working seniors in the CalEITC by eliminating the upper age limit.
  - Currently, working seniors over the age of 65 without qualifying dependent children or grandchildren are not eligible for the CalEITC.
- Include low-income working immigrant families with federally assigned Individual Taxpayer Identification Numbers (ITINs) and Social Security Numbers (SSNs) in the CalEITC.

- Many immigrant working families are excluded from the CalEITC because the credit is granted only if every person in the household has a SSN valid for work. Many immigrants use an IRS-issued ITIN to pay federal and state income taxes and file their tax returns.

**Staff Recommendation.** Informational item.

## Issue 2: New Employment Credit

**Governor’s Proposal.** The Governor's budget proposes trailer bill language to create a California Hiring Credit. This credit would be an expansion of the existing New Employment Credit. The new credit, calculated at the same 35 percent rate of qualified wages as the existing credit, would be expanded in several ways: by geography, industry, and the range of qualified wages. The new credit would be available for hires on or after January 1, 2019, and before January 1, 2024.

**Background.** In 2013, the Legislature created a New Hiring Tax Credit (now known as the New Employment Credit (NEC)) for employers’ taxable years beginning on or after January 1, 2014, and before January 1, 2021. To obtain a credit the business must:

- Hire a qualified full-time employee on or after January 1, 2014.
- Pay qualified wages attributable to work performed by the qualified full-time employee in a designated geographic area.
- Receive a tentative credit reservation from the Franchise Tax Board (FTB) (within 30 days of complying with the Employment Development Department new hire reporting requirement) for that qualified full-time employee.
- Annually certify each qualified employee.

The credit is based on 35 percent of qualified wages, on wages between 150 percent and 350 percent of minimum wage, with the wage range increasing over time due to increases in the minimum wage rate. In order to generate an allowable credit, the qualified taxpayer must have a net increase in its total number of full-time employees working in California, when compared to its base year, both based on annual full-time equivalents. A qualified taxpayer must meet the following criteria:

- Engaged in a trade or business within a designated geographic area.
- Not engaged in any excluded businesses, including temporary help services, retail trades, those primarily in food services, alcoholic beverage places, theater companies, dinner theaters, casinos, and casino hotels unless the business is considered a small business.
- Not engaged in a sexually-oriented business.
- Hires qualified full-time employees (unemployed, veteran, EITC participant or ex-offender) who work at least an average of 35 hours per week and meet other specified wage requirements.

In order to provide a stronger incentive, the trailer bill creates a credit that expands on the current credit in several ways. The wage range for qualified wages would be 100 percent to 350 percent of minimum wage. Another change is that the new credit uses the maximum of the local minimum wage or the statewide minimum wage to determine qualified wages. The existing credit uses the statewide minimum wage. The new credit would apply to qualified hires in all of California, whereas the existing credit applies only to qualified hires within qualified zones (designated census tracts plus former Enterprise Zones). Finally, the types of qualified employers would be expanded under the new credit to include retail and food services.

Other changes to the existing New Employment Credit include: 1) the credit would be available for the first 24 months that a qualified employee works for the employer versus 60 months for the existing New Employment Credit, and 2) the credit rate would be set in the Budget each year for the following taxable year. The existing credit would continue to exist for any employers who wish to continue using that credit until it sunsets. (The final day a new hire would qualify for that credit is December 31, 2020, but the credit can continue to be generated for 60 months after the date of hire). The new credit is expected to cost about \$50 million per year once it is fully phased-in.

This proposal also retains several features of the existing credit. The categories of qualified employee stays the same: long-term unemployed, veterans, ex-offenders, recipients of CalWORKs or General Assistance, and recipients of the federal Earned Income Tax Credit. Additionally, employers will still be required to make a credit reservation when they hire a qualified employee, show a net increase in jobs for the year, and claim the credit on their original filed return.

**Utilization of the current credit.** According to the LAO, when the existing credit was first proposed, the Administration estimated that taxpayers would claim \$22 million in the 2014 tax year and \$69 million in the 2015 tax year. Final, valid claims were \$340,822 in 2014 (two percent of the initial estimate) and \$693,323 in 2015 (one percent of the initial estimate). Over these first two tax years the credit was available, at least 1,829 taxpayers claimed the credit but 83 percent of the claims were invalid. The 310 valid returns were generated from hiring by a total of 62 individual businesses. (The number of taxpayers claiming the credit exceeds the number of affiliated businesses because pass-through businesses, such as partnerships and LLCs, generally have multiple investors and each investor may claim a proportional share of the credit.) These results suggest that the existing tax credit has been challenging or unappealing for businesses to use.

**Legislative Analyst's Office comments.** The LAO made the following observations in regards to the Administration's proposal:

- **A Stronger Incentive.** The Administration has proposed changes to the credit that should make it more attractive to employers. In particular, the proposed reduction in the wage floor from 150 percent to 100 percent of the minimum wage would reduce the starting wage requirement and increase the amount of the credit across the board.

- **More Businesses Would Qualify.** Under the proposal, all businesses in the retail and food services industries—about 170,000 establishments, according to EDD—would become eligible for the proposed credit. This change alone opens up eligibility for the credit to more than 10 percent of the state’s roughly 1.4 million private business establishments.
- **Statewide Credit Preferable to Geographically Limited Credit.** Unlike the existing credit, which is only available to businesses in certain areas of the state, the proposed credit would be available to businesses statewide. This change treats similar taxpayers—employers hiring new workers from among the targeted categories—similarly. This change also reduces the possibility of jobs shifting within the state without growing the overall economy.
- **Fiscal Estimate Uncertain.** The Administration estimates that the proposed credit would reduce General Fund revenues by \$50 million per year, but this estimate is uncertain. Estimating the fiscal effect of a new tax provision is difficult. For example, the Administration initially estimated the cost of the existing credit to be \$91 million over the 2014 and 2015 tax years combined, but taxpayers ultimately claimed only about \$1 million over that period. The changes proposed by the Administration, however, likely will increase the proposed credit’s use. The cost of the proposed credit would also depend on the credit percentage set by the Legislature in the annual budget act.
- **Reducing Duration of Credit Is Reasonable.** While the proposal limits the credit to two years of qualified wages, the proposed credit amount would be larger than the existing credit at any wage. The LAO believes that this change is reasonable because it creates a larger upfront incentive—by providing a greater tax reduction—for a business to hire an individual from one of the targeted categories. Few employers would let go of a trained employee once their tax credit is no longer available.

**Staff Comments.** The Administration’s goals in revising the New Employment Tax Credit make sense given the substantial underutilization of the existing credit. However, given that the existing credit was just one component of the state’s overhaul of economic development incentives in 2013 and the time that has passed; the Legislature should assess how the Administration’s proposed changes align with current priorities.

**Staff Recommendation.** Hold open.

### Issue 3: Audit Staffing Increase

**Governor’s Proposal.** The Governor’s budget proposes \$7.8 million General Fund in 2018-19, and ongoing, to address unfunded needs for staff resources performing audits. The funding will allow the FTB to hire 50 auditors into positions that have been held vacant and fund 25 upgrades. According to the FTB, these resources will enable them to generate an additional \$90 million in revenue.

**Background.** The audit division administers the Revenue and Taxation Code for individuals and business entities that do business in California. The program works with taxpayers and their

representatives to administer and enforce the law effectively to ensure that all taxpayers meet their obligations to file and pay the correct amount due. The program utilizes innovative methods to promote these objectives through customer service, education, self-compliance letters, initiatives, and partnerships with other federal and state agencies. In performing these activities, the program considers the effects on taxpayers, increases the timeliness and effectiveness of enforcement actions, and focuses on adherence to FTB Regulation Section 19032, Audit Procedures, to complete audits in a timely manner. The audit program is organized into the following key operating units:

- National Business Audit Bureau (NBA) -audits business entities including corporations, banks, and financials that conduct business both within and outside of California.
- Individual & Pass Through Entity Audit Bureau (PTE) -audits individual taxpayers and pass through entities including partnerships, S-corporations, limited liability companies, estates, and trusts. Conducts specialized programs including federal/state and automated audit programs.
- Audit Services, Administration, & Protest Bureau -provides protest, and audit services and administrative activities for audit programs.
- Technical Resource & Services Bureau -provides technical service and support to FTB programs and stakeholders.

The audit division has experienced an expansion of audits related to complex and sophisticated issues and filings. The relevant tax codes continue to be or have increased complexity and business entity organizational structures continue to introduce more complexity in tax filings and audits. The sophistication of tax professionals and the tax reducing strategies deployed continue to increase the complexity of the audit requiring increased skill sets by FTB staff.

California's tax system is based on the willingness of taxpayers to self-comply with the tax laws. Over 80 percent of taxpayers comply with the law. The remainder may need some sort of assistance to file correctly or pay on time. Audit staff play a key role in supporting the foundational basis of California's voluntary self-compliance system.

The resources requested are attributed to two root causes:

1. Complexity: Over the last five years, FTB has identified more workload at the Program Specialist I, II, and III levels which is inconsistent with FTB's funded position authority. Although to be limited in duration, FTB does not see this trend reversing. In recent years, FTB has performed various studies on the complexity of work. FTB found that available inventory for assignment was at the more complex end of the skill set spectrum, yet FTB did not have sufficient staff working at that classification level. In 2013, FTB concluded a study on inventory and staffing levels associated with the NBA workloads, and FTB found the following observations:

NBA	Tax Auditor & Associate Tax Auditor	Program Specialist I	Program Specialist II	Program Specialist III
Percentage of Workload Based on Analysis	23%	21%	46%	10%
Current Staffing Levels	40%	29%	26%	6%
Staffing Workforce GAP	17%	8%	-20%	-4%

In recent months, a comparable analysis of the PTE workloads showed a gap in the appropriate level of classifications as well.

PTE	Tax Auditor & Associate Tax Auditor	Program Specialist I	Program Specialist II	Program Specialist III
Percentage of Workload Based on Analysis	18%	25%	48%	8%
Current Staffing Levels	30%	37%	27%	4%
Staffing Workforce GAP	12%	12%	-21%	-4%

- Salary Levels for Senior classifications: FTB has a substantial amount of Program Specialist II and Program Specialist III staff in the maximum salary range. Generally, the majority of these positions are funded at the first salary step causing a significant gap in budgeted salaries versus salaries actually paid. FTB does not see this trend changing.

During the studies mentioned above, FTB also looked at the basic funding structure for the audit staff. While FTB is not immune to staff seeking new opportunities at their own choice or when they are heavily recruited by California tax firms, for those that choose to pursue careers with FTB, they tend to reach the last step of their salary range. All audit positions received prior to 2001-02 (73 percent of existing positions) are funded at the first step of the salary range. The remainder 27 percent of existing audit positions are funded at the mid-level step of the salary range and consist primarily of Tax Auditor, Associate Tax Auditor, and Program Specialist I positions. FTB conducted a study and found that, from 2013-14 forward, a substantial amount of senior staff are funded at the maximum salary step.

Percentage at Max Range	Tax Auditor	Associate Tax Auditor	Program Specialist I	Program Specialist II	Program Specialist III
2016-17	10%	29%	43%	67%	92%
2015-16	11%	37%	64%	90%	97%
2014-15	12%	26%	48%	75%	97%
2013-14	8%	31%	54%	93%	85%



**Legislative Analyst's Office comments.** The Legislative Analyst's Office has not raised any concerns with this proposal.

**Staff Comments.** Staff notes that a significant driver of this request is the internal reclassification of positions within FTB, which are typically done on an individual basis and funded within existing resources. However, another significant driver is the fact that many of FTB's audit positions are funded at the bottom salary step, instead of the mid-step which is how the state now budgets for new positions. Because of this and the revenue generating nature of FTB's audit positions, this request appears reasonable. However, FTB should take precautions going forward to ensure that internal reclassifications do not drive budget deficits.

**Staff Recommendation.** Approve as budgeted.

#### **Issue 4: Enterprise Data to Revenue Project**

**Governor's Proposal.** The Governor's budget proposes \$2.5 million General Fund and the conversion of 20 limited-term positions to permanent status in 2018-19 and ongoing.

**Background.** The Enterprise Data Revenue (EDR) project was a 66-month IT project that began a multi-phased effort to modernize FTB's processes and systems. The project started in 2011-12 and was completed in 2016-17. As of April 30, 2017, the EDR project has generated \$3.7 billion in revenue for the State since the inception of the project. FTB is well on the way to achieving the \$4.7 billion revenue target.

In 2015-16, FTB was granted 20 three-year limited-term positions to support ongoing work, continue to build the EDR solution and start the knowledge management and transition of the EDR solution to FTB. The solution adopted by the EDR project implemented improvements to FTB's enforcements activities and self-service tools. The EDR project enabled FTB to implement self-help tools for taxpayers and tax practitioners that eased burdens that existed related to filing a return or paying taxes due and supports California's voluntary compliance based taxation system.

To better position FTB to take ownership of EDR, the four stages outlined below were utilized. FTB has successfully completed Stages 0 and 1 of the transition to FTB and Stage 2 and 3 are well underway to be fully completed by June 2018. These 20 IT resources are critical to FTB's ability to successfully support EDR processes and applications ongoing. The four stages are:

- Stage 0 – Solution provider leads and performs maintenance and operational tasks.
- Stage 1 – Solution provider leads and performs tasks which FTB learns by over-serving and participating as possible in maintenance and operational tasks.
- Stage 2 – FTB leads and performs tasks while the solution provider observes for accuracy and contributes as necessary for continued transfer of knowledge.
- Stage 3 – FTB is fully responsible for ongoing maintenance and operations without vendor support.

---

**Legislative Analyst's Office comments.** The Legislative Analyst's Office has not raised any concerns with this proposal.

**Staff Comments.** The FTB has reported that the vendor is scheduled to exit the project on June 30, 2018. This request will allow FTB to assume maintenance and operations responsibilities going forward.

**Staff Recommendation.** Approve as budgeted.

#### **Issue 5: Information Technology Security Enhancements**

**Governor's Proposal.** The Governor's budget proposes \$5.0 million (\$4.9 million General Fund and \$135,000 Special Funds) in 2018-19, and \$4.1 million (\$4.0 million General Fund and \$111,000 Special Funds) in 2019-20 and 23 positions, to accommodate workload growth within the critical functions of Information Security, Worksite Security, Privacy and Disclosure, and FTB's Infrastructure.

**Background.** The Privacy, Security, and Disclosure Bureau (PSDB) develops and enforces security policies and procedures for the safety of FTB's employees and California citizens, to ensure the confidentiality, integrity, and availability of FTB's information systems and the security of the information they contain. These departmental policies and procedures guide staff in the analysis and assessment of security measures for the protection of FTB's facilities, and to prevent, detect, and identify unauthorized access to information technology systems, networks, and data.

The Chief Security officer (CSO) also promotes awareness of Privacy and Security issues among management and staff, ensuring sound security principles are reflected throughout the organization's vision and goals. Subject matter experts within the Privacy, Security, and Disclosure Bureau provide technical security expertise to the department. FTB's CSO is responsible for the oversight and management of all aspects of information security, physical security, privacy and disclosure.

FTB is one of four pilot partners actively engaged in the California Cyber Security Integration Center (Cal-CSIC) project. Cal-CSIC shares threat intelligence to help maintain the security and integrity of the state's Information Technology infrastructure by preventing or minimizing incident-based losses, theft of information or disruption of services that could result in serious loss of information assets, revenue, public confidence, reputation, or market share. This partnership works with FTB technical staff and increases the amount of intelligence available to mitigate threats and risk.

The requested resources will accomplish the following:

- Establish a continuously operational Security Operations Center wherein staff will be responsible for early detection of cyber-attacks resulting in quicker deployment of mitigation activities.
- Establish a Security Intelligence Program that is able to provide expert capability to analyze and address new and evolving threats to FTB critical systems and information.
- Analyze and detect inappropriate use of FTB's external applications.
- Provide oversight of security audit logging architecture, security logging requirements for all electronic systems, testing and validation of all security logging components.
- Help FTB evaluate central office compliance with security policy, and evaluate potential external threats.
- Ensure privacy controls are in place throughout FTB's systems and business processes.
- Perform the required safeguard reviews in order to ensure FTB is in compliance with state and federal laws, policies and regulations.

**Legislative Analyst's Office comments.** The Legislative Analyst's Office has not raised any concerns with this proposal.

**Staff Comments.** In addition to the important cybersecurity role that FTB must play for the state in protecting confidential and sensitive data, they also are subject to Internal Revenue Service risk control requirements. As cybersecurity attacks and risks continue to increase, FTB must take steps to protect the sensitive data and information it possesses.

**Staff Recommendation.** Approve as budgeted.

#### **Issue 6: Information Technology Classification Consolidation**

**Governor's Proposal.** A spring finance letter proposes \$1.8 million General Fund in 2018-19 and \$2.3 million General Fund in 2019-20 and ongoing to cover the costs of transitioning from the outdated Information Technology (IT) classification series to the new IT Classification series. The State Personnel Board (SPB) and Department of Human Resources collaborated to create a plan that modernizes IT classifications to attract and retain competitive and knowledgeable staff.

**Background.** On January 11, 2018, the SPB unanimously approved California's IT Classification Plan. Effective, January 31, 2018, California began using dozens of revised and consolidated information technology job descriptions. The project abolished and transitioned 36 current IT classifications into five rank and file IT classes and four IT supervisory/managerial classifications and added a Footnote 24 to seven classifications stating that those classes will be abolished after the incumbents vacate the classes.

The deep classes within the new classifications have alternate ranges that provide for employee retention by increasing levels of work experience and compensation without requiring repetitive examinations. These deep classifications consolidated multiple IT classifications under the former structure. While this creates a clear career path and promotes retention, it creates a salary

gap. As a result of the classification consolidation the top salaries increased for eight of the former IT classifications that were included in the consolidation effort. FTB has over 1,000 staff in IT classifications and estimates increased costs for many of these staff, including:

**Information Technology Specialist I**

- Increases are significantly attributed to the following factors:
  - Three of the six prior classifications consolidated into the new IT Specialist I classification have a new maximum salary cap under the new classification (increased by \$720), of which staff are eligible for based on education and years of experience.
  - FTB has on average 600 staff within these six prior classifications.
  - Over the last five years, on average 60 percent+ of these staff members are already at their maximum pay under the prior classifications.

**IT Technology Associate**

- FTB has on average about 150 staff within this new classification and approximately 30-40 percent of these staff are already at maximum pay under the prior classification pay ranges.

**Legislative Analyst's Office comments.** The Legislative Analyst's Office has not raised any concerns with this proposal.

**Staff Recommendation.** Approve as budgeted.