SUBCOMMITTEE NO. 4 Agenda

Senator Gloria Negrete McLeod, Chair
Senator Doug La Malfa
Senator Noreen Evans

Thursday, May 3, 2012
9:30 a.m. or upon adjournment
of Budget and Fiscal Review Committee
Room 112

Consultant: Keely Martin Bosler

State Administration and General Government

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Vote Only Calendar

1730 Franchise Tax Board (FTB)

1. Top 500 Tax Debtor List

Background. Chapter 455, Statutes of 2011 (AB 1424, Perea) expanded the current list of the top 250 tax debtors to include the top 500 tax debtors and update the list twice a year. This legislation also required the following new activities: (1) suspension of occupational, professional, and driver's licenses held by debtors, except as specified; (2) prohibit state agencies from entering into a contract for goods and services with a tax debtor on the top 500 list; and (3) allows FTB to offset tax refunds for delinquent tax debts owed to the IRS and other states, but only upon reciprocal agreements in which the other state's tax refunds are offset for delinquent tax debts owed to the FTB.

Governor's Budget. The Governor's budget includes **$755,000 General Fund** to support seven 3-year limited-term positions in the budget year to implement AB 1424 (Perea). The FTB estimates that the provisions of this legislation and these budget resources will result in **$43 million** in additional tax compliance revenues in the current and budget years combined. The FTB indicates that it has not requested budgetary resources associated with implementing the provisions that allow for the offset of tax refunds issued by other states since additional agreements need to be entered into before this provision is operative.

Staff Comments. Staff notes that the cost estimate in this proposal is in line with the estimate in the Senate Appropriations committee analysis when this bill was passed by the Senate last year.

Staff Recommendation. Staff recommends that the Subcommittee approve this budget proposal.

2. Voluntary Contribution Funding Codes – Budget Bill Clean-Up

Background. Current law allows taxpayers to contribute amounts in excess of their tax liability to various voluntary contribution funds listed on the state tax return by checking a box on their California income tax form. These funds must reach the minimum level of $250,000 in their second taxable year. If they do not meet the $250,000 minimum, the law authorizing these fund designations is repealed.

Finance Letter. The Finance Letter includes amendments to the budget bill to add four new funds. The four additions reflect legislation enacted in 2011 to establish these funds as follows:

- Child Victims of Human Trafficking Fund
- Municipal Shelter Spay-Neuter Fund
- ALS/Lou Gehrig's Disease Research Fund

Staff Comments. Staff finds that two of the three funds (Municipal Shelter Spay-Neuter Fund and ALS/Lou Gehrig's Disease Research Fund) had failed to reach the $250,000 threshold for contributions and were proposed to be eliminated, but additional legislation continued these funds.

Staff Recommendation. Staff recommends that the Subcommittee approve the budget bill amendments related to the voluntary contribution funding codes.

0860 Board of Equalization (BOE)

1. Natural Gas Public Purpose Programs Collections

Background. The BOE has administered and collected the surcharge on natural gas that is referred to as the Natural Gas Public Purpose Programs surcharge since 2001. The natural gas surcharge program was established by Chapter 932, Statutes of 2000 (AB 1002, Wright). The BOE was provided with $400,000 to cover the workload associated with collecting this surcharge, but was not provided with additional positions until 2009-10. In 2009-10, two limited-term positions were approved to improve compliance with the natural gas surcharge in a three-year pilot. These positions identified unregistered utilities and consumers and audited program registrants. The results were approximately $14 million in additional revenues collected annually.

Governor's Budget. The Governor's budget proposes to make the two limited-term positions permanent to continue tax compliance efforts related to collecting the natural gas surcharge. The ongoing cost of these positions is **$227,000** from the natural gas surcharge fund. The BOE expects return processing to continue to grow significantly over the next few years. The board also expects to continue adding new registrants each year and performing approximately five audits each year.

Staff Comments. No issues have been raised with this proposal.

Staff Recommendation. Staff recommends approving this budget proposal.

1730 Franchise Tax Board

Background. The Franchise Tax Board (FTB) is one of the state's two major tax collection agencies. The FTB's primary responsibility is to administer corporation tax programs and California's personal income tax (PIT). In addition, FTB administers several non-tax-related programs, including the collection of child support payments and other court-ordered payments. The FTB is governed by a three-member board, consisting of the Director of Finance, the Chair of the Board of Equalization (BOE), and the State Controller. An executive officer, appointed by the board, administers the daily operations and functions of FTB.

The *2012-13 Governor's Budget* proposes **$680 million** in support of FTB's operations, of which **$650 million is General Fund**. The remaining budget consists mainly of other special funds related to FTB's court fee collection and Department of Motor Vehicles collection programs. The proposed level of support represents a net increase of about $75.5 million General Fund related to the implementation of the Enterprise Data to Revenue (EDR) information technology project to modernize and make more effective the FTB's tax collection system.

The number of personnel-years (PYs) for FTB is budgeted to increase from 5,331 to 5,427 mainly due to implementation activities related to the EDR information technology project.

Tax Gap Reduction Measures

Summary. The FTB has recently updated its tax gap estimate based on the Internal Revenue Service (IRS) study for the 2006 tax year. The tax gap is an estimate of the outstanding tax liability that is owed to the state, but is not collected. This estimate is derived from an IRS study after making some California-specific adjustments. The new measure estimates that the total tax gap is about **$10 billion**, which is about $3.5 billion more than previous estimates. The growth has largely mirrored the growth in overall tax liabilities.

The FTB has numerous initiatives to reduce this tax gap using an enterprise approach. An enterprise approach means that staffs from all different divisions at FTB are involved in reducing the tax gap, including filing, audit, legal, and collections divisions. The FTB reported to the Legislature on its audit and compliance activities in December 2011. This report detailed the costs and revenues associated with FTB's audit and compliance activities, including actual data from 2010-11, estimated data for 2011-12, and proposed data for 2012-13. The activities and revenues generated are summarized in the following categories:

- **Collection Program.** The collection program involves collections of accounts receivables owed the State. The program had 960 personnel years in 2010-11 and generated **$2.3 billion** in revenue for the state at a cost of $135 million. This resulted in a 17:1 cost benefit ratio.
- **Audit Program.** The audit program includes four operating units as follows: (1) national business audit bureau; (2) individual and special audit bureau; (3) pass-through entity bureau; and (4) audit policy, protest and administration bureau. Each of these bureaus specializes in specific types of audits. This program had 979 personnel years in 2010-11 and generated **$2 billion** in revenue for the state at a cost of $153 million. This resulted in a 13:1 cost benefit ratio.
- **Filing Compliance Program.** The filing compliance program includes the following units: (1) filing enforcement; (2) non-wage withholding; and (3) fraud and tax gap. The filing enforcement unit contacts individuals and business entities that have a requirement to file a California tax return, but have not filed. The non-wage withholding programs ensure compliance with withholding on sellers of California real estate, nonresident entertainers, nonresident independent contracts, nonresident partners and beneficiaries, and others. The fraud and tax gap unit uses selection methods to conduct studies to detect fraud and discover taxpayers filing false claims, underreport their taxes, or do not file tax returns. This filing enforcement unit had 71 personnel years in 2010-11 and generated **$683 million** in revenue for the state at a cost of $23 million. This resulted in a 29:1 cost benefit ratio for the filing enforcement unit. The non-wage withholding unit had 64 personnel years in 2010-11 and generated **$682 million** in revenue for the state at a cost of $13 million. This resulted in a 53:1 cost benefit ratio for the non-wage withholding unit. The fraud and tax gap unit had 76 positions in 2010-11 and generated **$46 million** in revenue for the state at a cost of $5.5 million. This resulted in an 8:1 cost benefit ratio for the fraud and tax gap unit.
- **Tax Return Validation.** The tax return validation activities resolve routine math errors, complex taxpayer errors, incomplete tax returns, keying errors, and validate e-file returns and payments. This program had 462 positions in 2010-11 and generated **$1.4 billion** in

revenue for the state at a cost of $51 million. This resulted in a 28:1 cost benefit ratio for this program.

In summary, the FTB's tax enforcement efforts improved tax collection efforts by **$7 billion** in 2010-11. These efforts are estimated to bring in additional revenues in the current and budget year. Some of the programs have significant benefits, relative to costs, including a 53:1 cost benefit ratio for the non-wage withholding unit of the filing compliance program. Given the very large return on investment it seems like additional enforcement investments in this area could continue to bring additional revenues owed to the state that are not being properly reported.

Workforce Cap Impacts. The FTB participated in the government-wide workforce cap initiated under then-Governor Schwarzenegger's 2010 Executive Order to achieve 5 percent salary savings. The FTB reports that it eliminated 155 vacant positions and reduced expenditures by $8.8 million ($8.6 million General Fund). An additional $2.5 million in operating expenses and equipment was also eliminated from FTB's budget associated with the reduction in positions. The FTB indicates that revenue generating positions were exempt from this workforce cap.

Questions:

- **FTB:** A significant number of the positions eliminated were in the accounts receivable division and the filing division. Can you explain what these positions were focused on if they were not dedicated to enhancing tax collection for the state?
- **DOF:** How do you determine – for exemption purposes – what positions are "revenue generating" at FTB and what positions are not?

1. Enterprise Data to Revenue Project

Background. The Franchise Tax Board's (FTB's) tax filing system has not been substantially updated in the last 25 years. In order to modernize the FTB's filing system, the board initiated the Enterprise Data to Revenue (EDR) Project in 2009-10. This project will introduce a new Personal Income Tax (PIT) and Business Entity return processing system including expanded imaging, data capture, and return validation. Annually, the FTB processes approximately 15 million PIT returns and one million Business Entity returns. Overall, this project will enable FTB to correct erroneous returns in a more timely manner. It will also be more effective at providing data to identify noncompliance patterns and help identify fraudulent activity. This data system will also allow FTB to better prioritize its workload based on highest cost recovery. The FTB indicates that the new system will also expand self-help tools for taxpayers and tax practitioners to improve the filing and payment activities.

The FTB is using an alternate type of procurement for the EDR project that invites bidders to propose a comprehensive solution to address the overall goals outlined by the EDR project, instead of dictating the solution to the bidders. In this type of procurement, the State enters into a contract with a Primary Solution Provider (PSP) and the State works collaboratively with the provider to find a solution that meets the goals of the State. The FTB chose a PSP in November 2010.

The FTB is also using a benefits based procurement model to acquire the EDR Project and get the best value and business driven solution. This model is based on acquiring solutions to strategic business problems and only compensating the contractor when these solutions deliver new tax revenues and after certain State costs are recouped. Revenue benefits are then shared with the contractor up to a fixed contract amount. Furthermore, the contract is constructed so that the State does not incur upfront expenses to compensate the contractor.

When fully implemented, the FTB estimates that the EDR project will bring in over $1 billion in ongoing revenue annually. This will help to address the tax gap through increased collection of tax revenues that are due to the State but currently unpaid or uncollected for various reasons. The EDR project will also provide taxpayers with more self-service and self-help tools to ease burdens related to filing a return. Overall, the one-time costs of the PSP contract are estimated to be $398.9 million over the life of the 66-month (5.5 year) contract. However, this project is also projected to generate $4.7 billion in revenue over the life of the project and result in ongoing tax compliance benefits of $1 billion annually. The FTB indicates that revenue generated from the EDR project will exceed annual project costs over the life of the project. Over the life of the project the EDR is expected to generate a 7:1 benefit to cost ratio.

Governor's Budget. The Governor's budget includes **$96.5 million General Fund** and authorization for 56 permanent positions, 102 temporary help positions and 7 limited-term positions in the budget year to continue implementation of EDR. The position authority requested includes 45 permanent positions and 7 limited-term positions that will be supported with approximately $3.9 million that was requested in 2011-12. No additional positions were approved for EDR in 2011-12 and FTB redirected existing vacant positions to support this proposal in the short term. The EDR project is anticipated to generate additional tax collections of **$187.7 million General Fund** in the budget year.

Specifically, the funding requested in the budget year supports the following expenditures:

- **PSP Contract**. The FTB estimates that **$91.1 million** will be allocated to the contractor in the budget year. No payments are made to the contractor if the State does not receive increased revenue as projected.
- **Information Technology Positions.** The FTB is requesting 7 permanent and 7 limited-term information technology positions to support the development of the new return processing system, new data warehouse, creation of a taxpayer folder, new interfaces between EDR and existing legacy systems, and implementation of the EDR early wins. These positions are supported from the funding authorized in the 2011-12 budget request.
- **Compliance Positions.** The FTB is requesting 39 permanent compliance positions to handle the increase in account adjustments, collection opportunities, filing enforcement notices, and other taxpayer contracts. These positions are requested for the department's filing division and accounts receivable division and are supported by the 2011-12 budget request.
- **Temporary Help.** The FTB is also requesting the equivalent of 102 temporary help positions to address data entry required with EDR efforts to digitize various documents. These key data operators are necessary when the system cannot read data that needs to be migrated in to the new EDR system.

- **Other Positions.** The FTB is also requesting 11 additional positions in the budget year. Eight of the positions are additional compliance positions and three of the positions are administrative positions needed to support the additional positions being added to support the EDR project.

Staff Comments. Overall, staff finds that the EDR project has been thoroughly planned and the FTB has done significant work to ready the organization for the implementation of the new system, including a complete documentation of their business processes. However, the proposed solution by the PSP has a considerably different cost and revenue structure than originally estimated. It will be critical that the state continue to monitor how the estimated cost and revenue structure of this project tracks with actual revenues and expenditures. Furthermore, the calculation of the revenues attributable to the EDR project is essential to evaluating the relative value of the PSP contract.

Questions:

- **FTB:** What is the current status of tax compliance activities related to the EDR project in the current fiscal year? What are the main activities contributing to the improved tax collections in the current fiscal year?
- **FTB:** What new compliance activities are projected to result in increased tax compliance in the budget year?

Staff Recommendation. Staff recommends that the Subcommittee approve this budget request.

2. Accounts Receivable Management Program

Background. Accounts receivable are recognized tax liabilities owed the state by individuals and business entities that have not been collected. Accounts receivable balances for personal income tax filers have steadily grown over the past five years. Accounts receivable balances for business entities peaked in 2010 and have declined slightly in more recent years. In 2010, 111 two-year limited-term positions were approved to address the rising accounts receivable inventory balance. These positions were approved on a limited-term basis with the thought that part of the inventory growth could be attributed to underlying economic conditions that were bound to change.

Also in 2010, 14 two-year limited-term positions were approved to pilot a program with the Department of Motor Vehicles (DMV) that involved investigations of circumstances where no tax return had been filed or payment made on an existing accounts receivable balance and the individual had purchased a luxury automobile in the last year. This program generated $15 million in revenue in 2010-11.

Governor's Budget. The Governor's budget proposes to make permanent the 111 positions authorized in 2010 to increase collection efforts on the outstanding accounts receivable balance.

The Governor's budget also proposes extending for an additional two years the 14 two-year limited-term positions related to the DMV luxury vehicle program.

These positions are supported by expenditure of **$8.5 million General Fund**. The FTB estimates that these staff resources will generate **$120 million** in additional collections in the budget year.

Staff Comments. Staff finds that the same general concerns exist today as they did two years ago regarding making these positions permanent. The accounts receivable inventory levels are likely in part due to the weak economic conditions that have impacted the state over the past several years. Therefore, it is unclear that this level of resources is justified as permanent augmentations to FTB's budget. Furthermore, the FTB is involved in several other efforts that should enhance collection efforts related to the accounts receivable inventory, including investments made in EDR, the Financial Institutions Records Match effort, and the Federal Treasury Offset Program.

Staff notes that the Assembly Budget Subcommittee #4 has already take action on this request, but have approved it with two-year limited-term positions instead of permanent positions.

Staff Recommendation. Staff recommends that the Subcommittee approve the budget request, but continue all positions on a two-year limited-term basis.

Other Issues

1. Corporate Tax Collection—Informational Item

Background. The 2008-09, 2009-10, and 2010-11 budget packages all included corporate tax changes. Generally these tax changes were a mix of short-term suspensions that provided temporary budget relief and permanent reductions that were made effective prospectively. These changes are outlined in further detail below.

Temporary Loss of Tax Benefit - $900 million per year for four years ($3.6 billion total)

- **Temporary Limit on Tax Credits.** The 2008-09 budget package temporarily limited to 50 percent the amount of business tax credits that could be used to reduce tax liability in the 2008 and 2009 tax years. This provided $1.3 billion in temporary revenue to the state. However, corporations were able to continue to carry these credits on their balance sheets.
- **Temporary Suspension of Net Operating Losses.** The 2008-09 budget package suspended net operating loss (NOL) deductions for the 2008 and 2009 tax years, except for taxpayers with net business income of less than $500,000 in either year. The 2010-11 budget package suspended NOLs for an additional two years, except for taxpayers with net business income of less than $300,000 in either year. Collectively these actions provided $2.3 billion over the four year period. However, corporations were able to continue to carry and accumulate these losses on their balance sheets.

Permanent Tax Cuts - $1.3 billion in permanent cuts ongoing starting in 2011.

- **Permanent Change Unitary Group Credit Sharing.** The 2008-09 budget package authorized corporations that accumulate business tax credits to assign all or a portion of any unused credit to an affiliated corporation that is a member of the same combined reporting group. With respect to credits earned in tax years beginning before July 1, 2008, the assignee corporation would have to have been a member of the group from at least June 30, 2008, through the year of assignment. For credits earned subsequently, the assignee corporation must be a member of the group in the year that the credit is earned through the year in which the assignment occurs. This tax policy change will result in a loss of General Fund revenues of approximately $315 million annually starting in the 2010-11 budget year.

- **Extend NOL Carry Forward Period and Allow for Carrybacks.** The 2008-09 budget package further expanded the NOL carry forward period from 10 years to 20 years for losses incurred after January 1, 2008. Furthermore, the budget package, amended in 2010, authorized NOL carry backs for losses incurred in 2013 or later tax years. The carry back provision will phase in, with 50 percent of any 2013 NOLs available for carry back, 75 percent of any 2014 NOLs, and full carry back for NOLs in subsequent years.

- **Elective Single Sales Factor.** The 2009-10 budget package created a permanent ***elective*** single sales factor for apportionment of business income across states. In contrast, prior law averaged a business's proportion of sales, property, and payroll in California (with the sales factor double-weighted) to apportion the California share of multi-state business income. Under this new tax policy, corporations can elect to allocate net income for California tax purposes under the old formula or 100 percent to sales. Businesses that proportionally have fewer sales in California relative to property and payroll will see their taxable income in California fall. This change went into effect in the 2011 tax year. The annual losses projected from this policy change are in excess of $1 billion.

- **Cost of Performance.** The 2009-10 budget package replaced the "cost of performance" rule for corporate taxpayers with a market based rule when the elective single sales factor was enacted. Under the cost of performance rule sales of intangibles and services are assigned to California for tax purposes only if the greater cost of performance of the income producing activity occurs in California relative to other states. The market based rule would have required the sales of intangible goods and services to be used to apportion corporate income to California. The 2010-11 budget package repealed the market based rule returning the state to the old cost of performance rules for sourcing intangibles. The annual losses projected from returning to the cost of performance rule are approximately $100 million annually.

Governor's Budget. The Governor's budget does not include any modifications to tax policy that are part of the overall budget solution. However, the Governor's budget indicates that he will continue to pursue changing current law to make the multi-state corporate income apportionment method mandatory instead of elective and reforming the tax incentives that benefit enterprise zones. However, the Governor has indicated that he will pursue these policy changes separate from the budget as part of a larger job creation effort proposed through policy legislation. These policy changes require a two-thirds vote for enactment.

Elective Single Sales Factor Disadvantages California Based Companies. Allowing corporations to elect the formula they apportion income for tax purposes gives a comparative advantage to out-of-state corporations that have high sales, but low property and payroll invested in California. By allowing the corporation to elect the formula it uses to calculate tax owed, the corporation can then choose the calculation that is most advantageous to their situation. Furthermore, changing to mandatory single sales factor will bring California more in line with other states. Of the 23 states that have adopted single sales factor, only three allow an election. The FTB estimates that the increased tax liability under mandatory single sales factor will generally come from out-of-state businesses that will have higher tax liabilities.

Cost of Performance Rule Advantages Out of State Companies. The “Cost of Performance” rule specifically advantages corporations headquartered outside of California. Moving to a market-based rule reduces the ability of taxpayers to manipulate their sales factor and makes the treatment of intangibles consistent with tangible goods.

Carryback Provision Duplicative. While the carryback policy does conform to federal policy, there are unique circumstances in California that make this policy problematic. Specifically, the Proposition 98 guarantee that funds K-14 education depends on year-over-year growth in General Fund revenues. However, the premise of carrybacks is that corporations can go back and amend prior tax returns to lower tax liabilities and even trigger tax returns. However, the state has no ability to change the Proposition 98 guarantee retroactively to adjust for the amendments to revenues. Secondly, the carry forward policy allowed by current law essentially gets at the same policy goal, which is to average a corporation’s tax liability over a period of time in order to encourage investments that may take multiple years to recover.

Revenue Collections Below Estimates, but Corporate Profits Up. The latest reports on the collection of corporation tax indicate that the state will collect at least $400 million less than the estimates in the Governor’s January budget estimate. This is troubling given the relative growing strength of corporate profits generally. It is likely that some of the estimates related to the permanent tax cuts outlined above are also resulting in larger revenue losses than anticipated. The LAO has reported that it will likely be many years before the full effects of the permanent tax cuts are understood as there is a considerable delay in the reporting of final corporate tax data.

Questions.

- **LAO:** Do you think the lower than expected corporate tax collections are due to the corporate tax cuts enacted over the past three years?
- **LAO:** When will we have better information on the actual cost of the tax cuts enacted over the last several years?

2. Consistent Enforcement by Tax Agencies

Background. Under California law, FTB is responsible for reviewing and evaluating income tax returns of individuals and businesses. FTB has the authority to revise taxpayers' returns and adjust for underpayments as well as assess penalties. Actions can be based on an audit or other means of determination. Once FTB determines that a revision to the tax return is required, it issues a Notice of Proposed Assessment (NPA) to the taxpayer. The taxpayer can file a Protest Letter of this determination with FTB, and supply supporting documentation at this time. If requested by the taxpayer, a protest hearing is held regarding the issue and FTB will then issue a Notice of Action (NOA). In general, taxpayers may file an appeal with BOE after FTB has taken an action to deny a taxpayer's:

- Protest of a proposed deficiency assessment.
- Claim of refund or credit or loss carryover.
- Request for abatement of interest on a deficiency
- Request for the allowance of interest on any claim for refund.

If the taxpayer disagrees with an FTB action, an appeal can be made to the BOE within 30 days of the date of the issuance of the NOA. BOE is a separate government agency that handles all personal and corporate income tax appeals, and is an elected body consisting of four members from districts across the state, plus the State Controller. When the taxpayer files an appeal, the taxpayer and FTB are given an opportunity to provide additional supporting information and file briefs regarding their positions. The taxpayer may also request a hearing. Following BOE's consideration of the law and facts in the appeal, it issues a decision in writing and allows for a request from either party a rehearing within 30 days of the decision. A rehearing is an opportunity for BOE to hear the appeal for a second time if there were mistakes of law or errors made in the original appeal or if new evidence has been discovered. If no rehearing request is made, BOE's decision becomes final in 30 days.

If the taxpayer does not agree with BOE's decision, upon payment of the tax, the taxpayer can file an action against FTB in California Superior Court within 90 days. On the other hand, BOE's decision is final and binding on FTB, so it may not file action against the taxpayer in California Superior Court. After the California Superior Court makes a decision, either the taxpayer or FTB may file an appeal of the decision to the California Court of Appeal, and in some cases, to the California Supreme Court, and, ultimately, the United States Supreme Court.

Staff Comments. Staff finds that current law places FTB in an adverse position compared to the taxpayer. While the taxpayer can appeal an adverse decision of BOE, the FTB has no option to appeal. The two parties in any tax dispute are treated differently with respect to the ability to appeal. In order to allow both the taxpayer and the FTB the same appeal rights, bills have suggested allowing the FTB to file a lawsuit, as a *trial de novo* ('trying a new matter'), in superior court if the FTB disagrees with a BOE action related to a deficiency assessment, a claim for refund, or a disallowance of interest, as specified. This way FTB and the taxpayer would be similarly situated.

Furthermore, staff notes that the BOE does not always publish decisions; there is no statutory or constitutional requirement that they do so. Therefore, there is limited precedent setting guidance to follow, which leaves taxpayers and administrative tax agencies alike at a loss with respect to needed guidance in complex issues. Appeal rights by both sides would tend to create additional opportunities for precedent-setting in the judicial branch along with case guidance.

Generally other states with comparable tax systems to California have equivalent appeals rights for either party. For example, Florida, Illinois, Massachusetts, Michigan, Minnesota, and New

York all have equivalent appeals rights for both the state revenue agency and the taxpayer, although some variation in the exact process does exist among the different states.

Staff notes that the fiscal impact of a process change as suggested above is difficult to assess because it depends on the number and type of cases that are appealed. However, a review of the number of appeals in California and results of court appeals in comparable states suggests that the fiscal impact of equivalent treatment could be in the tens of millions of dollars annually.

Many tax professionals and academics have voiced concerns with the fairness of the California tax system. For example, as indicated in its report, the Commission on the 21st Century Economy recommended the establishment of an independent dispute forum with both sides able to appeal to superior court.

Staff Recommendation. Staff recommends that the Subcommittee adopt placeholder trailer bill language to provide FTB with the ability to file a lawsuit in superior court after an adverse BOE determination.

0860 State Board of Equalization

Background. The Board of Equalization (BOE) is one of California's two major tax collection and administration agencies. In terms of its responsibilities, BOE: (1) collects state and local sales and use taxes (SUT) and a variety of business and excise taxes and fees, including those levied on gasoline, diesel fuel, cigarettes, and hazardous waste; (2) is responsible for allocating certain tax proceeds to local jurisdictions; (3) oversees the administration of the property tax by county assessors; and (4) assesses certain utilities and railroad property. The board is also the final administrative appellate body for personal income and corporation taxes, which the Franchise Tax Board (FTB) administers. The BOE is governed by a constitutionally established board—consisting of four members elected by geographic district and the State Controller.

Governor's Budget. The *2012-13 Governor's Budget* proposes **$518 million** in support of BOE operations, of which **$292 million is General Fund**. The remaining budget consists mainly of reimbursements from local governments and support from various special funds. The proposed level of support represents a net increase of $13 million General Fund mainly from various budget proposals to improve tax collection efforts and a rent increase related to the BOE headquarters building. The efforts to improve tax collection are projected to collect additional General Fund revenues that are owed, but not currently being collected.

The number of personnel-years (PYs) for BOE is budgeted to increase slightly from 4,486 to 4,586.

Tax Gap Reduction Measures

Background. The BOE estimates that the total tax gap for sales and use tax is about **$2.1 billion**. The tax gap is defined as the total tax receipts due to the state less the tax receipts collected by BOE.

The BOE has undertaken several efforts over the last several years to reduce this gap. However, the BOE specifically encourages voluntary tax law compliance and tends to focus its efforts on education and providing assistance to the taxpayer. A December 2011 report from the Board reported on its audit and collection activities related to sales and use tax collection. These efforts are organized as follows:

- **Audit Program.** The audit program ensures businesses report neither more or less tax than required by law and educates taxpayers on proper application of sales and use tax. This program resulted in **$439 million** in additional revenues to the state in 2010-11 and a benefit to cost ratio of 5.2:1.
- **Consumer Use Tax Program.** The consumer use tax program works closely with state and federal agencies in administering the use tax due on non-dealer sales of vehicles, vessels, aircraft and mobile homes. This program resulted in **$62 million** in additional revenues to the state in 2010-11 and a benefit to cost ratio of 10.2:1.
- **Collection Program.** The collection program is oriented towards collecting outstanding tax owed to the state. In 2010-11 this program collected more than **$661 million** in delinquent taxes owed to the state. This program has a benefit to cost ratio of 20.2:1.
- **Return Analysis Unit.** The return analysis unit investigates discrepancies in returns selected for review. Returns are selected for review on BOE's Integrated Revenue Information System. This unit's activity resulted in **$31 million** in additional revenues collected with a benefit to cost ratio of 9.2:1.
- **Compliance Enforcement.** Compliance enforcement focuses efforts on identifying non-filers and under-reporters. These efforts include a program that does desk reviews of U.S. Customs data and agriculture inspection stations data for California destined purchases that owe use tax. The BOE has also implemented a Statewide Compliance and Outreach Program that involves canvassing areas to identify and register businesses that do not have sellers' permits. A Qualified Purchasers Program reviews taxpayers that receive at least $100,000 in gross receipts from business operations but are not otherwise required to register with BOE. In 2010-11, these various compliance efforts resulted in **$135 million** in tax collections that were previously owed, but not collected. These programs collectively have a 5.4:1 benefit to cost ratio.

The BOE's efforts summarized below resulted in the collection of **$1.3 billion** in tax revenues that would otherwise not be collected. However, considerable confusion continues to exist about payment of the use tax. Existing law requires that the use tax is owed by a California taxpayer making taxable purchases even when the seller (online retailer or other out-of-state company) do not collect the tax and submit it to the BOE on the taxpayers behalf. There continue to be billions of purchases made by California taxpayers where no use tax is remitted to the state.

Questions:

- **BOE.** There was recently a unanimous vote by the board to remove Qualified Purchasers from the program that had no use tax to report for three consecutive years. Was there administrative savings related to this board action? If so, how were these savings "reinvested"?
- **BOE.** There has been a suggestion made to staff that there is not a positive benefit cost ratio related to requiring Qualified Purchasers with gross receipts of less than $500,000 from registering, reporting, and remitting the use tax on out-of-state purchases. Can you please provide information on the performance of this tax compliance effort?

2. Tax Gap II

Background. In 2008-09 the BOE received $21 million ($14 million General Fund) to support a budget request referred to as "tax gap". This budget request supported several efforts, including audit improvements, compliance improvements and expanded bankruptcy and out-of-state collection. These efforts resulted in increased collections of $40 million in the first year of implementation. The collection efforts of this initial investment increased to **$84 million** in 2010-11 and an overall benefit to cost ratio of 3.9:1.

Governor's Budget. The Governor's budget includes a part II effort that builds on the tax gap efforts initiated in 2008-09. This new effort would expand the board's audit program and staff resources available to address bankruptcies, and would also initiate a use tax educational outreach campaign. This proposal includes **$4.4 million ($2.9 million General Fund)** to support 18 new positions and is expected to enhance tax collection efforts to the state by **$15 million** in the budget year. The individual components of the proposal are detailed below:

- **Use Tax Educational Outreach Campaign.** This element includes **$3.1 million ($2.1 million General Fund)** and 5.5 positions. Approximately $2.6 million is for one-time expenditures related to a statewide media campaign and professional public relations contract to improve voluntary compliance with the state's Use Tax law. The positions will enhance BOE's current education and outreach efforts, including: (1) establishing a Use Tax Advisory Group; (2) address compliance by both business and tax practitioners and clarify confusion about sales and use tax responsibility; and (3) act as a liaison between external affairs and the tax policy division with respect to technical aspects of the application of use tax and the implementation and administration of use tax programs. The board expects to collect an additional $10 million in taxes annually due to these efforts. The estimate is mainly due to increased Use Tax payments being made on income tax returns. The board estimates that this effort will have a 3.1:1 benefit to cost ratio in the budget year, but that this ratio will increase in out years to 16.6:1.
- **Audit Program.** This request includes **$919,000 ($633,000 General Fund)** and 9.5 positions to augment the existing audit program. The BOE proposes to focus these efforts on desk audits. This proposal is expected to increase tax collections by approximately **$3.4 million** annually for a benefit to cost ratio of 4.2:1.
- **Bankruptcy Collections.** This request includes **$330,000 ($240,000 General Fund)** and 2 positions to augment the existing bankruptcy collection program. These staff resources will enable the state to effectively manage tax recovery from bankrupt debtors. This

proposal is expected to increase tax compliance by approximately **$1.9 million** annually for a benefit to cost ratio of 6.4:1.

Staff Comments. Staff finds the board has had mixed results in conveying a consistent message to taxpayers regarding payment of the Use Tax. For example, last year after the Legislature enacted a new law that was intended to make it more convenient for the taxpayer to pay the use tax owed to the State, some board members sent out press releases from the BOE and authored editorials in major newspapers and blogs opposing this law change. These sort of efforts by Board members further confuse the general public about how they should go about complying with the state's Use Tax law. Given recent efforts to discourage the use of compliance tools by the Board it is unclear how effective this public relations campaign would be, because likely there would be no emphasis on tools the taxpayer currently has to comply with the law.

Furthermore, while there does seem to be general confusion about Use Tax enforcement, the materials provided the committee does not make a convincing case in support for the ultimate success of the media campaign contract. There are no specifics on who the target audience will be or what the overall goals and outcomes would be of a campaign. Furthermore, staff finds that the tax collection data related to the media campaign are highly speculative and there is significant risk that taxpayer behavior would not be changed by a media campaign.

Staff finds that there are other tax enforcement strategies that are likely to be more effective at improving compliance with state tax laws than a media campaign.

Staff Recommendation. Staff recommends that the Subcommittee take the following actions:

- Reject media campaign contract.
- Approve 5.5 positions related to internal education and outreach effort – but make two-year limited-term and require reporting by January 10, 2014 on efforts undertaken by these positions and performance metrics, including benefit cost ratio of this investment.
- Approve request to augment the audit program.
- Approve request to augment the bankruptcy collections program.

3. Use Tax Nexus

Background. Chapter 7x, Statutes of 2011 (AB 28X, Budget) was enacted last year to enable the state to collect use tax on purchases made by California customers from Internet companies that do not claim nexus in California and do not collect use tax on taxable goods sold to California customers. Current law already required that the use tax was owed by California customers regardless of where the product was purchased. This legislation made the following changes to nexus:

- **Long-Arm Nexus.** Revises the state definition of "retailer engaged in business in the state" to be as expansive as permitted under federal law.
- **Affiliate Nexus.** Establishes that contracts out-of-state retailers have with affiliates in California establish nexus for the purposes of collecting use tax.
- **Corporate Nexus.** Requires that any corporation that is part of a "commonly controlled group" of companies that filed corporate income tax as a unitary group of companies, that

has one or more of those companies based in California, is sufficient to establish nexus for the purposes of collecting use tax.

Later in the 2011 session, subsequent legislation (Chapter 313, Statutes of 2011 [AB 155, Calderon]) was enacted to delay the implementation of AB 28x until September 15, 2012, unless Congress authorized states to collect taxes on sales of goods and services to in-state purchasers without regard to the location of the seller. The Director of the Department of Finance must certify to the Legislature whether a federal law has been enacted by July 1, 2012. Amendments in AB 155 also increased the small business exception for affiliate marketing from total sales of $500,000 or more, to those with $1 million or more in total sales.

Governor's Budget. The Governor's budget includes **$3.2 million ($2.1 million General Fund)** to fund 28.3 positions to support the implementation of the use tax nexus changes implemented last year. The BOE is expecting upwards of 2,000 new use tax accounts to be registered under the new nexus laws and the majority of the positions are requested in the external affairs division to support communications with taxpayers, retailers, and tax practitioners as the new laws are implemented. The BOE is using a questionnaire to retailers to solicit information needed to determine if they need to register with the BOE due to changes in the nexus rules.

The Governor's budget assumes that Congress will not enact comprehensive legislation related to the collection of taxes on sales of goods and services to in-state purchasers without regard to the location of the seller. The contents of AB 28x will then be implemented and these policy changes are expected to generate **$50 million** in tax collections.

Staff Comments. Staff finds that the BOE's budget proposal does not specifically address all efforts to enforce corporate nexus and ensure compliance with long-arm nexus. The majority of the budget proposal addresses efforts related to affiliate nexus.

The BOE has indicated that it will hire two auditors in 2014-15 to address the new workload associated with the nexus law changes. The BOE has indicated that this law change could result in 2,000 new registrants. Two auditors for this new workload seems like it would provide only a very cursory review to selected returns filed.

The BOE has reported that the FTB has not provided a complete list of companies that are part of a "commonly controlled group" because of complexities in how the schedules are compiled. Staff finds that FTB is currently implementing a new corporate tax cut that allows credit sharing among companies filing taxes as part of a unitary group so it is unclear why an arrangement cannot be made between FTB and BOE to share data that will enable BOE to fully implement law changes included in AB 155.

Question.

- **DOF:** What is the basis of this revenue estimate? Prior estimates have been as much as $200 million, why is this lower estimate now assumed?
- **BOE:** What is the current status of the federal legislation?

- **BOE:** What strategies will be employed to find retailers that have nexus beyond a self-reporting questionnaire? Will the 12 positions in external affairs employ other strategies for ensuring compliance with the new law?
- **BOE:** Has the board explored experiences from other states in implementing affiliate nexus? What are strategies and best practices in other states that have already implemented this law change?
- **BOE:** What is the current status of getting information on commonly controlled groups from FTB?

Staff Recommendation. Staff recommends that the Subcommittee hold this item open pending additional information on how the BOE will enforce all of the new laws related to nexus.

4. Use Tax – Mandatory Reporting and Remittance

Background. One tax gap strategy first implemented in 2003 was the addition of a Use Tax line on income tax return forms. This line allows businesses and individuals to self-report use tax owed on out-of-state purchases. This policy was first enacted in Chapter 718, Statutes of 2003 (SB 1009, Alpert). Last year the Legislature enacted Chapter 14, Statutes of 2011 (SB 86, Budget) that included the implementation of a "look-up" table that would provide a safe harbor for taxpayers who had not kept track of purchases subject to the Use Tax. The look-up table provides an estimated amount of use tax owed based on a taxpayer's filing and income characteristics.

Governor's Budget. The Governor's budget does not propose any changes to this policy.

Staff Comments. Staff finds that the look-up table has been implemented with mixed success. Currently, there is no requirement that taxpayers that are not required to file a sales and use tax return with the BOE to report qualified use tax on the income tax form to FTB. Furthermore, because there is no mandatory reporting requirement paid tax preparers or certified public accountants are not required to even make an inquiry with their client as to whether or not that client has a use tax liability.

Staff finds that improving compliance on the FTB tax form would be a relatively inexpensive way to improve tax compliance. If a mandatory reporting requirement was in place, the tax preparer community would provide additional attention to this item and ensure compliance on behalf of their clients.

Staff Recommendation. Staff recommends that the Subcommittee adopt placeholder trailer bill language that accomplishes the following:

- Require every person who is not otherwise required to file a sales and use tax return with the BOE to report qualified use tax on the income tax return filed with the FTB.

5. Expansion of Financial Institutions Records Match

Background. Last year Chapter 14, Statutes of 2011 (SB 86, Budget) was enacted so that FTB could implement the Financial Institutions Records Match (FIRM) system to help reduce the tax gap. The FIRM is an information technology project that would require financial institutions doing business in California to match FTB information on delinquent tax and non-tax debtors against their customer records on a quarterly basis. The FIRM is patterned after the FTB's Financial Institution Data Match system, which is a project implemented as a result of federal legislation to identify the assets of delinquent child support debtors.

The FTB can use the new data collection to aid in the collection of debts under the authority of the existing "Order to Withhold" statutes. The proposal would not impact existing law that provides for constitutional due process protections and appeal rights available in either the audit or collection processes. In addition, the legislation required FTB to reimburse a financial institution for its actual costs incurred to implement FIRM, up to $2,500 for startup costs and no more than $250 per calendar quarter thereafter.

Governor's Budget. The Governor's budget proposes to build upon the FIRM program implemented by the FTB and expand FIRM to collection efforts at the Employment Development Department (EDD) and the BOE beginning in 2013. This proposal is expected to result in **$15 million General Fund** in additional tax collections for the current and budget years.

Staff Comments. Staff finds that the FIRM tax collection tool will enable BOE to also collect on sales and use tax debts that are owed the state. Furthermore, the other tax collection agencies can build on the FTB's experience and relationships with financial institutions and minimize the need to establish separate and independent efforts that aid in collection of taxes owed.

Staff notes that the BOE did not prepare nor submit a budget change proposal on pursuing FIRM as a tool for collecting sales and use tax owed the state. However, additional information from the Board indicates that it would cost $523,000 to initiate this effort, including establishing a programmer analyst that would be responsible for preparing and transferring taxpayer data to FTB and ensuring security of the data.

Staff finds that the tax gap continues to be a burden on taxpayers that comply with all the state's tax laws. Staff finds that expanding the FIRM system to BOE would help to reduce the tax gap by using a proven methodology.

Question.

- **BOE:** Why did you not submit a budget change to support this activity?
- **DOF:** If this trailer bill is enacted, do you support a budget augmentation for the board to support this new activity?

Staff Recommendation. Staff recommends that the Subcommittee adopt the Governor's budget proposal and trailer bill language to expand the use of FIRM to BOE collections of sales and use tax owed.

Other Issues

1. Headquarters Building

Background. The BOE Headquarters Building has a long and expensive history of problems. Construction was completed in 1993. The building has been fraught with construction defects causing water leakage, mold, and falling glass. The building has also experienced major system failures, including plumbing and the elevators. A major project was completed in 2006 to help remedy the problems. However, other problems continue and numerous employee complaints and lawsuits have ensued. The BOE estimates that this loss in productivity has resulted in annual revenue loss of approximately $22 million.

Furthermore, the BOE Headquarters building does not adequately meet BOE's space needs. Presently, the BOE staff is spread out over five different locations and the BOE has significantly more positions than capacity at the main headquarters building.

Governor's Budget. The State started the process of purchasing the building from CalPERS several years ago. The State Treasurer's Office finally closed on the bond sale which is financing the loan to purchase the BOE building in November 2011. The rental rates on the BOE headquarters building must increase to cover the additional financing costs related to the bond sale. The Governor has proposed to fully fund the increased rental costs of **$6.2 million ($3.1 million General Fund)** in the budget year. The financing costs associated with this building will significantly increase the annual rent costs from nearly $11 million to over $17 million annually.

Staff Comments. As mentioned above, the number of Sacramento BOE employees far exceeds the capacity at the headquarters building. The BOE had initiated a study with the Department of General Services (DGS) to study the possibility of relocating and consolidating BOE headquarters and annexes somewhere in the Sacramento region. The BOE has indicated that $500,000 was set aside for this study, but only $80,000 was expended. The BOE would like to see this study completed so that they may work on a path to eventually relocate to a building that can accommodate all headquarter divisions in one campus. The BOE has suggested supplemental report language to require DGS to complete the relocation and consolidation analysis, which would include an examination of potential future uses for the current BOE headquarters building.

Question:

- **DOF:** Why was the study never completed by DGS even though funds were allocated to complete the study?

Staff Recommendation. Staff recommends that the Subcommittee take the following actions:

- Approve the rent increase.
- Request more information from the Department of General Services on the status of the relocation and consolidation study for BOE.

2. Dell Computer Settlement

Background. The BOE has been named as the cross defendant in the class action case of *Diane Mohan v. Dell*. This case is currently pending in San Francisco County Superior Court. The case involves the collection of use tax by Dell Computers on the extended warranty service contracts during the years 2000 to 2008. The extended warranty service contract is an intangible and the court found that the use tax was collected erroneously. The class action attorneys have estimated as many as 10 million transactions over this time period. The BOE's experience is that about 20 percent actually completed refund claims and submitted them for payment, but this could still mean hundreds of thousands of claims that need to be processed.

The BOE has indicated that it does not have the staff to process these additional transactions. However, to date no final determinations or orders have been issued by the court about who will pay for these transactions.

Governor's Budget. The Governor's budget includes a "placeholder" request of **$3.2 million** ($2.1 million General Fund) in the budget year to support 14.5 positions to address the additional workload associated with processing the Dell refunds. The majority of these positions are proposed as limited-term, but the request does include two permanent positions. The positions are proposed to be allocated as follows:

- 2 tax auditors for 2-year limited-term to audit large and medium sized refund claims.
- 1 business tax specialist for 2-year limited-term to audit largest and most complex claims.
- 1 business tax specialist for 1-year limited-term to coordinate, initiate, and review refund processing.
- 3 tax technician IIIs for 2-year limited-term to search for better addresses for returned warrants and respond to inquiries by class action administrator.
- 3.5 tax technician IIIs for 1-year limited-term to validate name/address changes and process correspondence related to claim exceptions.
- 1 supervising tax auditor II for 2-year limited-term to manage the overall refund project.
- 1 associate accounting analyst permanently established to review refunds and reconcile claims filed and claims paid.
- 1 associate administration analyst permanently established to maintain claim databases.
- 1 tax technician II for 2-year limited-term to manage 30,000 additional calls in the call center expected from the class action lawsuit.

Staff Comments. The BOE has indicated that there is a signed settlement agreement in the Dell Computers case. The BOE has indicated that notices will be mailed to Dell customers by July 16, 2012 and that customers will have until mid-September 2012 to opt out of the class action lawsuit. The customers will be able to file claims through January 16, 2013. The BOE estimates that the majority of the claims will be paid in 2012-13.

It is unclear why some of these positions are needed for two years, since the settlement calls for deadlines in the budget year. Furthermore, it is unclear why any permanent positions should be approved for this workload, which is short-term.

Questions:

- **BOE:** Given that the settlement agreement was signed after the budget proposal was developed, are there any amendments to the budget proposal? If all claims must be submitted in the budget year – why are some positions needed for two years?
- **BOE:** Why are there two permanent positions requested for this temporary workload?

Staff Recommendation. Staff recommends that the Subcommittee hold this issue open pending a revised proposal that more accurately reflects the actual settlement agreement timeline.

3. State Responsibility Area Fire Prevention Fee Collection

Background. Last year, Chapter 8x, Statutes of 2011 (AB 29x, Budget) was enacted to implement a fire prevention fee on owners of habitable structures in state responsibility areas (SRAs). This legislation requires a fee of $150 per structure to support the fire prevention activities of the California Department of Forestry and Fire Protection. The BOE is assigned the responsibility of collecting the fee. The fee is expected to generate $50 million in the current fiscal year and $85 million in the budget year.

Governor's Budget. The Governor's budget includes **$6.4 million** in reimbursements and 57 positions in the budget year to administer this program.

Staff Comments. Staff finds that the legislation enacted last year requires the California Department of Forestry and Fire Protection to submit to BOE a list of names and addresses of those that are required to pay the fee. Therefore, it is unclear why BOE requires the number of permanent staff being requested. It is expected that there would be startup costs associated with implementing a new fee collection program like the SRA fee. However, the BOE's proposal does not reflect much of a decline in ongoing resources needed to support this program.

Staff notes that the Assembly Budget Subcommittee #4 has already taken action on this item and approved the staffing package on a two-year limited-term basis and also approved reporting language to get more information on actual experience related to collecting the SRA fee.

Question:

- **BOE:** Why does ongoing program administration cost the same as the initial startup costs?

Staff Recommendation. Staff recommends that the Subcommittee hold this item open.