AGENDA

ASSEMBLY BUDGET SUBCOMMITTEE NO. 4 STATE ADMINISTRATION

ASSEMBLYMEMBER JOAN BUCHANAN, CHAIR

TUESDAY, MARCH 20, 2012
1:30 P.M. - STATE CAPITOL ROOM 447

ITEMS TO BE HEARD

CONSENT

0968 CALIFORNIA TAX CREDIT ALLOCATION COMMITTEE

The California Tax Credit Allocation Committee (CTCAC) allocates federal and state tax credits used to create and maintain affordable rental housing for low-income households in the state by forming partnerships with developers, investors and public agencies. CTCAC works with public and private entities to assist with project development and monitors project compliance. CTCAC coordinates its functions with state and local housing fund providers and with private fund investors in the provision and maintenance of affordable housing. CTCAC consist of seven members from state and local governments, with the State Treasurer serving as chair. Other members are the Governor (or Director of Finance), State Controller, Director of Department of Housing and Community Development, Executive Director of California Housing Finance Agency, and two representatives from local government. The CTCAC budget calls for $6.0 million and 39 positions for 2012-13. This represents a slight increase from the 2011-12 funding level of $5.6 million and 37 positions. CTCAC is funded through fees generated by the issuance of debt and reimbursement, with no General Fund support.

CONSENT ISSUE 1: COMPLIANCE MONITORING STAFF AUGMENTATION

The CTCAC budget includes $247,000 and two additional full-time permanent staff to maintain adequate monitoring presence and ensure compliance. The proposal does not have a General Fund impact as fees collected through the program support the activity. As part of its activities, CTCAC is required to perform Internal Revenue Code (IRC) compliance monitoring services. Developers rely on federal, state, and local funding sources to build affordable housing. Since the developers rely on the associated credits as being valid, and to ensure federal compliance and properly maintained properties, CTCAC must perform on-going monitoring activities. CTCAC is the largest nationwide user of the federal low income housing tax credit (LIHTC) program. CTCAC has allocated more than $14 billion in tax credits between 1987 and 2010, which have been used to develop 260,000 units of affordable housing throughout the state.

CONSENT ISSUE 2: COMPLIANCE MONITORING ASSET MANAGEMENT CONTRACT FOR ARRA PROJECTS

The CTCAC budget includes $472,500 for outside asset management services. The proposal does not have a General Fund impact as fees collected through the program support the activity. The American Reinvestment and Recovery Act (ARRA) included the tax credit exchange program (TCAP) and Section 1602 program. Both of these programs were designed to stimulate the production of rental housing for low-income families and households. Part of the ARRA mandate requires that CTCAC preform asset management functions and ensure compliance, long-term viability, and financial health of the projects funded. CTCAC staff will provide additional site visits to monitor ARRA funded projects, and outside services will be required for the management component.

0985 CALIFORNIA SCHOOL FINANCE AUTHORITY

The California School Finance Authority (CSFA) provides facilities and working finance capital to school districts, community college districts, county offices of education, and charter schools. CSFA consists of the following members: State Treasurer, who serves as chair, the Superintendent of Public Instruction, and the Director of the Department of Finance. CSFA currently administers and oversees the following programs: Smart Bonds, Charter Schools Facilities, Charter Schools Facilities Incentive Grants and Credit Enhancement and Qualified School Construction Bonds.

CONSENT ISSUE 3: FEDERAL CHARTER SCHOOL FACILITIES INCENTIVE GRANTS PROGRAM

Budgeted expenditures for 2012-13 are $21.3 million, representing a slight increase from the current year expenditures of $21.2 million. There is one position request (but no additional funding) to administer the Charter Schools Facilities Grants Program. The position will verify eligibility and application completeness, verify ongoing eligibility and process grant funds, collect and maintain program data, and develop changes to program regulations. The position will replace retired annuitants that had been retained to do the tasks.

0840 STATE CONTROLLER'S OFFICE

CONSENT ISSUE 4: INTEGRATED DATA MANAGEMENT SYSTEM COST INCREASE

The State Controller's Office (SCO) has requested additional resources in 2011-12 and 2012-13 to accommodate cost increases associated with the Integrated Data Management System (IDMS). The support will fund Office of Technology (OTech) Data Center cost, and consists of $980,000 ($224,000 General Fund, $475,000 reimbursements, and $281,000 special funds) in the current year and $1.1 million ($262,000 General Fund, $552,000 reimbursements, and $326,000 special funds) in 2012-13. The request for 2011-12 resource allocation was received through the Section 28.50 process in December 2011.

The SCO has requested additional support to maintain an existing information system for three departments (State Controller's Office, California Highway Patrol and California State Teachers Retirement System) while these departments complete their own technology improvements. OTech will no longer offer IDMS system as a shared service as of March 31, 2012. The service will be offered as a dedicated service to the three agencies continuing to use this system. As part of the SCO ongoing technology improvements, the IDMS capabilities will be transitioned in the future.

The SCO has indicated that there are two statewide project efforts under way that would allow for the transition of the IDSM capabilities—the SCO's MyCalPAYS and the FI$CAL project. The SCO view is that IDSM contract with OTech should remain in place until these new systems can be used. The total annual cost of this dedicated system is approximately $2.2 million.

CONSENT ISSUE 5: INCREASED AUDIT WORKLOAD

The SCO is requesting additional resources to conduct audits for three federal programs. The request is for $2.1 million ($1.4 permanent funding and $673,000 one-time) in reimbursement authority to support 12.6 existing positions and 7.4 new positions beginning in 2012-13. The proposal will enable the SCO to conduct ongoing audits involving federal programs and increased audits to accommodate an increase in workload and ensure federal compliance.

Maintaining (and in some cases increasing the presence) of auditing, is requested with respect to the following program efforts:

1. Vendors participating in the Women, Infants, and Children (WIC) program administered by the California Department of Public Health (CDPH). This request is for the continued support of 12.6 positions through $1.3 million in reimbursements in order for CDPH (which contracts with the SCO) to maintain the increased auditing requirements of the US Department of Agriculture (USDA) which runs the WIC program. The increased workload is expected to continue indefinitely.

2. CDPH financial statements, single audit of the Safe Drinking Water Revolving Fund, and the CDPH's federally funded Public water System Supervision grant. This request is to continue the funding for 1.1 positions and $92,000 in reimbursements to continue permanently this position. The auditing presence is required in order for the state to receive federal grant funding of $75 million annually for the program.

3. California Department of Transportation (CalTRANs) construction projects funded by the American Recovery and Reinvestment Act (ARRA). This proposal is continue for one additional year, 6.3 positions, and $673,000 in reimbursement authority to perform audits of projects funded through ARRA. It is anticipated that there will be additional ARRA construction costs incurred through 2012-13, which would require an auditing presence for federal purposes.

VOTE-ONLY

0860 BOARD OF EQUALIZATION

VOTE-ONLY ISSUE 1: PERMANENT POSITIONS FOR NATURAL GAS PUBLIC PURPOSE PROGRAMS SURCHARGE

The budget includes a request for $227,000 in special funds for making permanent 2, two-year, limited-term positions for additional workload associated with the surcharge on natural gas consumed in the state. The surcharge revenues fund low-income rate assistance, weatherization, energy efficiency, conservation, and public interest research programs. Additional resources and positions will be devoted to educational outreach and audits. The activities are expected to result in additional revenues to the program of $14 million. The workload consists of identifying, registering, auditing, return processing and verifying payments collected by BOE from the natural gas utilities and consumers of natural gas.

The BOE has administered the surcharge since 2001. Prior to the approval of the limited-term positions in 2009-10, the BOE received funding of $400,000 to cover the technology costs, associated with the program, but no positions. The limited-term positions were part of a three-year pilot to identify, register, audit, and verify payments to the program. As part of this earlier BCP, additional revenue was projected to be $4.4 million in 2009-10. The amount of additional revenue actually received was $14 million in 2009-10 and $18.5 million in 2010-11.

0840 STATE CONTROLLER'S OFFICE

VOTE ONLY ISSUE 2: INCREASED ACCOUNTING AND REPORTING WORKLOAD

The State Controller's Office (SCO) has an extensive audit program in order to monitor and evaluate the financial performance of various state programs. To this end, the SCO reports added workload related to statewide cash management accounting and local government cost plan reviews. The budget request related to these additional activities is $200,000 General Fund and 2.1 positions for the former and $107,000 in reimbursements and 1.1 positions for the later.

Cash Management. The first request is to continue 2 existing two-year, limited-term positions for an additional two years. Prior to July 2008, SCO had five positions devoted to managing the state's cash. With the development of the state's budget tightness over the last few years, a position was added as part of the 2008-09 budget and the 2 limited-term positions added as part of the 2010-11 budget. The SCO reports that over the same period of time, the actual work hours required for the activity increased from 9,342 to 14,510. It expects this level of activity to continue over the next few years. The cash management activities have become increasingly important as the state's cash margins have narrowed. As such, the cash management team has focused efforts on monitoring daily cash balances to accommodate the issuance of warrants, expediting certain claims when cash permits, addressing claim backlogs, examining claims to determine sensitivity, and understanding priority/non-priority claims.

County Cost Claims. The SCO has authority for reviewing negotiating, and approving countywide cost allocation plans for the Department of Health and Human Services. These activities include establishing principles for determining costs for federal awards, developing information for supplemental cost plan instructions, and reviewing procedures for direct billing of central services. The program is funded by reimbursements from the California Department of Social Services (DSS) per an interagency agreement and consists of 5 positions. The increased workload that the BCP addresses is designed to accomplish timely desk and field reviews and approvals of procedures and methodologies for direct billing, pursuant to a federal mandate regarding cost allocation plans. DSS has requested the SCO increase its reviews in order to comply with the federally-funded county cost allocation plans and concurs with SCO that the workload requires an additional position.

Given the actual increase in workload generated by the budget problems in the last few years, the request for continuation of limited-term positions related to cash management for an additional two-years appears to be warranted. Unfortunately, given the state budget condition, the necessity of maintaining current staff in cash management activities is warranted. The county cost claim additional workload is a result of federally imposed mandates for increased overview of reimbursable claims and has been concurred in by the agency providing the services.

ITEMS TO BE HEARD

0840 STATE CONTROLLER'S OFFICE

The State Controller is the Chief Fiscal Officer of California. The State Controller's Office (SCO) is a separately established constitutional office. The Controller chairs or serves on 81 state boards and commissions, and is charged with duties ranging from participating in the oversight of the administration of the nation's two largest public pension funds, to protecting the coastline and helping to build hospitals. The Controller provides fiscal control for, and independent oversight of, more than $100 billion in receipts and disbursements of public funds. In addition, the Controller offers fiscal guidance to local governments, and performs audit functions to uncover fraud and abuse of taxpayer dollars. The SCO's primary objectives are to:

- Account for and control disbursement of state funds.
- Determine legality and accuracy of claims against the State.
- Issue warrants in payment of the State's bills.
- Administer the Uniform State Payroll System.
- Audit and process personnel and payroll transactions for state civil service, exempt employees, and state university and college system employees.
- Audit state and local government programs.
- Inform the public of the State's financial condition.
- Administer the Unclaimed Property Law.
- Inform the public of financial transactions of city, county, and district governments.

The SCO is funded through the General Fund as well as over 300 special funds and accounts and reimbursements. The Governor's Budget calls for resource support of $245.8 million ($88.6 million General Fund) and 1,544 personnel years. This represents a substantial increase from the current year, due largely to the 21st Century Project described below. In addition, several other initiatives and workload increases are budgeted for 2012-13.

2012-13 Governor's Budget

Fund Source (millions)	2010-11 Actual	2011-12 Projected	2012-13 Proposed	BY to CY Change	% Change
General Fund	$71.9	$75.4	$88.6	$13.2	17.5
Unclaimed Property Fund	26.8	27.9	33.3	5.4	19.4
Central Service Cost Recovery Fund	20.1	20.5	20.4	-0.1	-0.5
Other Special Funds and Accounts	45.0	40.0	44.8	4.8	12.0
Reimbursements	53.1	59.3	58.4	-0.8	-1.4
Total Expenditure	$216.9	$223.2	$245.8	22.6	10.1
Positions	1,276.9	1,451.3	1,544.5	93.2	6.4

Two important activities will characterize the SCO in the budget year. First and foremost, is the ongoing development of the 21st Century Project, described further below. The 21st Century Project is an ambitious revamp of the state's entire payroll processing and related services such as employment history, position management, and leave accounting. The project is a complex and expensive multi-year, multi-phase project requiring a substantial commitment of resources. Second, the SCO is a key player in the wind-down of redevelopment agency (RDA) affairs. RDAs are dissolved effective February 1, 2012 with any remaining obligations to be paid off by property tax increment. The SCO will play a crucial role in auditing the activities and providing guidance to local officials with respect to activities related to the disposition of former RDA assets and the maintenance of various required trust accounts.

ISSUE 1: 21ST CENTURY PROJECT

The 21st Century Project is an extensive revamp of the state's entire payroll processing and related services such as employment history, position management, and leave accounting. The SCO is responsible for paying approximately 294,000 state employees through its existing legacy system. This employee population includes state civil service employees, as well as elected officials, judicial council members, judges and the California State University System (CSUS) employees. To support the state's ongoing needs, the Legislature in 2004 authorized the development and purchase of a new system that would provide a technically-advanced solution and create the functions required to support future growth and increased complexities in state government.

This request is for 181 one-year, limited term positions and $81.4 million, for additional costs of the program. The funding request is composed of $46.9 million General Fund, $33.5 million special funds, and $1.0 million reimbursement authority. Of the 181 positions, 111 are a continuation of positions approved in a 2011-12 BCP. An additional 70 positions will address new project workload identified in Special Project Report (SPR) 5. These positions are be distributed to those areas (described below) as follows: 16 position in project management, 41 positions in business operations, 49 positions in technical operations, 50 positions in organizational change management, 10 positions in business transition, and 15 positions in other administrative functions. The SCO has indicated that these positions will likely be revised downward, with a corresponding budget request decrease, based on input from California technology Agency (CTA).

BACKGROUND

Project Governance

Project Governance activities are designed to provide strategic leadership, funding, and support while assuring a culture of accountability, transparency, and oversight. The Project Governance bodies include a Steering Committee, Business Transformation Council, and Configuration Standardization Committee.

- **Steering Committee**. The most senior group in the project governance structure is the Steering Committee. This group represents an executive body within the State of California that has a stake in the project. The Steering Committee supports the project by making required statewide decisions on processes and policies. To effectively enable change and manage issues that cross departments, the Steering Committee is responsible for the strategies required for a State government implementation. The committee's responsibilities are that business objectives are achieved, that an effective structure exists to consider the interests of stakeholders, that the state/vendor relationship is optimized, and that the project remains under control.

- **Business Transformation Council**. The Business Transformation Council is an advisory group for key business-related issues that affect the way the State operates as it transitions to the project. Its focus is primarily on the adoption by the end-user organizations' HRMS/Payroll functions. The council may recommend changes to State business regulations and processes to ensure that department interests are represented in system design and reflect uniform best practices. The council examines issues that meet certain criteria and can submit change requests for the project.

- **Configuration Standardization Committee.** The Configuration Standardization Committee is an advisory group that deals with issues that directly affect the configuration of the project. The committee provides guidance and recommendations to the project teams and interface partners regarding potential opportunities for standardizing business practices. The goal of the committee is to meet stakeholder business requirements while limiting enhancements to the project to minimize future costs.

Project Management

The Project Management Office is composed of teams with the objective of moving the project toward successful implementation. The office's day-to-day activities and direction to staff include administrative support with budgets, funding and contracts as well as ensuring control agency reporting and compliance. In addition, project risks, issues, costs, and status reporting are developed, monitored, and controlled by the office. A quality assurance team performs its duties using methodologies designed to measure the accuracy and success of the project implementation. Advisors with expertise in large-scale IT projects are on hand to provide additional guidance.

Business Operations

The Business Operations team provides expertise in all functional areas of project. These areas include benefits administration, leave accounting, organizational management, payroll processing, personnel administration, and time management. Business operations also conducts the unit and integration testing of the project system as it is developed. Business operations conducts the analysis of human resources management and payroll processes to validate and document business process design. In addition, business operations configuration activities will align SAP system programs with the State's business processes and identify customization of SAP functions.

Technology Operations

The Technology Operations team provides expertise for all technical requirements for the project. Technology operations is responsible for implementation and operation of project software and hardware, security configuration and validation activities, business warehouse, portal, user roles/authorizations, extraction of legacy data for loading to SAP, development of workflow, and the full development life-cycle activities for reporting, interfaces, enhancements, of SAP programs to ensure the State's business process are met.

Organizational Change Management

Preparing for change is essential for a successful transition of people to new technology and business processes. The organizational change management team provides expertise in preparing the State workforce for the implementation of the project. It works in partnership with the departments through the areas of communications, workforce transition, deployment, and end user training to ensure that people receive training and support to be successful in their new environment.

STAFF COMMENTS/QUESTIONS

The 21st Century Project has experienced considerable problems in the past—some related to the magnitude and complexity of the project and some related to the consultants hired to work on the project. Following the termination of a contract with a vendor (BearingPoint) in January 2009 for failure to meet contractual obligations, the SCO awarded a new contract to SAP in December 2009, which was approved in February 2010. After some delay in the execution of the contract, an update to the SPR 4 allowed for certain limited go-live activities to occur in September 2011.

Delays have again been encountered, and SCO proposes for this phase of the project to be implemented June 2012. This is a nine-month delay from the amended SPR 4 and 12-month delay from the approved SPR 4. The most recent SPR 5, submitted in November 2011, incorporates these dates. SCO reports that it could accelerate the total go-live, roll-out, but this would substantially increase the system risks. SCO reports that this acceleration would result in "substantial resource over-allocation, particularly from the functional team." In other words, this plan may be too much, too soon.

In 2005, the Legislature approved the project with an estimated total cost of $130 million. Total project costs provided in SPR 4 were $305 million, largely based on program additions. This estimate had increased to $370 million by the date of SPR 5. The increase is comprised of $23.2 million in personal services and $43.9 million in OE&E (the increase in consulting and professional services component of OE&E was $29.0 million). The chart below indicates actual costs to date and project costs in the future. According to the pro-formas presented below (estimated costs in shaded area), 2012-13 will be the high cost year at $81.4 million, as reflected in this BCP.

21st Century Project Costs and Funding ($ millions)

Year	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Project Costs	1.4	4.9	11.6	35.8	19.1	19.6	31.4	65.6	64.0	81.4	33.2	5.1	370.2
General Fund	0.0	0.0	0.0	18.1	9.9	11.8	16.2	30.3	34.5	46.9	6.5	0	174.2

Subsequent to the preparation of the BCP, the CTA reviewed the project as compiled by SCO and in conjunction with the SCO reduced the request by $1.6 million and reduced the proposed number of new positions by 29. Once the revise proposal is reviewed by DOF, it will be provided to the Legislature for action. Staff recommends this item be left open pending the decision by DOF on cost revisions for the proposal.

ISSUE 2: UNCLAIMED PROPERTY INSURANCE WORKLOAD

The SCO has requested $1.3 million from the Unclaimed Property Fund and 13.7 positions in the budget year, and $1.1 million from the Unclaimed Property Fund and 11.6 positions for 2013-14. For 2012-13, this will consist of 11.6 two-year, limited term positions and 2.1, one-year, limited term positions. The SCO states that the augmentation is necessary to address increased workloads resulting from non-compliant businesses, which fail to meet requirements necessary to restore property to property owners. The additional positions will be used to evaluate and address issues related to: owners not receiving death benefits and annuities to which they are entitled from the insurance industry; and, property, which has been remitted to the SCO without a Holder Remit Report.

With respect to the life insurance-related proposal, the request is for 11.6 two-year, limited-term positions for additional audits and increased audit activity on an on-going basis, cross-matching of commercial data bases with owners/beneficiaries, and additional notifications to owners. The issue related to noncompliance with Holder Remit Report requirements would be addressed by 2.1 one-year, limited term positions to conduct research related to the unclaimed property, process the property for purposes of posting information, contact the holder for additional information, as well as other related activities. The positions consist of program analysts, program technicians and a manager.

BACKGROUND

Under current law, the SCO is responsible for safeguarding unclaimed property until it is returned to the lawful owner. After a period of time, generally three years, property escheats to the state. The property owner may file a claim for the return of the property at any time in the future. There are several ways, both before and after the property is escheated to the state, for property owners to be notified of property being held including mailed notifications, website information regarding property held, and a toll free number. However, the success of the program is also dependent on the compliance of businesses with unclaimed property law. In recent years, there have been legislative and system changes, which have increased the workload in the areas of financial accountability, corporate actions, and the collection of securities. The goal of the program and the resource enhancement is to expedite the return of property to owners by increasing the ability of the SCO to preserve the integrity of the ownership trail.

The current proposal will seek to address two identified problems with the program:

- **Insurance Companies.** The SCO has conducted audits related to insurance companies that reveal practices that have prevented owners from receiving certain benefits to which they are entitled. Specifically, audits have indicated that rights to certain property (death benefits and annuities) have not been deemed to be unclaimed property and insurance companies have not gone through the required notification process. Owners of such benefits have not been notified nor has the SCO. Since notice has not been given and the SCO does not have the property on file, the property is seldom conveyed to the lawful owner.

- **Holder Remit Reports.** Some holders of property have submitted unclaimed property to the SCO without a Holder Remit Report that details information about the individual owners and property amounts. In the most recent three-year period, 1,582 remittances valued at $116 million have been made without the required report. Without such a report, the SCO is unable to take effective and necessary steps to locate the owner. The reporting requirement was further clarified in legislation last year.

STAFF COMMENTS/QUESTIONS

The insurance company related portion of the proposal is constructed based on workload, and arrives at the resources necessary to process and complete an estimated number of cases. The proposal uses the average number of under-reported properties from the audit results, and then applies percentages of property owners who would be contacted pre-escheat, as well as other assumptions regarding other insurance companies not included in the audit. Given the number of assumptions and estimated parameters, the results of the program could vary from the estimate provided. Assuming the program is up and running with sufficient results, the committee may request that the SCO report the results to the Legislature next year with suggestions for improvements.

ISSUE 3: FRAUDULENT CLAIMS DETECTION AND PREVENTION PROGRAM

The SCO has requested $2.3 million in permanent funding from the Unclaimed Property Fund and 17.9 permanent positions to establish a fraud detection unit within the Unclaimed Property and Information Systems Divisions. The fraud detection approach will include database application changes and enhancements to implement upfront authentication activities, contracted services that would perform independent verification for certain claims, and a fraud unit of analysts who would develop and implement protocols for fraud detection.

According to its statistics, fraudulent claims show a very erratic pattern over the last fours, ranging from 2 in 2007-8 to 1,017 in 2010-11. The dollar amount of theses fraudulent claims was $122,470 and $3.3 million for each of those years, respectively. On the other hand, the SCO was successful in detecting a good number of these claims, since its data indicates that only $2.9 million was paid out in fraudulent claims between 2000 and 2011. SCO has conducted an analysis of fraud in other industries and has reviewed efforts in other states. Based on the application of these data, SCO estimates that the actual number of fraudulent claims would be on the order of 7 percent, or $17.5 million of about $250 million in annual claims.

STAFF COMMENTS/QUESTIONS

It is not clear that the data used for various industries (health care and property insurance) are applicable in the context of unclaimed property. In addition, SCO data indicates that only $2.9 million in fraudulent claims were paid between 2000 and 2011, out of $6.2 million fraudulent claims filed. Understanding that estimation is difficult in this context, the SCO may find a better means of looking at past data and claims to get a sense of the actual number and value of fraudulent claims. Once the scope of the problem is identified, the creation of models that would lead more fruitful auditing and detection of claims could be initiated. This approach is generally used in the tax field in order to detect ineligibility for tax credits, excessive deductions, and transfer-pricing abuses. The committee may want to explore whether a smaller pilot should be established to help define the problem more thoroughly and develop a systematic approach.

ISSUE 4: REDEVELOPMENT DISSOLUTION-RELATED WORKLOAD

Through the Section 28.00 process, the SCO has requested additional funding to address increased responsibilities associated with the dissolution of Redevelopment Agencies (RDAs) across the state. The request is for $640,000 increase in reimbursement authority and 25 audit, 1 accounting and 1 legal position. The SCO indicates that additional on-going funding will be required through the end of the 2012-13 budget year. The audit staff will review the financial activities of roughly 400 RDAs that occurred between January 1, 2011 and February 1, 2012; the accounting staff will review the collection activities of the RDAs; the legal staff will ensure compliance with judicial orders. The annualized cost of the request would be roughly $3.8 million. Funds required from the augmentation would be categorized as administrative costs under the legislation and would be payable from the property tax increment. The workload is based on audit review of each of the RDAs and the successor agencies.

BACKGROUND

As a result of legislation adopted last year, and subsequent decisions by the State Supreme Court, RDAs were dissolved as of February 1, 2012. Between the time, the Governor proposed the elimination of RDAs as part of his 2011-12 Governor's Budget and dissolution, RDAs engaged in activities including the transfer of assets that need to be reviewed. The SCO is responsible for ascertaining the validity of such transactions and preserving public assets. In addition, as a result of this dissolution, extensive measures need to be undertaken by the successor agencies to the RDAs and the county auditor-controllers, including the disposal of assets and establishing accounts for payments due on RDAs debts. The SCO is responsible for oversight and guidance regarding numerous aspects of this process.

STAFF COMMENTS/QUESTIONS

Former RDAs maintained substantial resources and assets that have been conveyed to the successor agencies. During the period between the Governor's proposal to dissolve agencies and the actual date of dissolution, some real property and other assets may have been disposed of, even though the RDAs were under a freeze. The purpose of the legislation was to redirect property taxes to local governments and convey assets in a manner to maximize the value for purposes of schools, counties, cities, and special districts. Given this, and the magnitude of the assets at stake, the temporary positions requested are reasonable.

0860 BOARD OF EQUALIZATION

The State Board of Equalization (BOE) is comprised of five members: four members each elected specifically to the board on a district basis, plus the State Controller. The BOE administers the sales and use tax (including all state and local components), oversees the local administration of the property tax, and collects a variety of excise and special taxes (including the gasoline tax, insurance tax, and cigarette and tobacco products taxes) and various fees (including the underground storage tank fee, e-waste recycling fee, and fire prevention fee). The BOE establishes the values of state-assessed property, including inter-county pipelines, railroads, and regulated telephone, electricity, and gas utilities. The BOE also hears taxpayer appeals of FTB decisions on personal income and corporation taxes.

The Governor's budget proposes resource support of $518.1 million ($291.6 million General Fund), and 4,586 positions for the BOE in fiscal year 2012-13, as shown in the following table. The budget proposes a total funding increase by $26.0 million (5.3 percent), and General Fund support increase of $12.9 million (4.6 percent), compared with spending estimates for the current year. Proposed staffing in the budget would increase by 99.8 positions (2.2 percent) from the current-year estimate.

2012-13 Governor's Budget

Fund Source (millions)	2010-11 Actual	2011-12 Projected	2012-13 Proposed	BY to CY Change	% Change
General Fund	$232.6	$278.7	$291.6	$13.0	4.6
Special Funds	57.8	67.5	76.8	9.3	13.8
Reimbursements	135.2	145.9	149.7	3.8	2.6
Total Expenditure	$425.6	$492.1	$518.1	26.1	5.3
Positions	4,021.8	4,486.4	4,586.2	99.8	2.2

The BOE is responsible for overseeing and administering taxes that contribute a significant share of state revenues, as well as various local revenues. Two overriding concerns have developed over the last couple of decades and the more recent budget difficulties have exacerbated these problems.

- First, there is a significant 'tax gap'—defined as the difference between taxes owed and taxes paid—for taxes administered by BOE. The ability of the agency to ensure compliance with various taxes and to enforce such compliance when necessary has become increasingly important. There are a number of items in the budget that address this issue as discussed below.

- Second, technology has become vital in ensuring access to information, reducing processing and enhancing performance for the agency. The board continues to lag in this area and should developed alternative methods for financing and implementing technology improvements. The state other major tax agency—the Franchise Tax Board—has made strides in this area.

ISSUE 1: SALES AND USE TAX—TAX GAP II

The budget provides for additional activities to address the continuing tax gap for the sales and use tax and other taxes administered by the BOE. The initiative funded by the additional resources consists of an educational campaign regarding the use tax, additional desk audits of registered taxpayers, and expanded bankruptcy collections. The budget provides $4.4 million ($2.9 General Fund and $1.5 million Reimbursements) and an additional 18 positions as part of this program in 2012-13 and $1.7 million ($1.2 million General Fund) for 2013-14. The efforts in this area are expected to result in additional General Fund revenues in the budget year of $10 million, plus added special fund and local government revenues, for a total of approximately $15 million.

The proposal consists of the following programs that address tax gap issues related to the use tax and registered taxpayers:

- **Use Tax Educational Outreach Campaign.** This element addresses voluntary compliance with the use tax and requests $3.1 million ($2.1 General Fund) and 5.5 permanent positions to provide on-going outreach and education efforts to generate additional compliance and generate additional revenues of $9.7 million, based on an increase in tax filings. In addition to the positions, the request includes $2.5 million for one time funding of statewide media/marketing campaign. About $1.1 billion of the $2.3 billion tax gap is due to non-payment of use tax owed.

- **Registered Taxpayers.** This element is targeted at registered taxpayers that either under-report their sales or use tax or report the tax but fail to pay the amounts due, and consists of two components: (1) For the desk audit initiative, this request is for $919,000 ($633,000 General Fund) and 9.5 permanent positions. The program will expand the number of desk audits that can be completed, especially using third-party data that has become available. The initiative is expected to generate revenues of $3.4 million annually; (2) For the bankruptcy initiative, the request is for $330,000 ($240,000 General Fund); and, 3 permanent positions to identify and effectively manage tax recovery for bankrupt debtors. The bankruptcy workload increased in recent years and the proposal will address the necessity of timely filings by the department. About $560 million of the $2.3 billion tax gap is attributable to registered taxpayers.

BACKGROUND

As part of the 2010-11 Budget, BOE received additional resources for the Tax Gap I initiative. This initiative encompassed five components: in-state service business compliance, internet sellers, audit improvements, compliance improvements, and expanded bankruptcy/out-of-state collection. The benefit:cost ratio of this effort of the last three years was roughly 3:1. In the most recent full year—2010-11—costs were $21.4 million with additional revenues of $84 million, for a benefit:cost ratio of 3.9:1.

STAFF COMMENTS/QUESTIONS

With respect to the educational outreach and media campaign, the focus may be tightened somewhat in order to target appropriate groups. The nature of the firm to be retained for this exercise, and the likelihood that it will meet with success, is at best unclear in the material provided. In addition, there has not been a convincing case made that the nature of this effort requires an on-going commitment of resources with respect to the personnel element. The committee may want to direct that the media consult aspect of this proposal not be approved and the positions for this initiative be funded on a limited-term basis.

Several years ago, the BOE developed a comprehensive assessment of the tax gap for the taxes it administers along with general strategies to narrow the gap. Since that time, the BOE has proposed and been funded for several specific programs to address this compliance issue. The legislature may request that the BOE update this plan and assess overall progress that has been made to date.

ISSUE 2: DELL COMPUTERS SETTLEMENT

The requests $3.1 million ($2.1 General Fund) and 14.5 positions in 2012-13 and $905,000 ($593,000 General Fund) and 10 positions in 2013-14 in order to process refund requests related to the miscollection of sales tax on computer warranty contracts. The 2012-13 budget request includes $2.1 million for OE&E, including consulting and professional services. From 2000 to 2008, Dell incorrectly collected use tax on the cost of optional extended warranty service contracts. Such purchases of optional extended warrantees (as opposed to cost of mandatory service contracts) are treated under law as nontaxable transactions. The tax was collected by Dell and remitted to the BOE.

The BOE was named as a cross-defendant in a class action suit against Dell Computers, based on the erroneous collection of use tax by Dell on the cost of optional extended warranty service contracts. An estimated $200-$250 million in use tax was erroneously collected from 10 million customers, 20 percent of whom are expected to file a claim for refund. BOE is now responsible for refunding the taxes erroneously collected by Dell, resulting in this resource request. BOE indicates that the final amount of refunds to be made is unknown at this point. As a result, the estimates for the amount of resources necessary to make such refunds are still approximate. Final resource estimates will be updated with the understanding that BOE may submit a Spring Finance Letter once negotiations are finalized.

STAFF COMMENTS/QUESTIONS

BOE had a similar request last year, which was not funded. There appeared to be no convincing reasons why approval was necessary at that time. The administrative costs associated with this activity are still preliminary. Since the BCP is still a placeholder, staff recommends this item be held open until additional information is available. In addition, the summary of the request identifies only limited-term positions (as is fitting for a program with a finite existence) while the detail identifies two positions classified as permanent. To the extent the committee approves a version of this request, at this or future meeting, they may want to approve on the basis of limited-term.

ISSUE 3: AB 155 USE TAX NEXUS

The budget proposes additional resources of $3.2 million ($2.1 million General Fund and $1.1 million special funds) and 28 positions to implement the expanded collection of the use tax by out-of-state business pursuant to AB 155. These additional resources will be used to identify out-of-state business required to collect the use tax and institute compliance programs for the initiative. The Legislature passed and the Governor signed as part of the 2011-12 budget, AB 28 X1 (Blumenfield), Chapter 7, Statutes of 2011, which required that out-of-state businesses with certain connections to California—such as sales using affiliates or the presence in the state of related companies—be required to collect the use tax on behalf of the state. Subsequently, the operative date of this bill was delayed until fiscal year 2012-13 through the passage of AB 155 (Charles Calderon and Skinner), Chapter 313, Statutes of 2011, with the date of implementation dependent on the outcome of certain federal actions.

For the purposes of the funding request, BOE has used an implementation date of September 15, 2012. The program is expected to generate an additional $107 million in General Fund revenues in 2012-13. BOE expects an additional 2,000 new use tax accounts to be registered under the provisions of the bill. Resources required for these activities include positions to participate in discussions with federal officials regarding potential legislation, draft regulations, address incoming inquiries from retailers, taxpayers, tax practitioners and other interested parties, and provide outreach services. Resources in the subsequent years are expected to increase as a result of litigation, appeals, and settlements.

As a means of preparing for additional use tax remittances, the BOE has completed a series of interested parties meetings regarding AB 155 and recommended amendments to Regulation 1684 to incorporate the bill's provisions. The Board discussed the amendments during the Board's Business Taxes Committee Meeting on February 28, 2012, and authorized staff to publish the amendments at that time. BOE is also updating the questionnaire it sends to retailers to request information regarding their California activities. The updated questionnaire will request the additional information the Department needs to determine whether a retailer is required to collect California use tax in accordance with the new provisions of AB 155 when AB 155 becomes operative.

Since retailers are free to change the way they do business at any time, BOE is not assuming that any retailer that is not currently registered to collect California use tax will or will not have affiliate nexus with California and thereby be required to register to collect California use tax when the provisions of AB 155 become operative. BOE will have to gather information to determine whether any specific unregistered retailer is required to register to collect California use tax after AB 155 becomes operative. BOE will also be looking at all types of traditional and non-traditional soliciting activities when determining whether the affiliate nexus provisions of AB 155 apply to a particular retailer after the new provisions of AB 155 become operative.

STAFF COMMENTS/QUESTIONS

The most significant portion of the new use tax nexus legislation is the component related to affiliate nexus. Providing resources necessary to effectively implement this legislation are addressed in this BCP. In addition, however, the legislation also included provisions related to nexus based on corporate ownership. Certain retailers are members of a commonly controlled group and members of a combined reporting group that includes another member of the retailer's commonly controlled group that pursuant to an agreement with or in cooperation with the retailer performs services in this state in connection with sales of tangible personal property sold by the retailer. These retailers would also be considered to be doing business in this state and subject to the use tax collection requirement.

The resources necessary to implement this part of the law are not addressed in this BCP. In addition, BOE reports that it has contacted the Franchise Tax Board (FTB), which is unable to provide information related to commonly controlled and combined reporting groups. The committee may want to ask departmental staff regarding its approach to enforcing this aspect of the tax law, including whether additional resources from this BCP should be devoted to this effort. If FTB records are insufficient, for example, they could be supplemented with addition third-party data that would facilitate a matching process.

ISSUE 4: EXPANSION OF FINANCIAL INSTITUTIONS RECORDS MATCH

Last year, the Legislature approved the Governor's Budget request and trailer bill language establishing the Financial Institutions Records Match (FIRM) for FTB. The project is expected to result in additional revenues of about $30 million annually. FIRM established a record match process between financial institutions customer records and tax debtor records. FTB uses the match information to collect delinquent state income tax debts using existing laws and collection methods. It permits FTB to identify previously unknown deposit accounts held by delinquent income tax debtors, collect outstanding income tax debts, and help narrow the tax gap.

The proposed TBL would expand the FIRM program to taxes and fees administered or collected by the BOE, primarily sales and use taxes, as well as by the Employment Development Department (EDD). The bill would authorize BOE and EDD to provide FTB with information relating to delinquent tax debtors and allow that information to be used in the collection of delinquent accounts. The program would allow information on delinquent tax debtors to be matched against the lists of information provided by financial institutions to facilitate the collection of the tax. The law adopted last year requires financial institutions doing business in California to conduct records matches on delinquent taxpayers

Upon determining that there is a match with respect to tax debts and financial institution data, FTB would convey this information to BOE. Current state law allows BOE to use several collection tools in order to collect delinquent tax liabilities. The program expansion would result in additional General Fund revenues of $11 million in 2012-13, plus special fund and local government revenues. FTB would be reimbursed for its costs by BOE and EDD for the program expansion.

STAFF COMMENTS/QUESTIONS

The program imposes costs on financial institutions, but they are compensated with $2,500 per institution in start-up costs and $250 per calendar quarter for reimbursement of data matching costs. Additionally, financial institutions can impose fees up to $125 on customers for the costs of processing levies. This proposal would not expand tax agencies' authority but rather simply expand the taxes and fees that can be collected.

ISSUE 5: MANDATORY USE TAX REPORTING AND REMITTANCE

Among BOE's various tax compliance efforts, some have been instituted at little cost, such as the use tax line on income tax return forms. The line on the income tax return allows businesses and consumers to self-report use tax owed on out-of-state purchases and was originally put in place by SB 1009 (Alpert), Chapter 718, Statutes of 2003. Since that time, revenue generated from this policy have increased steadily. Costs associated for this program are approximately $100,000. As part of last year's budget, this program was retained and granted permanent status.

Last year the Legislature adopted SB 86 (Budget and Fiscal Review) Chapter 14, Statutes of 2011, that required the BOE to develop 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. Similar look-up tables were formerly provided at the federal level with respect to interest on consumer debt when such amounts were deductible from taxable income. The 'look-up' table appears as part of the tax year 2011 instructions, and remitted taxes are first applied to outstanding income tax or corporation tax liability.

There were also proposals last year to make the reporting and remittance of any use tax mandatory on the income tax return if the taxpayer had not remitted such taxes directly to BOE by the prior January 31. This TBL is similar to the proposal initially included in last year's legislation in that it would require:

- Every person who is not otherwise required to file a sales or use tax return with the BOE to report qualified use tax on the income tax return filed with FTB (but not any person that is not otherwise required to file an income tax return with the FTB, such as charitable organizations).

- A paid tax preparer or certified public accountant to make an inquiry with their client as to whether or not that client has a use tax liability, due to the fiduciary responsibility a paid tax preparer or CPA has in accurately preparing a tax return.

- Payments received on the FTB returns would to be first allocated to cover use tax liabilities reported on the income tax return, and then to FTB liabilities.

STAFF COMMENTS/QUESTIONS

Making use tax reporting mandatory would provide an appropriate counterpart to previous statutory measures to increase tax compliance and a very cost effective means of increasing taxpayer compliance with the state's use tax law. The committee may approve trailer bill language to accomplish this goal.

ISSUE 6: STATE RESPONSIBILITY AREA FIRE PREVENTION FEE

As a component of the current year budget, the state will impose fire prevention fees on the owners of habitable structures in state responsibility areas (SRAs) beginning in 2011-12. This fee is to be imposed pursuant to AB 29 X1 (Budget Committee), Chapter 8, Statutes of 2011, which requires the fee of $150 per structure to be used to support the fire prevention activities of the Board of Forestry and the California Department of Forestry and Fire Prevention. Under the legislation, the BOE is assigned the responsibility of collecting the fee and remitting the proceeds, upon legislative appropriation, to the agencies named above. The fee is expected to result in revenues of $50 million in the current year and $85 million in the budget year.

The BOE has requested additional resources of $6.4 million in reimbursements and 57 positions for 2012-13 to administer this new program. There is also a request for partial funding for 2011-12 of $3.3 million in reimbursements and 11.2 positions. The source of the reimbursements is proceeds from the fee. BOE expects that there will be 850,000 owners of habitable structures on which the fee would be assessed and collected. The activities include registering accounts, annual issuances of notices of determination, collection of past due fees, and processing refunds and notices of redetermination. In addition, the agency notes that there would be additional fee payer assistance measures, increased mail inquiries, cashiering and key entry, account maintenance, and reconciliation, and ongoing IT costs given the volume of the new fee base. Technology appears to be a continuing issue based on the complexity of BOE's legacy systems.

STAFF COMMENTS/QUESTIONS

There is a substantial effort and resource requirements for implementing a new tax or fee, particularly in cases with a broad base of fee payers. This is certainly the case with SRA fee. After the initial investment in the program however, personnel costs and IT costs should generally decline. The proposal includes a ramp-up of personnel costs for $1.1 million in the current year to $3.9 million in the budget year and remains at $3.9 million in 2013-14. The committee may want to ask the department whether a decline in personnel is expected in the out years and any drawback associated with limited-term positions rather than permanent. During the same period, OE&E goes from $2.2 million to $2.4 million to $2.0 million. Given that the implementation would be largely complete and necessary fee-payer assistance should be declining, the need for permanent staff is questionable.

The Department of Forestry and Fire Protection (CalFire) has requested $9.3 million in reimbursements for its cost of administering the fee, one activity of which is providing a listing annually of the name and address of each person who is liable for paying the SRA fire protection fee and the amount of the fee to be assessed. Given the relatively small number of annual property, turn over, coupled with the fact that CalFire is providing the data to BOE; it may be that personnel requirement would drop after the initial implementation period. The committee may want the department to restructure the proposal based on a portion of the positions being limited-term.

ISSUE 7: HEADQUARTERS BUILDING RENT INCREASE

The budget calls for a $6.2 million increase ($3.1 million General Fund, $1.5 million special funds, and $1.6 million reimbursements), to pay for a rent increase associated with the issuance of debt to finance the purchase of the Board of Equalization (BOE) headquarters building. Prior to the issuance of the binds, BOE was paying interest; with the refinancing, the principal and interest will result in an increase from $10.9 million to $17.1 million, annually.

The BOE headquarters building has a long and unfortunate history of problems. Construction was completed in 1993. The original owner was CalPERS, and the state leased the building on behalf of BOE. The state purchased the building several years ago because financing a purchase appeared more cost-effective than ongoing lease payments. The state Pooled Money Investment Board (PMIB) advanced BOE $88 million from Pooled Money Investment Account (PMIA) to purchase the building from CalPERS. The PMIA was repaid with the bond sale.

1730 FRANCHISE TAX BOARD

The Franchise Tax Board (FTB) 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 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.

The Governor's Budget proposes expenditures of $680.2 million ($649.6 million General Fund) and 5,427 positions for FTB. This represents a continuation of substantial increase in support for the agency compared to the 2009-10 fiscal year. Expenditures grew from $533.1 million in 2009-10 due primarily to reinstating some of the budget reductions from earlier years as well as new programs. The budget reinstatements were made to reverse negative revenue impacts of the prior administration’s statewide cuts, which included the state's tax collection agencies. In addition, the budget calls for augmentations for specific tax compliance programs and technology improvements related to the department's revenue collection activities.

2012-13 Governor's Budget

Fund Source (millions)	2010-11 Actual	2011-12 Projected	2012-13 Proposed	BY to CY Change	% Change
General Fund	$506.7	$574.1	$649.6	$75.5	13.1
Special Funds and Accounts	26.4	35.1	30.5	-4.6	-13.1
Total Expenditure	$533.1	$609.2	$680.1	70.9	11.6
Positions	5,499.3	5,330.8	5,426.9	96.1	1.8

Tax administration and compliance has become increasingly driven by information, data, and technology over the last couple of decades. The FTB processes more than 15 million personal income tax returns and one-million business enterprise returns annually. Given the volume and complexity of tax returns, filings and programs, it has become imperative that tax agencies remain current in information technology in order to access and exchange information. FTB's operations are heavily reliant on effective storage and use of data from a variety of sources in order to maintain adequate compliance and enforcement activities. The FTB has made significant progress in this area, and this continues to be a focus of its activities. These efforts can also have a positive impact on reducing the 'tax gap' (the difference between taxes owed and actually collected) related to the tax programs administered by the agency. The department estimates the current annual tax gap to be $10 billion ($8 billion personal income tax and $2 billion corporation tax). A review of its ongoing activities was provided by the department as part of the committee’s hearings last year.

One tax gap measure was authorized by SB 86 (Senate Budget and Fiscal Review Committee), Chapter 14, Statutes of 2011, requires FTB to operate and administer a Financial Institution Records Match (FIRM) that utilizes automated data exchanges to identify accounts of delinquent tax debtors held at financial institutions doing business in California. FIRM is an enforcement tool used to collect delinquent taxes and non-tax debts of individuals and business entities. The Governor’s Budget proposes to expand the FIRM Program to the Employment Development Department (EDD) and the Board of Equalization (BOE) with implementation beginning in January of 2013. FTB costs of $592,000 will be reimbursed by EDD and BOE.

ISSUE 1: ENTERPRISE DATA TO REVENUE PROJECT

The FTB processes more than 15 million personal income tax returns and one-million business enterprise returns annually. Its operations are heavily reliant on effective storage and use of data from a variety of sources in order to maintain adequate compliance and enforcement activities. This request is for continued funding for its Enterprise Data to Revenue (EDR) Project, which will address the agency's return processing and utilization of data, as well as provide connections among various systems. This request constitutes the fourth year of the EDR project and the second year of the primary solution provider (PSP) vendor contract.

This budget request calls for $96 million General Fund support and 165 positions (56 permanent, 102 temporary and seven limited-term) for the EDR project, which is expected to generate $151 million in revenues in the budget year. This request includes 52 positions that received funding but no position authority in a 2011-12 Spring Finance Letter. The proposal is a multi-year information technology project that will modernize and consolidate FTB's operations. Total project costs over the ten-year period are expected to be $689.9 million and generate $4.9 billion in revenue for the state for an expected benefit:cost ratio of 7:1. Once the project is fully in operation, increased state revenues are expected to be approximately $1 billion annually from enhanced compliance and enforcement.

EDR will introduce a new personal income tax and business entity return processing system including expanded imaging, data capture, and return verification with an enterprise data warehouse and common services. The EDR Project has three major goals. First, it seeks to capture all tax return data in an electronic form. Second, the project will integrate the various existing 'siloed' tax databases at FTB into a data warehouse. Third, the project will enable FTB to add third-party data (for example, county assessor data) to its data warehouse. The FTB asserts that the EDR Project will allow it to substantially improve detection of underpayment and fraud in order to collect taxes from those who are not paying the full amount that they owe. In addition, FTB indicates that the project will enable it to improve service and give taxpayers better access to their tax records.

The project includes the following improvements to FTB’s systems that process personal income tax and business entity tax returns:

- An underpayment modeling process that would be integrated with the Accounts Receivable Collections System and Taxpayer Information System.

- An enterprise data warehouse with data search and analysis tools.

- A taxpayer records folder that is accessible to the taxpayer and allows taxpayers and FTB staff to access the information.

- Re–engineering of existing business processes—including imaging of tax returns, data capture, fraud and underpayment detection, tax return validation, filing enforcement, and other audit processes—and integration of these enhanced business processes with FTB’s existing tax systems.

- Improved business services at FTB such as address verification, issuance of notices, and a single internal password sign-on for its IT systems.

FTB indicates that its plans to finance the EDR Project using a benefit-funded approach are proceeding. Contractor payment for system development and implementation are conditioned on generating additional revenue that will more than cover the cost. Revenues from the project are expected to increase as additional features come on line. This approach is intended to protect the state and also give the contractor a strong incentive to develop the project in a manner that produces significant revenue quickly. The FTB has used this approach previously for a number of its IT projects. Under the model, the PSP is compensated only when the new tax revenues are realized and after certain state costs have been recouped. Revenue benefits over and above these amounts are shared with the PSP based on a fixed price contract. In this way, the project budget is constructed so that the state does not incur up from expenses prior to the receipt of additional revenues.

The EDR project will take approximately six more years to implement fully and, once completed, will replace several older FTB information technology systems and streamline other existing systems. Total costs shown below are inclusive of one-time IT costs, on-going IT costs, and staffing.

EDR Project Costs and Revenues ($ millions)

Fiscal Year	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	Total
Project Costs	6.1	9.9	40.7	122.8	173.6	109.3	91.6	88.5	47.4	689.5
Project Revenues	7.5	25.4	65.3	187.7	280.1	716.1	1,188.0	1,237.0	1,196.2	4,903.5

STAFF COMMENTS/QUESTIONS

The EDR project has gone through a number of changes, expansions, and shifts since it was started in 2008-09. This is not unexpected for large IT projects. The costs and revenues incorporated in the project are substantially different from those originally conceived by FTB. Given the nature of the technology procurement process, this is not a surprise; however, it does raise an issue as to whether additional substantial adjustments may occur in the future and what actions FTB may take to deal with this possibility.

One of the means by which FTB has maintained the benefit:cost ratio is through incorporating additional 'early wins' into the project. As new opportunities arise, FTB has been able to incorporate these into the project and make required adjustments. When the project was detailed in the Feasibility Study Report, the original cost was estimated to be $511.7 million over the ten-year period, with comparable revenues of $3.7 billion. Both of these have increased, but the expected benefit:cost ratio has stayed roughly the same. FTB continues to work closely with the California Technology Agency (CTA) in order to keep the project on track.

The budget proposal also notes that FTB remains concerned about the impact of future restrictions on resources on the completion of the project. The committee may want FTB staff to address contingency plans that could be put in place in the event of resource restriction measures.

ISSUE 2: ACCOUNTS RECEIVABLE MANAGEMENT PROGRAM AND TAX GAP PILOT

FTB requests $8.5 million, and the continuation of 125 positions associated with working down the existing inventory of accounts receivable and a tax gap pilot program with the Department of Motor Vehicles (DMV). The proposal includes converting 111 positions to permanent and continuing 14 expiring positions for another two years. These positions were approved on a two-year, limited term basis in 2010-11.

- FTB's tax collection activities involve collection against accounts receivable, and include automated billing and collection activities, notices, levies, attachment of assets, and routing accounts to collector. FTB's accounts receivable inventory has increased substantially over the last few years, from $5.4 billion in 2007 to $8.5 billion in 2011. The inventory in accounts receivable increased substantially during the years when the agency's resources were curtailed due to furloughs, work force reductions and other types of retrenchment during the previous administration.

- The tax gap pilot program with DMV involves investigations of circumstances where no tax return has been filed and no balance due, and the individual has purchased a luxury automobile in the last year. The individual is contacted with an inquiry and if no response is received, a Notice of Proposed Assessment (NPA) may be issued. FTB follows up with collection activities as needed. The program generated $15 million in revenue last year.

Additional collection activities, including new methods and programs, are expected to reduce the inventory and result in additional revenues of $120 million in 2012-13, comprised of $108 million from accounts receivable workload and $16 million for the automobile tax gap program. In 2013-14, the department expects revenues from the program to be $124 million. The benefit:cost ratio for the request (based on the marginal increase in revenues) is approximately 14:1.

STAFF COMMENTS/QUESTIONS

The department has provided data and other information justifying the need for continued enhance accounts receivable resources. However, it also expects efficiency improvements to occur in the future. FTB notes that continuing efforts are being made to reduce the accounts receivable inventory through: (1) technology, including EDR (discussed above), the recently instituted Federal Treasury Offset Program (FTOP); (2) partnering with other agencies and additional data sharing; (3) outsourcing particular collection activities. As these improvements to the existing system come on line, there should be a reduced need for additional personnel resources. In addition, to the extent that there is an improvement in general economic conditions, this should also have an ameliorative impact on the accounts receivable inventory. Given this, the committee may want to provide funding for limited-term positions, as these would be a suitable and effective alternative to permanent positions

ISSUE 3: DEPARTMENT OF REVENUE—CONSOLIDATION AND REORGANIZATION

As a component of the Governor's initiative to make government more efficient, the Budget calls for two significant changes that would affect the department's way of doing business. First, the Budget proposes consolidating the activities of the Employment Development Department (EDD) that relate to tax collection (primarily personal income tax withholding and payroll tax administration) with FTB activities into a new Department of Revenue (DOR). There are no details on this proposal, but in general, this could make sense in an organizational context as well as increase the level of information exchange among the various programs. Some concerns relate to the potential of impairment of activities during the consolidation and the ease with which activities of EDD can be split-off from other functions that are not part of the consolidation.

The second major change is to include this new DOR in the newly proposed Government Operations Agency (GOA). The GOA would combine activities related to procurement, information technology, human resources and administration and include General Services, Human Resources, Technology, Office of Administrative Law, The Public Employees Retirement System, State Teachers Retirement System, State Personal Board, Government Claims Board, and DOR. Similar to the FTB-EDD consolidations, no details are available on this proposal to date. The committee members may inquire of the department or DOF the procedures to be used for the consolidation and reorganization and the timeline for the process.

ISSUE 4: APPEAL PROCEDURES AFTER AN ADVERSE DECISION

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. Taxpayers may appeal through FTB's administrative process and, if there is no agreement, appeal the case to the Board of equalization (BOE). The BOE is an elected body consisting of four members elected by districts across the state, plus the State Controller. 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.

BOE's determination on an appeal from an action of FTB is final unless FTB or the taxpayer petitions for a rehearing. FTB lacks statutory authority to appeal if it loses at the BOE; however, if BOE rules against the taxpayer, the taxpayer may pursue the negative ruling in superior court against FTB. Thus, the two parties in the tax dispute are not on equal footing with respect to the ability to appeal.

An approach to equivalence in this setting would be to allow the FTB to file a lawsuit, as a trial de novo ('trying a new matter'), in superior court after an adverse BOE determination regarding a deficiency assessment, a claim for refund, or a disallowance of interest, as specified. This step would place FTB in the same position as the taxpayer with respect to appealing a decision of the BOE. The FTB appeal ability could be limited to cases involving liabilities in excess of a certain threshold or limited to particular circumstances.

BACKGROUND

Under federal law, in general, taxpayers may petition the federal Tax Court to re-determine deficiency assessments proposed by the IRS. This redetermination is a trial de novo. Either party may appeal an adverse Tax Court determination to the federal appellate courts. In lieu of petitioning the Tax Court to re-determine a deficiency, the taxpayer may pay the tax and file a claim for refund with the IRS. Assuming the IRS denies the claim for refund, the taxpayer may bring a lawsuit in federal district court or the U.S. Court of Federal Claims for the recovery of the overpayment (suit for refund). The action is a trial de novo. Either party may appeal an adverse court determination to the federal appellate court. A review of several other states with comparable tax systems to California's—Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York—found that equivalent appeal rights prevailed for either party, although these displayed some variation in the exact process.

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. However, this is dependent on the exact wording of any legislation, any threshold regarding appeals, and effective dates relating to the measure. In addition, there would likely be not insignificant behavioral effects on settlements and determinations of appeals.

The actual revenue impact would depend on numerous factors, but the amount of revenue, at least in question, would be substantial. For example, in one recently decided case involving Pacific Bell, the BOE decided against FTB on questions related to income from the sale of stock in a company where the taxpayer had partial ownership. The ruling held that the income was non-business income and thus not taxable in California. Applying this decision to other companies in similar circumstances could result in negative revenue impacts (over multiple fiscal years and involving several tax years for several taxpayers) of over $500 million. This is not to suggest that had FTB appealed the case, the court would have ruled in its favor, but only to indicate that the cases at issue can be major ones, with correspondingly large potential revenue impacts.

STAFF COMMENTS/QUESTIONS

This matter is not a proposal of the department, but has been a component of previous legislation, most recent in SB 1113 (Wolk). Many tax professional and academics have voiced concerns with the fairness of 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. The recommendation of the Commission for a reformed process was based on American Bar Associations "Model State Tax Tribunal Act." The establishment of equivalent appeal rights would one means by which to address what is at least perceived as problems of fairness with the existing system.

One of the issues, which has become increasingly problematic, is the lack of published decisions by the BOE. This can leave taxpayers and administrative tax agencies alike at a loss with respect to needed guidance in complex issues, as well as lead to inconsistent rulings. In a recent case involving Comcast, the BOE ruled in favor of FTB and against the taxpayer in a decision as to whether a one-time payment of $1.5 billion to the company was taxable in California. The taxpayer petitioned for a re-hearing (subsequently withdrawn), claiming that the BOE's decision was based on insufficient evidence and contrary to law. There was letter decision on the matter with brief descriptions of its findings, but a published opinion by the BOE laying out the legal basis for its decision would give Comcast additional guidance regarding its chances should it decide to appeal to the courts.

Appeal rights by both sides would tend to create additional opportunities for precedent setting along with case guidance. In addition, the prospect of court review would tend set a clear example for the decision-making process for the BOE. The committee may want to take action to approve placeholder trailer bill language providing for FTB to appeal adverse decisions.

ISSUE 5: TAX GAP MEASURES—TOP 500 TAX DEBTORS

The Legislature approved AB 1424 (Perea), Chapter 455, Statutes of 2011, that expanded the list of designated delinquent taxpayers, required updating the delinquent taxpayer list, and provided certain tax collection tools used to collect tax debt. To implement this legislation, the Budget includes $755,000 General Fund and 7 three-year, limited-term positions. The program will result in additional revenues of $19 million in 2011-12 and $24 million in 2012-13. The purpose of AB 1424 is to narrow the tax gap by providing the Franchise Tax Board (FTB) with additional tools to collect tax debts.

The programs either initiated or expanded in the legislation are:

- Increase the FTB's list of top 250 tax debtors to the top 500 tax debtors and require FTB to update the list twice annually.

- Require state licensing agencies to suspend occupational, professional and driver's licenses held by Top 500 debtors appearing on a certified list.

- Prohibit any state agency from entering into a contract for goods and services with a Top 500 debtor.

- Allow FTB to offset tax refunds for delinquent debts due in other states, if there is a reciprocal agreement with that state.

2150 DEPARTMENT OF FINANCIAL INSTITUTIONS

The Department of Financial Institutions (DFI) is currently housed within the Business, Transportation, and Housing Agency. The department is responsible for oversight, supervision, and regulation of financial institutions licensed by the state. These institutions include banks and trust companies, credit unions, savings and loans, and industrial banks. It also oversees local agency security, money transmitters, and business and industrial development corporations. The activities conducted by DFI are intended to ascertain and ensure the safety and soundness of financial institutions. The Governor's Budget includes support for DFI of $35.2 million (special funds and reimbursements) and 263.1 positions. This would result in a slight increase in funding and no change in positions from the current year schedule. The department is largely funded by annual assessments on financial institutions.

2012-13 Governors' Budget

Fund Source (millions)	2010-11 Actual	2011-12 Projected	2012-13 Proposed	BY to CY Change	% Change
General Fund	$0.0	$0.0	$0.0	$0.0	-
Local Agency Deposit Security Fund	0.3	0.4	0.4	0.0	0.0
Financial Institutions Fund	23.9	25.6	26.2	0.6	2.2
Credit Union Fund	6.6	7.3	7.5	0.1	1.4
Reimbursements	0.8	1.2	1.2	0.0	0.0
Total Expenditure	$31.6	$34.5	$35.2	0.7	2.0
Positions	269.2	263.1	263.1	0.0	0.0

As with many other state general government units, the department is attempting to make strides in the area of information technology. It is engaged in multi-year projects that are designed to improve their overall performance as well as improve service and responsiveness to the institutions that it oversees.

As part of the Governor's Budget, DFI is to be restructured by combining its duties with those of the Department of Corporations. The new department would be known as the Department of Business Oversight and fall under the Business and Consumer Services Agency. Although no additional detail on this proposal has been received, the rationale is that since both agencies perform the mission of licensing and regulating financially related business entities, their efforts should be combined.

ISSUE 1: CONVERSION OF BANK EXAMINER POSITIONS TO PERMANENT

DFI has requested that five existing bank examiner positions be converted from limited-term to permanent positions. The five limited-term positions were approved as part of a Spring Finance Letter in 2010. The positions are funded through assessments paid by licensees regulated by DFI, with no General Fund cost. The program cost is $529,000 in the budget year, increasing to $553,000 in 2013-14.

DFI reports that the program is currently operating with 90 examiners as a result of the hiring freeze, although it has been allocated 105 positions. The positions are responsible for examinations with respect to capital, assets, management, earnings, liquidity, market sensitivity, and operations. In addition, the examination provides a review of the licensee's compliance with both State and federal laws and regulations.

The positions were originally approved, as limited-term positions based on the view that the increase in conditions and number of stressed financial institutions would abate over a period of time. DFI indicates, however, that the workload has not improved since the original approval was given. In fact, it reports that the number of "problem" licensees has actually increased, requiring more frequent on-site examinations, increased off-site monitoring, and potentially multiple enforcement actions to assist institutions.

STAFF COMMENTS/QUESTIONS

DFI's position with respect to the continuation of the positions is a reasonable one. Ordinarily, staff would recommend approval as two-year, limited–term positions; however, the department has indicated that State Personnel Board (SPB) regulations do not make it possible to extend limited-term positions for another limited-term period. According to DFI, either the positions must be allowed to expire or be converted to permanent positions. Given that, the positions are needed and the training required for such examiner positions means that they are not fully effective until several years after hiring; DFI should be able to retain the existing experienced staff. The committee may want to ask DFI whether waivers or exceptions to this regulation are available as an option. Alternatively, the committee could approve the positions along with a reporting requirement in two years' time. DFI could also address its interpretation of trends in the industry and whether conditions in the industry will prevail over the next few years, warranting permanent positions. DFI notes that the proposal would not increase costs or licensee assessments.

ISSUE 2: CONVERSION OF CREDIT UNION EXAMINER POSITIONS TO PERMANENT

DFI has requested that three existing credit union examiner positions be converted from limited-term to permanent positions. The three limited-term positions were approved as part of a Spring Finance Letter in 2010, based on poor industry conditions and increased workload. The positions are funded through assessments paid by licensees regulated by DFI, with no General Fund cost. The program cost is $314,000 in the budget year, increasing to $326,000 in the budget year.

DFI reports that the demands on the examination program have not abated since the Spring Finance Letter was approved, and by some measures, the workload has increased. Overall, the percentage of credit unions in the state in what the department considers 'satisfactory' condition has remained virtually the same. The positions are responsible for examinations with respect to capital, assets, management, earnings, liquidity, market sensitivity, and operations. In addition, the examination provides a review of the licensee's compliance with both State and federal laws and regulations.

The positions were originally approved, as limited-term positions based on the view that the increase in conditions and number of stressed financial institutions would abate over a period of time. DFI indicates, however, that the workload has not improved since the original approval was given. In fact, it reports that licensees will continue to require increased frequency of examinations and supervisory contacts, longer duration examinations, and increased monitoring of financial information. The department expects this will result in actual workload increases in some areas; for example, full safety and soundness examinations are expected to number 112 in 2012 and 118 in 2013, up from 102 in 2011. Similarly, follow-up examinations are expected to number 62 in 2012 and 65 in 2013, up from 56 in 2011.

STAFF COMMENTS/QUESTIONS

The general observations are the same as for regarding bank examiners. DFI's position with respect to the continuation of the positions is a reasonable one. Ordinarily, staff would recommend approval as two-year, limited–term positions; however, DFI has indicated that SPB regulations do not make it possible to extend limited-term positions for another limited-term period. According to DFI, either the positions must be allowed to expire or be converted to permanent positions. Given that, the positions are needed and the training required for such examiner positions means that they are not fully effective until several years after hiring; DFI should be able to retain the existing experienced staff. The committee may want to ask the department whether waivers or exceptions to this regulation are available as an option. Alternatively, the committee could approve the positions along with a reporting requirement in two years' time. DFI could also address its interpretation of trends in the industry and whether conditions in the industry will prevail over the next few years, warranting permanent positions.

2180 DEPARTMENT OF CORPORATIONS

The Department of Corporations (DOC), under the direction of the California Corporations Commissioner, provides consumer and investor protections by regulating a variety of non-financial institutions including securities broker-dealers, investment advisors and financial planners, and certain fiduciaries and lenders. DOC also oversees the sale of securities, franchises, and off-exchange commodities. The mission of DOC is to ensure an orderly and transparent marketplace, promote financial literacy, foster a professional environment, and protect the public from fraud and abuse. The department is funded from special funds and reimbursements, with the largest amount of support provided by the State Corporations Fund. The Budget calls for resources of $45.3 million, representing a slight decline from the current year level of $46.8 million. This support would provide funding for 314.7 positions, compared to 313.8 in the current year.

As part of the Governor's Budget, DOC is to be restructured by combining its duties with those of the Department of Financial Institutions. The new department would be known as the Department of Business Oversight and fall under the Business and Consumer Services Agency. Although no additional detail on this proposal has been received, the rationale is that since both existing agencies perform the mission of licensing and regulating financially related business entities, their efforts should be combined.

2012-13 Governor's Budget

Fund Source (millions)	2010-11 Actual	2011-12 Projected	2012-13 Proposed	BY to CY Change	% Change
General Fund	$0.0	$0.0	$0.0	$0.0	-
State Corporations Fund	32.1	46.7	45.2	-1.5	-3.2
Reimbursements	0.0	0.2	0.2	0.0	0.0
Total Expenditure	$32.1	$46.8	$45.3	-1.5	-3.2
Positions	275.4	313.8	314.7	0.9	0.3

ISSUE 1: INFORMATION TECHNOLOGY QUALITY NETWORK PROJECT CONTINUATION

The Budget calls for continuing funding of the department's information technology quality network project (DOCQNET). The request is for 7 limited-term positions and $6.1 million (special fund and reimbursements), and two years to complete the project. The project was initiated in 2009 as a means to consolidate many of the department's specialized and unique programs that were developed in a variety of software languages and are typically not linked. DOC is also requesting an extension of the original timetable.

Over the years, the department's IT systems have developed around specific business processes in separate organization units. Many applications were built in-house using tailor-made software or by small consulting firms. The systems were developed in a variety of languages and on different platforms. This system, like many others around the state suffered from efficiency drawbacks and numerous customer complaints. The existing project is one of several designed to unify, standardize and combine data.

DOC was unable to hire for positions or suffered other personnel reductions in 2010 and 2011. The positions were approved for 2009-10, but the department was not able to hire during 2009-10 and hired only 1 limited-term position in 2010-11. It received hiring freeze exemptions in June 2011 and is currently in the hiring process. Because of the delay, the proposal is for appropriation authority and an extension of the project deadline. The project, after delays, is now expected to award a contract in April of this year.

STAFF COMMENTS/QUESTIONS

Staff has no concerns with this proposal; however, the department has noted that it expects to experience an additional delay in the actual deployment of the project, beyond those already noted in the BCP.

9210 LOCAL GOVERNMENT FINANCING

Local Government Financing encompasses a variety of subventions from the state for designated purposes such as health, welfare, and public safety programs. The state also provides general purposes revenue to counties, cities, and special districts when special circumstances or events occur. Local Government Financing includes those payments to local governments where the funds may be used for any general government purpose as well as funds for one-time designated purposes. The source of funding for this item is generally from the General Fund, and occasionally, special funds.

The proposed budget for 2012-13 is $2.1 billion General Fund. This represents an increase in expenditures for Prop 1A borrowing from $91 million in 2011-12. This 2009-10 Prop 1A debt will be fully repaid in 2012-13. Local Government Financing includes three state subvention programs for local governments. In addition, there is a small $0.5 million subvention related to former Redevelopment Agencies (RDAs) to help retire a portion of outstanding debt that was backed by the personal property tax. Finally, there is a new subvention of $4.4 million General Fund proposed this year for Mono and Amador counties, as discussed below.

ISSUE 1: AID TO LOCAL GOVERNMENT—AMADOR AND MONO COUNTIES

The Governor proposes a new General Fund subvention of $4.4 million to backfill Mono and Amador counties due to circumstances arising from the 'triple flip' that occurred in connection with the state's issuance of Economic Recovery Bonds (ERBs) and the revenue 'swap' related to the previous administration's action to reduce the Vehicle License Fee (VLF). These events have resulted in a revenue shortfall for these counties, in that they receive less revenue than they would have had these events and policies responses not have occurred. The revenue loss apparently occurred in 2011-12 and will continue into 2012-13. The impact in the out-years is not clear, nor has the administration indicated whether its proposal is one-time or ongoing.

BACKGROUND

In 2004, two policies shifted local property tax from schools to cities and counties, requiring the state to backfill schools for the property tax revenues.

- The first of these events was the 'triple flip,' related the state issuance of the ERBs. To pay debt service on the bonds and retain the overall sales tax rate, the local sales tax for cities and counties was reduced by ¼ cent and the State sales tax was increased by ¼ cent to repay the ERBs. To hold cities and counties harmless, property tax was redirected from schools to cities and counties. The ¼-cent rate is to be restored when the ERBs are repaid.
- The second event was the Legislature's enactment of the 'swap' which provided local property taxes to cities and counties instead of a state backfill to make up for the VLF reductions in 2004. The goal was to provide a more reliable funding mechanism to backfill cities and counties for the local revenue cut by the State when the VLF tax on motor vehicles was reduced from 2.0 percent of a vehicle's value to a 0.65 rate.

Pursuant to these events, cities and counties receive increased property taxes from two sources: first, the countywide property tax Educational Revenue Augmentation Fund (ERAF) and, second (if ERAF resources are not sufficient), base K-14 district property tax revenues. State law specifies, however, that 'basic aid' K-14 district property tax revenues are not available for allocation to cities and counties for this purpose. Basic aid districts are those that receive sufficient funding from the local property tax and do not receive resources from the state for general educational purposes.

In Amador and Mono Counties in 2010-11, the cost of offsetting the triple flip and swap exceeded the funds in their ERAFs. Because every school district in the counties was basic aid, no K-14 district property tax revenues were available to shift to the cities and counties. Since current law would not allow additional property tax shifts to make these counties whole, the estimated loss for the two counties in 2010-11 was $4.4 million—representing approximate 20 percent of these counties' general funds.

STAFF COMMENTS/QUESTIONS

On an aggregate basis, local governments generally benefited from the more robust growth in property taxes, compared to the sales tax and the VLF. Data suggests most counties have received a net benefit from the shifts; however, in the event that the property taxes cannot be shifted, this higher growth rate provides little comfort. While there was no backfill guarantee in the original legislation, clearly the possibility of all schools within the county becoming 'basic aid' was simply not anticipated. These circumstances were simply unforeseen.

At the same time, any subventions provided to local governments in these—or similar circumstances—should weigh the merits of any subventions against the reality of state finances, as well as financial stresses experienced by other local governments. While this particular subvention is not based on need, but rather on the basis of fairness, it would be useful to get definitive information on the scope of the problem and whether other counties are potentially at a 'tipping point.' LAO reports that based on the number of basic aid K-14 districts within their borders, the counties most likely to experience funding shortfalls in the future could include Inyo, Marin, Plumas, San Mateo, and Sonoma.

LAO recommends the Legislature consider this proposal for local fiscal relief in the context of overall state-local finance and develop a plan that is financially viable for the state and counties over the long term. This is as appropriate advice today as it was 30 years ago, but absent an immediate plan, the issue remains unresolved. While one-time assistance may be appropriate, given the fiscal position of the state and the unknown potential magnitude of the problem, it would be unwise to set a precedent for this type of assistance. The committee may want to request that LAO and DOF explore options regarding formulas (incorporating factors such as local need or shortfalls as a proportion of local general funds) that could be used to give definition to state assistance and report to the committee.