AGENDA
ASSEMBLY BUDGET SUBCOMMITTEE NO. 4 ON STATE ADMINISTRATION

PART II

Assemblymember Rudy Bermudez, Chair

TUESDAY, APRIL 12, 2005, 1:30 PM
STATE CAPITOL, ROOM 447

ITEMS TO BE HEARD

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ITEM 0860 STATE BOARD OF EQUALIZATION

The State Board of Equalization (BOE) is comprised of four members elected specifically to the board from districts and the State Controller. The BOE administers the sales and use tax (including all state and local components), oversees the 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). The BOE also hears taxpayer appeals of FTB decisions.

The budget proposes $365 million ($209 million from the General Fund) and 3,628 personnel-years of staff for the BOE in fiscal year 2005-06. Total funding increases by $6.3 million (1.8 percent), and General Fund support increases by $1.6 million (0.8 percent), compared with spending estimates for the current year. Proposed staffing declines slightly—by 20.2 personnel-years (0.6 percent) from the current-year estimate.

ISSUE 1: INCREASING ELECTRONIC FILING

The Legislative Analyst's Office (LAO) points out that the BOE has made some progress in using electronic technologies and automation, but substantial improvements could be made. While the board receives about 60 percent of the total SUT payment amounts through electronic funds transfers (EFTs), EFTs account for a much smaller proportion of the number of payments. In addition, electronic tax filings (or submissions that can be scanned and converted to digital form) represent a small share of total tax returns to the board. The workload at BOE tends to be largely paper-driven. Submissions of documentation are generally still conducted through paper methods and, as a result, the processing of such submissions tends to be manually intensive.

Recent BOE Actions. The board has accepted e-filing over the Internet since 2001, but for the first half of 2004-05, BOE received only about 7,218 e-returns from a total of about 700,000 eligible retailers, in part this low participation is because e-filing must be done through private companies that charge fees. BOE now plans to develop a free in-house e-filing option for retailers that it will have on-line by December 2005. BOE has a target of a 10-percent increase in the number of e-filers as a result of this free in-house e-filing option. For the future, BOE indicates that it plans to expand e-filing to include multiple-location retailers (only single-location businesses now qualify), allow use of credit and debit cards for payment in addition to EFTs, and also allow e-filing of special taxes in addition to the SUT.

LAO Recommends BOE Report at Hearing. LAO recommends that BOE report at budget hearings regarding its medium- to long-term goals regarding increased use of technology, to reduce its processing costs and increase its ability to compile and make use of the information that it receives.

COMMENTS

Would Mandates or Incentives Help? BOE's current target of a 10-percent increase in e-filing represents a gain of only about 1,500 e-filings annually—a miniscule portion of total filings. One approach to increasing participation would be to mandate retailers to e-file (most income-tax preparers are required to e-file) and/or to provide some incentive for e-filing—for example a small credit against tax due equal to a portion of the state's cost savings.

ISSUE 2: ARE WASTE RECYCLING FEE ADMINISTRATION COSTS TOO HIGH?

To address the growing problem of electronic waste, the Legislature adopted Chapter 526, Statutes of 2003, (SB 20, Sher), which instituted a comprehensive system for the recycling or disposal of certain electronic devices. Subsequent legislation—Chapter 863, Statutes of 2004 (SB 50, Sher)—required BOE to collect the Electronic Waste Recycling Fee. The budget includes an additional $5.7 million (reimbursements and special funds) for the collection of this fee.

The LAO points out that terms of the, the board's proposed administrative costs appear to be on the high side compared with costs for other special taxes and fees that the BOE collects. For the Tire Recycling Fee Program, for example, the BOE has about 16 positions and collects about $32 million, or one position for every $1.9 million collected. For the Electronic Waste Recycling Fee, the budget proposes 77 positions in order to collect fees of $78 million, or one position for every $1 million collected. Although some start-up costs are expected with such a program, these seem excessive given costs associated with other special fee programs. LAO recommends that the BOE report at hearings regarding this proposal and provide backup regarding its cost estimates and how these can be distinguished from its program costs for existing programs.

COMMENTS

The BOE indicates that it has reevaluated its budget proposal and agrees that the cost can be reduced. The board should identify the amount of the reduction if it has been determined at this time.

ISSUE 3: OTHER JANUARY BUDGET CHANGE PROPOSALS

- **California Tire Fee Increase.** The Governor's budget proposes an increase of $224,000 in reimbursements and 5.6 personnel years in the budget year to administer the increase of California Tire Fee on behalf of the California Integrated Waste Management Board and the California Air Resources Board.

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- **Ongoing Cigarette and Tobacco Products Taxes Increase.** The Governor's budget proposes to add $850,000 special funds and 9.6 personnel-years to continue the ongoing administrative workload associated with Proposition 10, the California Children and Families First Act of 1998.

- **Underground Storage Tank Maintenance Fee Increase.** The Governor's budget proposes to add $79,000 and 1 personnel year special funds to administer the increase in the California Underground Storage Tank Maintenance Fee.

COMMENTS

No issues have been raised regarding these proposals.

(Note: April Department of Finance Letter requests will be taken up at a subsequent hearing.)

ISSUE 4: AMNESTY UPDATE

Budget trailer legislation for 2004-05 enacted an amnesty program that waives penalties (but not interest) for individuals and businesses that pay overdue tax liabilities for years prior to 2003. The "window" for these amnesty filings closed on April 1 for SUT liabilities.

COMMENTS

The BOE should update the subcommittee on the results of the amnesty program for sales and use tax.

TAX GAP ISSUES

The "Tax Gap" represents the shortfall between taxes owed and taxes paid. The BOE estimates that the 2003-04 tax gap for the sales and use tax totaled $1.1 billion annually, of which the state General Fund share was $1.1 billion.

ISSUE 5: POTENTIAL ACTIONS TO REDUCE THE SALES AND USE TAX GAP

1. **Business Use Tax Compliance.** According to the BOE, the largest single component of the SUT tax gap results from failure of businesses to pay their use tax liability on purchases from out-of-state sellers. Noncompliance is a particular problem for businesses that are not registered with the BOE because they are not in the business of retailing. The board currently does not normally audit businesses that do not have a seller's permit, such as law firms, architects, etc. However, these businesses incur a use-tax liability when they purchase supplies or equipment from an out-of-state seller that does not collect sales tax. AB 911 (Chu), currently in the Assembly Revenue and Taxation Committee, seeks to improve business use tax compliance through a number of mechanisms. For example, it would require businesses to declare whether they have paid use tax on the business property lists that they provide to county assessors, and it would deny income tax depreciation deductions on equipment for which use tax had not been paid.

2. **Controlling the Use of Resale Certificates.** Retailers with seller's permits may legally purchase goods for resale without paying the SUT. However, there are few controls in place to prevent abuse of this tax exemption. To avoid paying sales tax, the purchaser need only present a "resale certificate." The certificates are forms that are easily purchased or printed out from the Internet. The purchaser must fill in their seller's permit number and the nature of their business. The seller must keep a copy of the resale certificate, but there is no requirement to verify that the permit number on the certificate is valid or that the purchaser is authorized to use it. Potentially, anyone with some knowledge of the process could evade sales tax by misusing resale certificates. One approach to improve compliance could be for BOE to issue resale permit cards, similar to a credit card with the identity of the permit holder and the permit number coded on a magnetic stripe. Larger retailers (such as Costco or Wal-Mart) could be required to swipe these permit cards for any tax-exempt sale for resale and maintain these records in its sales database so that BOE could easily track total purchases for resale attributed to each permitee.

COMMENTS

1. The subcommittee may wish to ask BOE and the LAO to comment on the approach taken by AB 911 and any suggestions for additional approaches to collection of business use tax.

2. The BOE has indicated that it could conduct an exploratory audit of resale certificates accepted by a sample of large retailers in order to determine the extent of tax evasion due to abuse of resale certificates. This would help to determine if the scope of the problem is large enough to warrant new requirements, such as requiring the use of resale permit cards

ITEM 1730 FRANCHISE TAX BOARD

The Franchise Tax Board (FTB) consists of the State Controller, the Chair of the State Board of Equalization (BOE), and the Director of Finance. The FTB administers the Personal Income Tax and the Corporation Tax. FTB also assists other departments and programs in the collection of delinquent debts, including delinquent child support payments. The budget proposes total spending of $699 million ($512 million from the General Fund) and 5,285 personnel-years of staff for support of the FTB in fiscal year 2005-06. Total proposed spending increases by 13.2 percent from the current year, but General Fund spending increases by a much lower 5.4 percent. Staffing declines slightly by 0.8 percent—primarily due to the expiration of limited-term positions for the tax amnesty program. The overall spending increase primarily reflects increased funding for development and initial implementation of the Child Support Enforcement System.

ISSUE 1: UNALLOCATED REDUCTION—WILL REVENUE ALSO BE REDUCED?

The FTB's budget includes an unallocated General Fund reduction of $7.84 million--about 1.5 percent of its General Fund budget--with the flexibility to implement this reduction through layoffs, hiring freeze, procurement reductions, or other administrative means as it may choose. The budget does not assume any revenue loss due to this reduction.

The FTB indicates that it is assuming that "strategic sourcing" savings will be available to help offset this budget reduction. To cover the remaining balance in the short term, FTB will reduce spending on operating expenses and equipment to the extent possible. In the long-term, FTB indicates that it will look for on-going savings that may take the form of IT projects that produce efficiencies or expanding e-filing requirements and alternatives. The FTB cautions that while its goal is to absorb this budget reduction without impacting revenue, the department cannot guarantee that there will not be any revenue loss.

COMMENTS

1. The FTB should explain to the subcommittee its plans for implementing the unallocated reduction and the potential impact on revenues.

2. *Apparent Double-Counting of Strategic Sourcing Savings.* Staff notes that savings from the Strategic Sourcing Initiative have been overstated in the budget and, in any case, those savings are separately attributed to strategic sourcing in Control Section 33.50, which allows the Department of Finance (DOF) to further reduce departmental budgets to capture strategic sourcing savings. Consequently, Strategic Sourcing savings at FTB would be used to achieve budgeted Section 33.50 savings rather than offsetting the unallocated reduction.

3. *Why Treated Differently from the Board of Equalization (BOE)?* The budget does not propose any unallocated reduction for the state's other main tax agency (the BOE). The DOF should explain its rationale for the unallocated reduction to FTB, whether it will reduce revenue, and its basis for the different treatment of the BOE.

ISSUE 2: SAVINGS FROM INCREASED ELECTRONIC FILING

The Legislative Analyst's Office (LAO) notes that the FTB is experiencing a substantial growth in e-filing and e-payments. This growth has occurred as a combined result of statutory mandates for tax practitioners as well as a "natural" migration from paper to electronic filing by individual and business taxpayers. The FTB reports that between the 2000 tax year and the 2003 tax year, electronically filed returns expanded from 2.3 million to 3.7 million, or 63 percent. Similarly, electronically filed remittances grew from 0.8 million to 1.2 million, or 47 percent. The department expects 10 percent annual growth in electronic remittances through 2008, and 5 percent to 10 percent annual growth in electronic returns through the same period.

Reflecting the growth in electronic filings and remittances—and the large cost savings associated with the use of this technology—the department's budget was reduced in stepwise fashion beginning in 2001-02 and continuing through 2003-04. These reductions ranged from $400,000 to about $1 million. The largest reduction was proposed in the context of requiring mandatory e-filing by tax practitioners filing in excess of a specified number of tax returns.

No similar budget reductions were proposed as part of the 2004-05 budget or the 2005-06 budget. Given the continued growth in e-filing and the cost savings associated with not printing, mailing, or processing paper returns, FTB has experienced cost savings associated with this shift in filing methods. Based on the lower end of the savings achieved in prior years, we recommend that the Legislature reduce the FTB budget by

$800,000, reflecting savings achieved in 2004-05 and 2005-06 through the development and deployment of electronic technologies.

COMMENTS

FTB concurs with the LAO that it expects to achieve an additional $800,000 of savings from increased e-filing and e-payments. The FTB, however, indicates that it would prefer to retain this money in its budget as an offset to the unallocated reduction discussed in Issue 1.

ISSUE 3: OTHER BUDGET CHANGE PROPOSALS

Child Support Enforcement. The Governor's Budget for the FTB includes an augmentation of $26.1 million General Fund, $52.9 million in reimbursements from the Department of Child Support Services (DCSS), and 15.5 positions to continue the federally mandated development of a single, statewide child support enforcement system in 2005-06. It also includes an augmentation of $170,000 General Fund and $330,000 reimbursements for activities related to the State Disbursement Unit. The FTB is responsible for development and operation of these systems in cooperation with the DCSS. The administration currently plans to complete the first phase of this large project which will provide a centralized state database and disbursement system by September 2006. It is anticipated that successful completion of this phase will end federal penalties of $226 million annually.

Privacy Protection. The Governor's Budget includes $698,000 ($513,000 General Fund) to implement privacy protections for social security numbers as required by Chapter 907, Statutes of 2003 (SB 25, Bowen).

Senior Citizens' Tax Assistance Program Changes. The Governor's budget proposes to replace the current Senior Citizens' Property Tax Assistance Program with an expansion in the Senior Citizens' Property Tax Deferral Program. In addition, benefits and eligibility for the Senior Citizen Renters' Tax Assistance are proposed for substantial reductions (see the Tax Relief section for more detail). The FTB administers the two tax assistance programs. Because the Governor's proposals would reduce eligibility and therefore the FTB's administrative workload, the budget includes savings of $575,000 and 12 positions for FTB in 2005-06.

COMMENTS

LAO Recommends Approval of Child Support Enforcement and Privacy Protection Proposals. Although the LAO originally raised concerns with the Child Support Enforcement proposal, those concerns have been addressed and the LAO now recommends approval of this proposal. No issues have been raised regarding the Privacy Protection proposal.

Tax Assistance Program Administration. The senior tax assistance programs are budgeted in Item 9100 (Tax Relief), which will be considered at a subsequent hearing. Administrative funding for FTB should conform with the decision on the tax assistance programs.

The Department of Finance also has submitted several additional April Finance Letter requests for the FTB that will be considered at a later hearing.

TAX GAP ISSUES

The "Tax Gap" represents the shortfall between taxes owed and taxes paid. FTB estimates that California's annual tax gap for the Personal Income Tax (PIT) and the Corporation Tax (CT) totals about $6.5 billion, an amount equal to 12.3 percent of the $52.6 billion that the Governor's Budget estimates will be collected from the PIT and CT in 2005-06. Based on national studies by the Internal Revenue Service (IRS), most of this tax gap (about 80 percent) comes from underreporting of taxable income on tax returns filed by individuals and corporations. Typical examples of underreporting include claiming excessive deductions or credits; using cash transactions to hide income, and excluding income that the IRS and FTB find difficult to track (such as income from pass-through entities or payments to independent contractors). The remainder of the tax gap is due to nonfilers and to persons and businesses that make underpayments.

Over the past two years, the Legislature has approved a number of amnesty-type efforts aimed at reducing the tax gap. The Voluntary Compliance Initiative (VCI) in 2004 recovered more than $1.3 billion from corporations and high-wealth individuals who had made use of abusive tax shelters (transactions without economic substance that are structured to produce apparent tax losses). Budget trailer legislation for 2004-05 enacted an amnesty program that waives penalties (but not interest) for individuals and businesses that pay overdue tax liabilities for years prior to 2003. The FTB closed the "window" for these amnesty filings closed at the April 4th.

ISSUE 4: GOVERNOR'S BUDGET TAX GAP PROPOSALS

Tax Gap Enforcement Proposal. The Governor's budget proposes a package of five measures to reduce the tax gap at a cost of $8.6 million (General Fund) and 99.2 positions. The effort will target preparers of fraudulent returns, increase audit staff, use more information sources to identify nonfilers, expand underground economy criminal investigations, and provide informant rewards. The budget estimates that these measures will generate $34 million of General Fund revenue in 2005-06, increasing to nearly $44 million in 2006-07.

The administration's proposal includes a sizeable cost component for the hiring of auditors. The proposal calls for the hiring of 36 associate tax auditors at a monthly salary of $4,782, which is the midrange of the salary schedule.

Abusive Tax Shelters. The Governor's budget is proposes $1.8 million and 17.1 positions to increase staffing for the Abusive Tax Shelter Taskforce. The additional funding to combat abusive tax shelters is expected to generate $43 million in General Fund revenue in fiscal year 2005-06 and $60 million in fiscal year 2006-07. This proposal builds on resources provided in the current year to enhance the FTB's capabilities to discover abusive tax shelters and to assess and collect the tax that should have been paid. With this augmentation, the FTB will have 90 staff devoted to the Abusive Tax Shelter Taskforce.

LAO Recommendation. LAO recommends approval of the bulk of the Governor's Tax Gap proposals. However, LAO recommends an adjustment to the hiring level of the additional auditors included in the Tax Gap Enforcement Proposal. To a large extent, FTB's most experienced auditors have been shifted over to the abusive tax shelter project, where complex auditing and financial reviews are conducted. According to the LAO, the audits that are likely to be associated with tax gap activities, by contrast, are likely to be rather straightforward and not require a substantial amount of previous experience. Accordingly, LAO recommends budgeting these positions at the entry level for a savings of $200,000.

COMMENTS

FTB concurs with the LAO recommendation, but would prefer to retain this money in its budget as an offset to the unallocated reduction discussed in Issue 1.

ISSUE 5: AMNESTY UPDATE

The FTB has reported that it received more than $3 billion of "extra" tax filings that appear to be related to the amnesty program. However, the FTB has cautioned that an unknown, but potentially significant, portion of this apparent windfall may be ephemeral. Some of the filings are amounts that would have been made have been paid later, but were accelerated to avoid penalties. Other amounts may be for "protective" filings outside of amnesty. These filings do not avoid the normal penalties, but by filing before the amnesty deadline, they preserve the right to claim refunds later and avoid the possibility of the additional post-amnesty penalty (50 percent of the accumulated interest on unpaid tax through March 2005). Some taxpayers currently in audit or protesting FTB assessments probably have filed for larger amounts that are larger than they expect for their final tax liability and plan to file for refunds later.

COMMENTS

The FTB has indicated that it will provide the subcommittee with a preliminary assessment of the amnesty results.

ISSUE 6: IMPROVING COMPLIANCE BY INDEPENDENT CONTRACTORS

The LAO's February report on California's Tax Gap reviewed some of the characteristics of noncompliance that have been identified by federal and state tax administrators in order to devise appropriate enforcement policies. Two key characteristics that contribute to noncompliance are:

- ***Absence of Withholding.*** The lack of withholding for tax purposes in certain situations can lead to an increase in taxpayer noncompliance. Conversely, where taxes are actually withheld at the point of payment (such as with wages) the amount of noncompliance is quite small, and the chances quite good that the taxpayer will file a return with the amount of income accurately stated.

- ***Little or Poor Information Reporting.*** The second major characteristic of noncompliance occurs in situations where there is little or inaccurate information reporting. This is clearly the case in cash transactions, as well as in other areas where there is a lack of adequate independent reporting requirements. For example, when businesses do not accurately report payments to subcontractors, tax agencies have no way in which to verify the income.

Income earned by independent contractors (individuals, and certain corporations, who are paid by a business but are not employees) has both of these characteristics. There is no withholding (except for payments to out-of-state contractors) and information reporting for independent contractors has many shortcomings.

Recent Report by FTB Points Out Some Problems with Withholding. In an exploratory effort last year (as part of the 2004-05 budget), the Legislature directed FTB to conduct a study regarding the policy impacts and feasibility of imposing withholding requirements on payments to certain contractors. The resulting *Independent Contractor Withholding Report* indicates that while a comprehensive withholding requirement would increase tax compliance among independent contractors, it would also have certain drawbacks. Much of the potential difficulty relates to the variation among different types of independent contractors. For example, only a small portion of a rental payment may be taxable profit, but most of the commission earned by a real estate agent may be taxable net income. This variability makes it impossible to use one withholding rate schedule for all independent contractors. In contrast, income from wages is predominantly net income, simplifying withholding.

Although payments to independent contractors are subject to reporting (on IRS form 1099), this reporting requirement has several shortcomings. Payers are not required to verify the accuracy of taxpayer identification numbers (TINs) of independent contractors and the FTB does not systematically match payments reported on 1099s with the actual amounts of income reported by the taxpayers with matching TINs. In fact, about the TINs for about 500,000 1099 reports annually do not match any active TIN.

What Steps Might Be Worth Exploring? A number of steps may be worth exploring to improve compliance for independent contractors.

- **Withholding.** The LAO suggests exploring a more flexible withholding requirement that would allow for waivers or different rates. Another approach might be to impose withholding only for certain types of independent contractors, such as real estate agents, that share common characteristics.

- **Verification of TINs.** The IRS now offers businesses an online verification service that verifies the validity of a TIN/name combination. The state could require verification, at least in some circumstances.

- **Better Use of 1099 Reports.** The FTB could expand its information processing efforts to do a more thorough job of matching the amounts reported on 1099s with the amounts actually shown on tax returns from independent contractors and others who receive 1099s.

COMMENTS

The LAO and FTB should report to the subcommittee on their ideas for improving compliance for independent contractors and others receiving 1099 payments.

The FTB has informally suggested that it would like to hire an independent consultant to evaluate strategies for withholding and for improving the usefulness and accuracy of 1099 reports.

ISSUE 7: ADDITIONAL ACTIONS TO REDUCE THE TAX GAP

Several additional types of actions have been identified by LAO and staff that could have the potential of reducing the tax gap. These include:

1. **Integrated Information System.** FTB has a number of information systems that are used for specific purposes, such as the compilation of tax data and audit selection. The Board of Equalization and Employment Development Department also maintain their own data systems. Other potentially useful sources of data for tax compliance purposes reside in information systems within other agencies, such as professional licensing, driver's licenses, and corporate registrations. An integrated data system with a universal taxpayer identifier would improve compliance and enforcement capability for all of the tax agencies. However, development of a comprehensive information system would be a massive, expensive, and risky project.

2. **Reinstate Discovery Audits.** Discovery audits (audits that are randomly selected) can provide valuable information on new areas of tax evasion or noncompliance. They also can uncover areas where simplification or better instructions could assist honest taxpayers. FTB had a discovery audit program in the past, but resources were redirected to more immediate priorities. FTB indicates that it could implement a multidisciplinary compliance discovery audit program with 20 additional positions at an annual cost of $1.7 million (half that amount for a January 1, 2006 startup in 2005-06). FTB also notes that smaller augmentations still would be useful. FTB estimates that discovery audits would more than cover their cost.

COMMENTS

The FTB and LAO should discuss the pros and cons of the additional actions identified above and other alternatives for reducing the tax gap.