AGENDA
ASSEMBLY BUDGET SUBCOMMITTEE NO. 4 ON STATE ADMINISTRATION

Assemblymember Warren Furutani, Chair

TUESDAY, APRIL 27, 1:30 PM
STATE CAPITOL, ROOM 447

CONSENT ITEM

VOTE ONLY ITEMS

ITEMS TO BE HEARD

CONSENT ITEM

ITEM 1730 FRANCHISE TAX BOARD

ISSUE 1: HOMEOWNERS AND RENTERS ASSISTANCE PROGRAM REDUCTION

The Franchise Tax Board (FTB), administers the Homeowners and Renters Assistance (HRA) which provides assistance payments to qualified homeowners and renters to offset their direct or indirect property tax payments. As a result of budget constraints, the 2009-10 budget did not provide funding for payment of HRA claims, and beginning in 2010-11 the program will cease to function. This Finance Letter requests a reduction of $495,000 and 7 PYs in the HRA program due to the elimination of program administrative functions. In addition, the Finance Letter requests a realignment of $1,116,000 and 3 PYs from the HRA program to the tax program for activities that represent fixed costs of the department.

STAFF COMMENTS

The HRA program has been facilitated by access to FTB's tax program IT mainframe operations, and thus shared in the system's fixed costs. With the termination of the HRA program, the fixed costs formerly borne by the program will be shifted to the tax program.

Staff Recommendation: Approve funding reduction and realignment.

VOTE ONLY ITEMS

ITEM 1730 FRANCHISE TAX BOARD

ISSUE 1: LIMITED LIABILITY COMPANY PROTECTIVE CLAIMS

Recent 2008 Court of Appeal cases (*Northwest Energetic Services, LLC v. Franchise Tax Board* and *Ventas Finance I v. Franchise Tax Board*) made the determination that the manner in which California's Limited Liability Company (LLC) fee was administered in an unconstitutional manner because it was not apportioned. Taxpayers have filed requests for refunds of LLC fees paid in excess of what should have been assessed based on the court decisions. These claims were made in order to protect their Statutes of Limitation while awaiting court decisions. FTB staff must examine and process the claims and determine which claims warrant a refund. The request is for $172,000 General Fund and 3 PYs for a 1-year limited-term.

STAFF COMMENTS

Additional resources are required in order to process the claims in a timely manner, minimizing taxpayer inconvenience as well as state costs. The approval of additional resources on a limited term basis will expedite taxpayer claims and minimize state exposure to additional costs. The LLC fee has been restructured based on the court decisions.

Staff Recommendation: Approve.

ISSUE 2: COURT ORDERED DEBT COLLECTIONS PROGRAM

Legislation adopted in 1994 established the authority of the Court Ordered Debt Collection (COD) Collection Program to collect court-imposed fines, penalties, forfeitures, and restitution orders. FTB was mandated by subsequent legislation to offer collections services to all California counties and courts. The program is benefits-funded from revenue collected by the program. The request is for $903,000 in reimbursement authority and the conversion of 8 limited-term positions to permanent.

STAFF COMMENTS

The program is structured in manner that does not require General Fund support, relying solely on collections revenue. Current uncollected court ordered debt is estimated to be $5.6 billion. Improvements in collection of this debt would significantly help court finances and the judicial branch budget.

In May, the Subcommittee will be considering a proposal sponsored by the Administrative Office of the courts (AOC) and the California state assn. of counties (csac) to enact a comprehensive program to enhance collection of court ordered debt. The proposal is being developed pursuant to statutory direction (penal code section 1463.010). FTB collections and offsets are consistent with this statutory direction.

Staff Recommendation: Approve.

ISSUE 3: SECURITY WORKLOAD GROWTH

FTB security operations are designed and deployed to ensure the confidentiality, integrity, and privacy of taxpayer information. The department has multiple layers of security protection for its information systems and as the surety risks have shifted, FTB efforts have been increasingly focused on internal risks while maintaining a presence with respect to external threats. Of the requested positions, 3 positions will focus on informational internal security auditing which monitors 34 tax systems and 300 event-server logs, and 2 positions are related to external security, particularly regarding network-attached systems, new systems, and outside vendors. The data and information subject to risk is state data and taxpayer information. Additional data is from the Internal Revenue Service, which constitutes a critical component of FTB's compliance and enforcement efforts. This proposal is a request to convert 5 existing limited-term positions to permanent, at a General Fund cost of $447,000.

STAFF COMMENTS

The positions were instituted on a limited-term basis. The on-going requirement for such security resources has been demonstrated.

Staff Recommendation: Approve.

ITEMS TO BE HEARD

ITEM 0860 BOARD OF EQUALIZATION

The Board of Equalization (BOE) administers and collects state and local sales and use taxes, administers a variety of business and excise taxes and fees (including motor fuel taxes, cigarette taxes, and alcoholic beverage taxes), and oversees the administration of the property tax by county assessors. The BOE is governed by a five-member board, consisting of four regionally elected members and the State Controller. The Board is the final administrative appellate body for the taxes and fees it administers, as well as the personal income and corporation taxes, administered by the Franchise Tax Board (FTB). Currently, BOE's tax and fee administration programs result in the collection of approximately 32 percent of the state's annual revenues, as well as substantial revenues for local governments and special programs.

BOE administers taxes benefiting the state General Fund, various special funds, and local governments. The source of its support is allocated among the various funds on a benefits-received basis. The Governor proposes expenditures of $473.0 million ($265.8 million General Fund) and 4,368.3 PYs of staffing for BOE in 2010-11—an increase of $47.7 million, or 11.2 percent ($27.5 million, or 11.5 percent, General Fund) and an increase of 51.4 PYs (1.2 percent).

Costs and PYs	2008-09 (actual)	2009-10 (estimated)	2010-11 (proposed)
Expenditures	$408.2 million	$425.3 million	$473.0 million
Personnel Years	3859.4	4316.9	4368.3

A large proportion of the increase in funding is a result of proposals to restore the 2009-10 baseline reduction of $13.5 million, and the one-time reduction of $28 million. These reductions were applied to BOE's budget based on the Board's decision not to participate in the Governor's furlough program. BOE was able to absorb the base-line and one-time reductions through a hard hiring freeze and voluntary work reductions. While the agency was able to direct staff to the most productive revenue–related activities, delays in the receipt of revenue as well as permanent revenue losses occurred.

ISSUE 1: PROTECTING STATE REVENUE

For 2009-10, the BOE budget was reduced by $41.5 million, comprising a $13.5 million baseline reduction and a $28 million one-time reduction. These reductions were put in place in lieu of the Board's participation in the Governor's furlough program for all state employees. This BCP proposal seeks a restoration of the 2009-10 baseline budget reduction of $13.5 million (and requests no further reductions in the budget year). The $28 million one-time reduction is to be restored as a part of the 2010-11 budget. The 2009-10 budget reductions were absorbed by BOE by instituting a hard hiring freeze and voluntary work reductions.

BOE estimates that the 2009-10 budget reductions (equivalent to savings attributable to three furlough days), resulted in the loss or delay of $264 million in state revenues ($156 million General Fund). If the $13.5 million base-line reduction is not restored as part of the budget, BOE estimates a loss or delay of an addition $88 million in revenue for the budget year. Some of this would be recovered in subsequent fiscal years, but other portions would represent a permanent loss. If budget reductions continue, revenue delays could convert to actual permanent losses. Permanent loses would be the result of:

- Losing audit opportunities though expiration of statutes of limitation;
- Businesses closing prior to the commencement of collection activities;
- Higher interest payments to taxpayers due to processing delays; and,
- Untimely liens and claims under bankruptcy laws.

The overwhelming majority of taxpayers voluntarily comply with the state's tax laws. As a result, the majority of the revenue loss identified by BOE is due to a curtailment and reduction in activities associated with the BOE's compliance and enforcement efforts, such as audit activities and collection efforts. The department engaged in reallocation of existing resources in order to maximize revenue collection within given budget constraints. Since this is a restoration and BOE has absorbed the current year reduction through a hiring freeze and voluntary work reductions, there are no additional positions requested in the proposal. The origin of this proposal is BOE, following discussion with the Department of Finance.

Funding Source	2009-10 (000s)	2010-11 (000s)	2011-12 (000s)
General Fund		$9,944	$9,944
Special Funds		$3,512	$3,512
Total		$13,456	$13,456

STAFF COMMENTS

1. In order to address the budget reductions during the current year, BOE redirected some staff and reallocated existing resources to minimize the revenue impact on the state. This is likely to have lead to some decline in the resources devoted to ongoing administrative activities associated with voluntary compliance and taxpayer assistance programs.

2. To the extent that the budget reduction led to revenue delays, this may have resulted in a backlog in audits and collection efforts. There may also be some related increase in the amount of accounts receivable that could warrant an additional period of redirection

of resources (or temporary positions) in order to address any increase in backlog that may have occurred.

3. BOE provides a supplemental report to the Legislature on its auditing and collection activities. Restoring BOE's budget would have an impact on the reported benefit cost ratios. The current accepted guideline for audit and collection activities is in the range of 4:1. In the supplemental report, several activities conducted by BOE are well in excess of this ratio, including: desk audits, collection programs, and return analysis. BOE should comment on whether reallocation of existing activity among these revenue generating activities may be warranted. BOE could also comment on additional resources and whether these could be deployed productively.

4. BOE has reported that its average benefit:cost ratio for revenue-related activities is 12.4:1, with a marginal ratio of 5.2:1. A reasonable ratio (as historically applied to the tax agencies) is 4:1. BOE staff indicated that their current plans based on this restoration press the agency to the limit because of hiring and training requirements. That is, staff indicates that they simply cannot absorb any more staff even though the benefit:cost ratio might warrant such an additional expansion.

SUGGESTED QUESTIONS

1. **In its supplemental report to the Legislature on audit and collections activity, BOE reports average benefit:cost ratios are in excess of current accepted guidelines for most of the activities. Can the department comment on the marginal benefit:cost for additional resources down to a 4:1 benefit:cost ratio?**

2. **Given that resources were redirected to the most productive revenue-generating activities, one would assume that there is now somewhat of a backlog of accounts that would have developed. Can the department comment on additional resources necessary to work down this backlog?**

Staff Recommendation: Approve.

ISSUE 2: AGRICULTURE INSPECTION STATION TAX LEADS

BOE is responsible for compliance and enforcement of the use tax, which is a companion tax to the state sales tax and imposed at the same rate and on the same tax base. The use tax is imposed on the use of goods in California that have been purchased outside of the state. Unlike registration requirements for in-state sellers, states cannot require out-of-state sellers to register and collect the tax. Thus, the use tax represents an attempt to prevent purchasers from avoiding the tax by buying items from outside of the state and using them in-state. Much of the use tax goes uncollected as a result of noncompliance. The non-payment of the use tax by individuals and businesses contributes significantly to the "Tax Gap"—defined as the difference between taxes owed to the state and taxes actually paid. BOE has had an ongoing effort for a number of years to reduce the magnitude of the tax gap.

In investigating different components of the Tax Gap, BOE staff determined that a significant amount of tangible personal property subject to taxation enters California by way of motor carrier transport. Some of the property being shipped (and upon which the sales tax is not paid), would be subject to the use tax. BOE further determined that due either to intentional tax avoidance or lack of understanding of the law; the use tax may not be remitted by the California purchaser and goes unpaid. Through its various inspection stations, the California Department of Food and Agriculture (CDFA) is able to inspect all motor carriers coming into the state and also has access to the bills of lading for such shipments.

Pilot Program. As a component of its Tax Gap enforcement initiative, BOE entered into an interagency agreement with CDFA, through which it obtains copies of bills of lading. These bills of lading serve as potential leads for follow-up by BOE staff to see whether use tax was paid on items shipped into California. BOE staff determines if the customers are businesses are registered with the state, and assigns staff for additional contact, analysis, assessment of taxes and permitting of unregistered businesses. The program began in 2007-08 as a pilot program at the Needles CDFA border inspection station and relied on BOE staff at the Riverside district office. The program generated revenues of $13.2 million in 2007-08 and $13.0 million in 2008-09, resulting in a benefit:cost ratio of 9:1. The original revenue estimate was $8.9 million. The program is scheduled to expire June 30, 2010.

Current Proposal. This BCP proposal would continue the inspection program at the Needles location, and expand the program to include inspection stations at Hornbrook, Truckee and Yermo. These locations were selected based on the amount of motor carrier traffic, the types of merchandise being shipped, and the likelihood that the station would generate potential leads for use tax collection by the agency. The proposal would require funding of $6.7 million ($4.4 million General Fund and $2.3 million special funds) in 2010 and $6.0 million in 2011-12 ($4.0 million General Fund and $2.0 million special funds). This would result in converting 16 limited-term positions scheduled to expire this year to permanent positions, and fund 42.5 new permanent positions for program expansion. The continuation and expansion of the program is expected to generate revenue of $36.7 million in 20010-11 and $44.4 million in 20011-12 and subsequent years.

Funding Source	2009-10 (000s)	2010-11 (000s)	2011-12 (000s)
General Fund		$4,409	$3,972
Special Funds		$2,272	$2,046
Total		$6,681	$6,018

STAFF COMMENTS

1. The Blythe station would appear to meet the criteria for both sufficient motor carrier traffic and potential leads to warrant inclusion in the expansion of this Tax Gap program. This location was eliminated from the expansion based on concerns about traffic delays and safety issues.

2. The pilot program was established with limited-term positions. The program expansion is proposed to consist of permanent position.

3. BOE staff indicates that it is examining opportunities for additional programs at shipping points for other modes of transport, including air freight and rail.

SUGGESTED QUESTIONS

1. **The benefit:cost ratio for the program is in excess of 7:1. BOE should comment on the expansion of the program that would generate additional revenues but maintain a reasonable benefit:cost ratio.**

2. **The program was not extended to the Blythe station because of concerns about traffic delays and safety. BOE should address potential mitigation measures that could be instituted to mitigate these issues.**

3. **Could educational efforts by the agency reduce the necessity of this program in the future? What would be the drawbacks of approving 2-year limited-term positions for the expansion as opposed to permanent positions, while retaining the conversion to permanent positions for the current limited-term positions?**

4. **What is the status of fashioning programs similar to the CDFA program for air freight and rail shipping?**

Staff Recommendation: Approve, on the basis of 2-year limited-term positions for program expansion.

ISSUE 3: ENSURING FUEL TAX COMPLIANCE

This proposal represents a request to continue BOE's participation in two programs that relate to compliance with California's fuel tax law and the collection of program revenues.

1. The first component continues the agency's participation in the Joint Operations Center (JOC) project for national fuel compliance, which is intended to reduce fuel tax evasion for the participating states. The program provides staff, data and expertise from states and the federal government to identify under-reporting, non-reporting and trends in tax evasion. The proposal calls for the continued finding of 2 positions for 3-year limited-terms. The source of annual funding is $300,000 from Federal Highway Administration funds.

   JOC has established a National Data Center and is in the process of integrating California data into the national data base. In 2009, BOE began the process of analysis and investigation of leads being generated by the data center and will soon begin its initial joint examinations with other participating entities.

2. The second component is continued funding for BOE's participation in the International Fuel Tax Agreement (IFTA). Participation in IFTA is required of all 48 contiguous states in order to secure federal matching fuel funds. California receives about $3 billion of such funds annually. IFTA provides the administrative framework for apportioning fuel taxes among the 48 contiguous states and Canada. This request is for $230,000 from the Motor Vehicle Account to make permanent 3 limited-term positions that will expire June 30, 2010.

   IFTA requires state and Canada to process tax returns and distribute funds (or send a billing) to other participating jurisdictions by the end of each month for the correct distribution of taxes among the participants. IFTA also requires truckers to file an IFTA return, which is keyed and entered into the processing center data. BOE must review and confirm all returns in order to be in compliance with IFTA.

STAFF COMMENTS

JOC was subject to numerous delays and remains in the development and implementation phase. Funding is minimal and will allow for the assessment of additional fuel tax revenues that could be received by the state. It may be appropriate to coordinate the actual term for the positions with when any results of the program will be evident.

Each jurisdiction participating in IFTA is evaluated every 4 years. BOE was cited in 2003 and 2007 for untimely remittals of moneys and filings. BOE avoided IFTA sanctions by approving funding for additional positions which will expire this year.

SUGGESTED QUESTIONS

1. **When is it likely that results of the JOC will be evident? What are the likely additional (or safeguarded) revenues that will result from this program?**

2. **Would limited 2-year limit-term positions for JOC be a more appropriate period, given the history of the project?**

Staff Recommendation: Approve.

ISSUE 4: FUEL TAX SWAP ADMINISTRATIVE COSTS

BOE administers the sales and use tax and various excise taxes on vehicle fuels. The Legislature approved ABx8 6 and SB 70 (the Fuel Tax Swap) which will result in (i) a reduction in the sales tax on gasoline and an increase in the excise tax on gasoline effective July 1, 2010, and (ii) an increase in the sales tax on diesel and a decrease in the excise tax on diesel, effective July 1, 2012. The Fuel Tax Swap also requires annual calculations and potential tax rate adjustments in order to maintain revenue neutrality.

Under the Fuel Tax Swap, BOE administrative responsibilities will expand as a result of potential annual increases and decreases in the tax rate. These responsibilities include reprogramming the Integrated Revenue Information System (IRIS); revising returns, notices and other forms; notifying taxpayers; and, registering taxpayers for the floor stock taxes. An increasing rate could result in more motor vehicle fuel accounts being subject to audit. Varying rates will also add complexity to refund processing and require additional field audits. This Finance Letter requests $1.5 million ($1.2 Motor Vehicle Fuel Account) for 2010-11 and $1.4 million ($1.1 Motor Vehicle Fuel Account) to administer the Fuel Tax Swap. This augmentation would add 11.4 PYs on an on-going basis.

Funding Source	2009-10 (000s)	2010-11 (000s)	2011-12 (000s)
General Fund		$138	$118
Special Funds		$1,249	$1,128
Reimbursements		$151	$129
Total		$1,538	$1,375

STAFF COMMENTS

Some of the activities identified by the department appear to be short-run costs that should eventually decline as taxpayers get used to the annual adjustments. For example, the Finance Letter notes that the sales tax return analysis and allocation section workload will increase because of additional complexity and more taxpayer errors. There are other areas that suggest increased workload due to increased complexity that would be expected to decline over time and may warrant some positions associated with short-term costs to be limited-term.

The sales and use tax administrative expenses are borne by the General Fund, special funds and reimbursements. To the extent that the General Fund share has declined as a result of the Fuel Tax Swap, a recalibration of the cost-sharing methodology may be appropriate. BOE could comment on the distribution of costs and when these are recalibrated.

SUGGESTED QUESTIONS

1. **Identify the short terms costs associated with the administration of the fuel tax swap that would be expected to be reduced over the longer-term.**

Staff Recommendation: Hold Open, pending receipt of additional information and explanation.

ISSUE 5: COST RECOVERY—COLLECTION FEES

The overwhelming majority of taxpayers are compliant with the state sales and use tax law. In the event that taxpayers are non-compliant, BOE staff engage in extensive efforts to work with taxpayers in order to achieve full or partial payment of the liability in manner that is both fair to the taxpayer in question and equitable to all California taxpayers who pay their tax liabilities in a responsible fashion. In situations where BOE and the taxpayer are unable to reach an agreed-upon solution, BOE may initiate collection proceedings.

BOE expends considerable legal and collection resources in an effort to secure payment of the full or partial tax liability. Currently, BOE does not impose collection fees on the taxpayer for such efforts. As a result, collection costs are borne by compliant taxpayers who pay their tax liabilities in a timely fashion. FTB also engages in collection efforts to collect on tax debts. Based on its average collection costs, FTB imposes collection fees of $217 for individuals and $413 for corporations. Many other states impose collection fees on businesses that do not comply with their state's sales tax laws. BOE estimates that if it were to impose collection fees comparable to FTB collection fees, based on average collection costs, the fee would be $230. This fee level would result in the assessment of $41.4 million one-time (current plus retroactive liabilities) and $25.3 million on an on-going annual basis.

Actual "cash in the door" resulting from the establishment of collection fees would depend on whether BOE is granted the authority to use collection tools to collect on the fees. Currently, BOE staff does not believe that the authority to use such tools exists. Without such tools, BOE staff indicates that "cash in the door" would be on the order of $5 million annually, while using collection tools would increase the cash received to approximately $22 million.

STAFF COMMENTS

Last year Subcommittee-4 approved an action to establish general statutory authority to allow all departments to charge a fee for their costs of collecting delinquent accounts receivable and to allow the BOE to add the contingency fee for in-state private collection agencies' fees to tax liabilities.

The Committee could request BOE staff to formulate a potential collection fee program for cost recovery purposes.

SUGGESTED QUESTIONS

Given the assessment of fees by FTB and other states, establishing similar fees for significant costs borne by BOE would be reasonable. BOE should comment on:

1. **What are the over-all collection activity costs and the average cost per-case of collection efforts?**
2. **What would be the administrative costs for putting a collection fee program in place and whether it would require Board approval?**
3. **What are the negative implications of granting the agency additional authority for the use of collection tools?**

Staff Recommendation: No action. Hold open for additional information.

ISSUE 6: OVERSIGHT—HEADQUARTERS BUILDING

The BOE Headquarters Building has a long and expensive 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 the ongoing lease payments.

Building Repairs and Remediation. The building has a history of construction defects causing water leakage, mold, and falling glass from the building curtain wall. There have been system failures as well, including but not limited to the elevators and plumbing. A major project to replace the curtain wall glass and seals and to remediate areas of water leakage was completed in 2006. Leakage problems, other building system problems and employee complaints of building-induced illness continue, nevertheless. For various building repairs, radiation and improvements, $32.1 million has been absorbed by the state, including $15.5 million for the curtain wall project, alone. Projected costs for additional work to bring the structure to a fully-functional level are about $27.5 million, bringing the total amount already expended and estimated future costs to $59.5 million.

Building Financing. The state pooled money investment board (PMIB) advanced BOE $88 million from PMIA to purchase the building from CalPERS. PMIA was to be repaid with a lease revenue bond sale, which has not occurred. According to BOE, bond financing for the purchase never was completed due to the ongoing problems and temporary financing from the Pooled Money Investment Account (PMIA) remains in place.

Last year subcommittee-4 approved the use of $5.9 million from BOE's budget, that would have been used to pay bond debt service for the building's purchase (had bonds been sold), to instead be used for repair and remediation of building problems.

DOF reported at the pre-hearing that if bond market conditions continue to improve, the delayed lease revenue bond sale may take place in October. If this comes to pass, BOE will no longer have the $5.9 million available to maintain building remediation that may be necessary in the future, since it now will be used to pay off the lease revenue bonds. Further, if the building continues to be in need of major remediation and repair, the lease revenue bond sale could be jeopardized, as the building would not provide the kind of collateral necessary to secure the bonds.

Occupancy Exceeds Desirable Level. The BOE indicates that the recommended maximum occupancy for the building is 2,200 and that estimated occupancy will exceed this level by 700 if full repair and remediation were completed for the building. Any additional growth in the agency would obviously require additional space elsewhere. A portion of BOE legal staff has been housed at FTB facilities in Rancho Cordova and certain administrative function occur at facilities in West Sacramento.

The Board indicates that leasing additional space and reducing crowding is necessary to maintain employee productivity and morale and to protect the health and safety of employees because the building's HVAC and other systems are being stretched and because remediation of ongoing problems requires continually shifting employees out of the areas affected by the remediation work.

Employee Productivity and Revenue. BOE staff has noted the significant impact of the building contretemps on productivity and revenue collection for state and local governments. Based on the shifting of resources identified above, BOE estimates a loss in productivity of 111 PYs at a cost of $8.3 million. This has generated a revenue loss of $22 million annually.

STAFF COMMENTS

BOE headquarters building will likely continue to suffer from ongoing issues, even after remediation. This is because mold will continue to exist between walls and in other areas not accessible to staff. This situation will require on-going monitoring of air quality in order to ensure a healthy work environment. Thus, even with the completion of repairs and remediation, BOE will be housed in a building with ongoing costs and which is too small to adequately house agency staff. This is likely to affect the overall efficiency, productivity and effectiveness of the organization.

Last year Subcommittee-4 urged BOE and Department of General Services to complete an analysis of options for future action to relocate the BOE as quickly as possible, so that the state could minimize additional building costs that it has been incurring and resolve the issue once and for all. To date, staff is unaware of any final assessment of relocation options.

SUGGESTED QUESTIONS

BOE (or the Department of General Services, as appropriate) should summarize for the subcommittee the history of the building, repair and remediation costs imposed, and current occupancy levels. BOE should specifically address the following questions:

1. **What is the most recent assessment regarding relocating headquarters staff to leased space in the Capital and environs, given the advantageous rental market?**

2. **When does BOE and DGS believe a report on relocation options and costs will be forthcoming?**

3. **Does the Board anticipate an additional funding request in the near term to address the additional costs for repair and remediation identified above? What is likely to be the magnitude of this request?**

ISSUE 7: OVERSIGHT—USE TAX LINE ON INCOME TAX RETURNS

BOE estimates the current gap for taxes that it administers at approximately $2 billion in lost revenues annually due to noncompliance, with General Fund reductions of $1 billion annually. The major components of the Tax Gap are: use tax liabilities of businesses and individual consumers, tax evasion by nonfilers, and under-reporting and nonpayment by registered taxpayers.

BOE has a number of programs—largely through the sales and use tax program—that are aimed at reducing the size of the Tax Gap. Some of these are designed to increase voluntary compliance and focus on education and outreach efforts to inform consumers and businesses regarding their tax collection and remittance obligations. In other cases, Tax Gap efforts are focused more on the compliance and enforcement activities, such as the agricultural station inspection program discussed under Issue 3 in this document.

Much of the Tax Gap is difficult to address, and doing so may impose excessive costs on both revenue agencies and taxpayers. Nevertheless, numerous programs 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 put in place by SB 1009 (Alpert) in 2003. Since that time, revenue generated from this policy has increased to an estimated $10.2 million in state and local revenue for tax year 2008. Costs associated for this program are approximately $100,000.

Due to the sunset date incorporated in the original legislation, the 2010 tax year is the last year the program will be in effect. Legislation extending the program [AB 469 (Eng)] was vetoed by the Governor in 2009. BOE estimates that the bill—which included a "look-up" table to assist taxpayers in calculating their tax liability, and a mandatory reporting requirement if the tax was noted reported to BOE—would have generated approximately $13.7 million annually.

STAFF COMMENTS

BOE staff should provide additional information regarding:

- **The use tax line and whether other options are available to collect this portion of the consumer use tax.**
- **There may also be issues with how this approach fits with the agency's overall Tax Gap strategy.**

ISSUE 8: OVERSIGHT—TAX GAP INITIATIVES

BOE has a number of additional Tax Gap initiatives currently in place. BOE received substantial resources as part of the 2008-09 budget to engage in activities related to narrowing the Tax Gap. It received $11.6 million to fund 112 PYs to carry out its Statewide Compliance and Outreach Program (SCOP), estimated to generate revenues of $38 million in 2008-09 and $51 million in 2009-10. In addition, BOE received $13.7 million for improving compliance by in-state service businesses with respect to out-of-state purchases, and improving and expanding audit and collection efforts. This effort was also expected to generate considerable revenues for the state.

Other Tax Gap programs include receiving referrals from U.S. Customs regarding shipments that arrive at California ports and may have use tax liabilities associated with them. BOE staff have also begun to audit service businesses throughout the state that are not registered sellers with the state and may have use tax liabilities based on out-of-state purchases. In addition, BOE has made improvements to its data classification system that eases the identification of potential cases for audit as well as applying a statistical approach to audit selection. Other initiatives undertaken by BOE include information-sharing with FTB which has helped identify use tax compliance. Finally, the department is continuing to investigate California on-line sellers' compliance with the sales and use tax law.

STAFF COMMENTS

BOE has had a Tax Gap strategic plan in place since 2007. In bringing the components of the plan into operation, BOE has initiated a number of specific programs—including those outlined above. BOE staff should describe for the Committee:

- **The results of its Tax Gap initiatives to date and the overall success of the program.**
- **The effect of budget reductions on strategic planning for its Tax Gap initiatives.**

ITEM 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 proposed expenditures of $587.8 million ($552.2 million General Fund) and 5,598 positions for FTB. This represents a substantial increase in support for the agency compared to the current year. Most of the budget year increase is due to restoring the impacts of the Governor's three-day furlough program in 2009-10, a policy which included the state's tax collection agencies. This policy and associated reductions are not part of the 2010-11 budget. In addition, the budget calls for augmentations for specific tax compliance programs and technology improvements related to the department's revenue collection activities.

Costs and PYs	2008-09 (actual)	2009-10 (estimated)	2010-11 (proposed)
Expenditures	$522.4 million	$500.4 million	$587.8 million
Personnel Years	5371.0	5276.4	5597.9

As a result of the furlough program for FTB, there was a significant impact on revenues collected during the current year. FTB took a number of steps to reduce this impact, including redirecting staff to direct revenue production activity, reducing or eliminating long-term strategic efforts, and limiting vacation use by staff. Despite these efforts, revenue reductions occurred due to reduced or delayed audit activity, reduced or delayed collection efforts, curtailed filing enforcement actions, as well as other revenue-related impacts.

FTB's 15% reduction corresponds to about 600 positions. A large majority of FTB personnel are revenue related with each auditor generating roughly $1 million and each collector $0.5 million, annually. FTB was a "self-directed" department with respect to the furlough program, giving it the flexibility in minimizing the revenue impacts of the program. Even with the efforts to mitigate the revenue effects, FTB estimates $465 million in delayed and lost revenues attributed to the following fiscal years:

- $296 million in 2009-10
- $85 million in 2010-11
- $86 million in 2011-12

One of the overlooked negative impacts of furloughs and budget reductions is in the area of strategic activities related to Tax Gap initiatives and Abusive Tax Shelter enforcement. In reallocating staff to the most direct and highest return revenue producing activities, FTB has shifted resources away from strategic activities, jeopardizing the effectiveness of these efforts in the longer-term.

ISSUE 1: TAX GAP ENFORCEMENT

The Tax Gap is defined as the difference between what taxpayers should pay according to law and what is actually remitted. The Tax Gap is the result of non-compliance with the state's tax law, either through intentional disregard or unintentional means. The FTB has identified an annual Tax Gap related to the personal income tax and the corporation tax of $6.5 billion. The presence of the Tax Gap puts an additional strain and burden on compliant taxpayers since, if all individuals and businesses complied, taxes for compliant taxpayers could decline and still result in generating the same amount of revenue for the state

FTB pursues various programs to narrow the Tax Gap. Some of these programs focus on taxpayer education and seek additional compliance from those who may not be aware of certain tax requirements. Other measures relate to enforcement efforts to improve compliance among individuals and businesses that chose not to comply with the state's tax laws. These measures result in additional revenue for the state that would otherwise not be received. Equally central to the core value of good tax collection practices is that such efforts make the tax system fairer to everyone by distributing the burden according adopted laws.

FTB has on-going audit and collections activities that ensure a certain level of tax compliance. Its Tax Gap activities, on the other hand, are designed to address particular problem areas where noncompliance is particularly acute and raises significant revenue issues for the state. This request includes two components that will allow FTB to continue two programs which are aimed at increasing compliance in specific problem areas:

1. **Increase Compliance with Nonresident Withholding.** FTB seeks $343,000 General Fund and 5 positions to expand funding for its efforts to increase compliance regarding California income earned by non-residents. FTB has directed its existing program to the entertainment industry, and has shown cost effective results. FTB now seeks funding to expand the non-resident compliance program to property rental income, royalty payments, franchise payments, and the accounting, service and temporary agencies. FTB estimates revenue of $5 million in 2010-11, with increasing amounts thereafter.

2. **Extend Compliance Enhancement Measures.** FTB seeks $5.4 million General Fund to make permanent 62.2 limited term positions that expire in the current year, and extend 14, 2-year limited-term positions. These positions are related to FTB's 2008-09 Compliance Enhancement Measures BCP and have been a significant part of its efforts to narrow the Tax Gap. The programs included within this program include new data sources (for example, luxury auto registration), address verification and correction, and master file return information from IRS.

Program Revenues	**2010-11 ($ m)**	**2011-12 ($ m)**	**2012-13 ($ m)**	**2013-14 ($ m)**
Nonresident Compliance	$8.0	$15.0	$16.5	$18.2
Enhanced Compliance	$106.3	$104.3	$95.0	$95.0
Total	$114.3	$119.3	$111.5	$113.2

STAFF COMMENTS

This program has demonstrated its cost effectiveness in the past, suggesting that continued funding is warranted. There is some drop-off in revenue associated with second component of the proposal. This drop-off coincides with the expiration of the 14 limited-term positions, indicating that continuing these at that point may be warranted. The benefit:cost associated with each of the components is well above the acceptable level, although FTB indicates that due to delays in training and hiring, additional resources would not be warranted at this time. The total cost of the request is $5.7 million and will generate $114.3 million in the budget year.

The Legislature approved FTB requests for a total of $17.6 million and 224 positions in the 2008-09 Budget for a variety of activities intended to improve compliance and collection of the PIT and the CT. At last year's Subcommittee-4 hearing, FTB estimated that these efforts would generate $104 million in additional revenue in 2008-09 and larger amounts annually thereafter.

SUGGESTED QUESTION

1. **What was the final financial impact of tax gap enforcement efforts in 2008-09, what is estimated for 2009-10, and how does that compare to the estimate above for 2010-11?**

Staff Recommendation: Approve.

ISSUE 2: ENTERPRISE DATA TO REVENUE PROJECT

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. This request is for a second year of funding for its Enterprise Data to Revenue (EDR) Project, which will address the agency's return processing and utilization of data and connect various systems. The request calls for $6.9 million General Fund and 40 positions. Over the long term, the project is expected to generate and safeguard significant state revenues in the high hundreds of millions of dollars. As a result of certain components coming on-line, the project generated $3.8 million in revenues in 2009-10 and is estimated to generate $19.9 million in 2010-11. The one-time cost of the multi-year project is estimated to be $234 million, and generate revenues $3.7 billion over its lifetime.

For 2009-10, the Governor's Budget requested $3.9 million of funding and 58 positions for this project. However, this request was deleted (without prejudice) in the 2009-10 Budget Act. That action reflected concern that this is the initial request for a major new data integration project at FTB that would cost almost $300 million (through 2016-17) to implement and which should be subject to further legislative review. The Administration then submitted an April Finance Letter that modified the proposal by accelerating, from January 2010 to July 2009, the hiring of staff such that the 2009-10 costs increased to $5.2 million, along with an increase in the 2009-10 General Fund revenue associated with the project.

EDR Budget Proposal and Project Description. The continuation of the EDR project is expected to (1) resolve an existing backlog in business entity return processing and collections correspondence; (2) fund the hiring of additional staff and consultants to document FTB's business processes as a precursor to development of the EDR Project; and (3) begin planning for the EDR project, including issuing a request for proposals. The FTB estimates that the proposal will increase General Fund revenue collected by $19.9 million in 2010-11 and $22.4 million in 2011-12, primarily by adding staff to process the current backlog of business entity returns and begin collection correspondence in order to accelerate revenue. The EDR project would take approximately seven years to implement fully and, once completed, would replace several older FTB information technology systems and streamline other existing systems.

Main Goals. 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.

Project Components. 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.

Benefit-Funded Approach. FTB indicates that it plans to finance the EDR Project using a benefit-funded approach. Contractor payment for system development and implementation will be conditioned on generating additional revenue that will more than cover the cost. This approach is intended to protect the state and also give the contractors a strong incentive to develop the project in a manner that produces significant revenue quickly. The FTB has used this approach previously. FTB's benefit-funded approach makes use of revenue gains from reducing the business entity backlog to more than offset costs in 2009-10 through 2012-13. Although these gains could be accomplished regardless of whether project development goes forward, it makes sense to move forward now because cleaning up the backlog is a necessary condition to efficient project development. In subsequent years, the estimates in the project's Feasibility Study Report (FSR) indicate large increases in annual revenue gains that would be more directly attributable to the IT project. From 2012-13 through 2015-16 annual revenue gains increase from $80.9 million to $888.8 million, while IT project implementation costs increase from $58.7 million in 2012-13 to a peak of $111.6 million in 2014-15 and then decline to $18.3 million by 2015-16.

The method of financing EDR is the same approach being taken with EDD's Automated Collection Enhancement System (ACES), which this Subcommittee approved two weeks ago.

STAFF COMMENTS

1. Because the net benefit of this project (as estimated in the FSR) ramps up quickly and becomes very large, the net present value loss to the General Fund that results from delaying the project by one year is somewhere between $600 million and $900 million (depending on discount rate). The investment required to avoid this loss is about $24 million over the next three years (disregarding revenue from backlog reduction). As noted above, the project begins to produce significant net revenues starting in 2013-14.
2. The FTB has among the best track records in California state government for the successful development and implementation of major information technology projects. FTB projects have experienced some significant delays and cost increases, although these problems generally have not prevented successful completion.
3. Existing Supplemental Report Language requires FTB to report to the Legislature when revenue, costs, scope or schedule variance exceed 10 percent.

SUGGESTED QUESTIONS

1. **FTB estimated revenues in 2009-10 of $7 million. What events caused revenues to not reach the estimated level?**

2. **In order to collect EDR related revenues, will there eventually be a need for additional positions?**

Staff Recommendation: Approve.

ISSUE 3: FEDERAL TREASURY OFFSET PROGRAM

FTB's compliance efforts benefit significantly from the interchange of data with other state departments and the federal government. Cross–matching data increases the likelihood of reaching successful conclusions in enforcement efforts and also increases the speed with which such activities are concluded. One of these cooperative programs is the Federal Treasury Offset Program (FTOP) which allows the state to collect on tax liabilities through a reduction in the amount of federal refunds owed to federal taxpayers.

Federal law provides authority for the federal government to collect various past due liabilities owed to states—including state tax obligations—by reducing the amount of refunds owed to its taxpayers. In return, the federal government requires states participating in the program to offset against state refunds certain federal obligations past due. Forty states currently participate in this federal program; California is only one of two states with a state income tax that does not currently participate. In 2008, the program resulted in $380 being collected for participating states.

The FTOP project will consist of four phases. The first phase will incrementally expand the current pilot program as well as begin the design, development and enhancements of FTB's accounting and collection systems for personal income tax cases. The second phase will begin the automatic transmission of personal income tax data to the federal program. Phases three and four will implement a similar program for businesses entities. This proposal is for phases one and two and consists of a request for $847,000 and 11 positions.

Project Estimates	2010-11 ($ millions)	2011-12 ($ millions)	2012-13 ($ millions)	2013-14 ($ millions)	Total ($ millions)
Revenue	$6.0	$80.0	$113.0	$93.0	$292.0
Expenses	$1.8	$3.6	$2.8	$2.8	$11.0
Net Revenue	$4.2	$76.4	$110.2	$90.2	$281.0

STAFF COMMENTS

The Federation of Tax Administrators (FTA) considers the offset program an effective collection tool for states to use. Its effectiveness was demonstrated in a pilot program put in place last year by FTB. The program effectiveness is demonstrated not only through the offsets actually made, but the number of taxpayer who—upon receiving a Notice to Offset from FTB—chose to submit payment directly to FTB. The initial year of the project has a benefit:cost ratio of 3.3:1. Once established, the project is estimated to have a benefit:cost ration of 33:1.

Staff Recommendation: Approve.

ISSUE 4: INFORMATION TECHNOLOGY REFRESH

FTB's tax processing activities are highly automated and are predicated on reliable and accurate information technology (IT) systems to process tax returns, remittances and related revenue-generating functions. The programs administered by FTB rely heavily on net-worked, automated systems, including;

- Data Center mainframe computer, which houses FTB's two key tax accounting systems:
    - Taxpayer Information
    - Business Entities Tax System

- FTB's internal network, which provides access to the mainframe, FTB's revenue and return processing system, the paper-return processing pipeline, and server based applications such as:
    - Integrated Nonfiler Compliance (INC)
    - Accounts Receivable Collection System (ARCS)
    - Professional Audit Support System (PASS)

The project request seeks funding to replace the Enterprise Tape Library System (ETL). The ETL provides continuous access to current accurate information that FTB's automated systems and staff rely upon to send accurate notices and perform appropriate, timely revenue generating activities. The funding request is over a two-year period which will spread the cost to the state over a longer period of time. The request is for $2.29 million General Fund in 2010-11 and for an additional $2.27 million General Fund in 2012-13.

STAFF COMMENTS

The ETL improvements addressed by the request help form the very core systems for FTB processing activities. The project was proposed last year but delayed. Unfortunately, much of the system components will fall out of vendor support during the budget year, leaving the department vulnerable to system failure. The option of using a third-party vendor is not a particularly good one, since coverage and service may not be the high level of quality required. Not funding this project would submit the department to an unreasonable level of risk.

Staff Recommendation: Approve.

ISSUE 5: RESTORATION OF FURLOUGH REVENUE

As indicated above under the general discussion of the FTB and staffing level, the department was significantly affected by the furlough program in terms of revenue generation. This request would serve two purposes. It would:

1. Exempt FTB from any furlough requirements if the furloughs were to continue—which, in the Governor's Budget they are not.

2. Provide additional temporary resources for the agency to address the backlog in various divisions that occurred due to the furlough program.

In the current year, FTB directed staff toward workload which had the highest benefit:cost: ratio in order to maximize revenue to the state. These revenue loss mitigation steps were discussed in the overview section of the department. The result was an increased buildup of workload which was set aside, even though this represents work that can be efficiently and effectively undertaken. This workload consists of direct revenue production including new and expanded audits, return processing, and additional filing enforcement efforts.

The contingent portion of the BCP—exemption from any 2010-11 furlough programs—would generate $860 million in revenue. In order to accomplish a reduction in the accumulated backlog of work, FTB has additionally requested $14.7 million General Fund and 158 PYs for the budget year. This will consist entirely of overtime and temporary help authorization and result in revenues of $50 million in the budget year.

STAFF COMMENTS

FTB should discuss the revenue impact of delays in the hiring of temporary help as well as any time that would be required to train staff that is hired. Using existing staff and overtime or hiring retired annuitants would seem to be the most effective means to deal with the temporary back-log situation.

One of the overlooked negative impacts of furloughs and budget reductions is in the area of strategic activities related to Tax Gap initiatives and Abusive Tax Shelter enforcement. In reallocating staff to the most direct and highest return revenue producing activities, FTB has shifted resources away from longer term strategic activities. While this work may not have the same immediate return as more direct revenue activities, the activities constitute a vital component of the agency's overall mission regarding tax compliance and enforcement. FTB should discuss the impact of the budget on these efforts.

In February the Senate Office of Oversight and Outcomes reported the following: *Workers typically use their furlough time before tapping vacation. The amount of vacation banked by Franchise Tax Board employees has risen steadily since furloughs were imposed in February 2009, from 1.1 million hours to1.4 million hours by the end of December 2009. (During the same period in 2008, accrued vacation declined 13,000 hours.) Managers will have to juggle the workforce to cover the stockpiled vacation. Many employees may also cash out their banked vacation and retire in the face of Schwarzenegger's proposal to cut state worker salaries across the board between 5% and 10% and boost employee pension contributions by an additional 5%.*

SUGGESTED QUESTIONS

1. **What will be the impact on staff resources and revenue collection by accommodating heavier use of staff vacation time as FTB employees begin to use up their accrued vacation due to the furlough policy?**

2. **Similarly, what will be the costs to the State General Fund if large numbers of FTB employees choose to retire and cash out large amounts of accrued vacation hours?**

Staff Recommendation: Approve.

ISSUE 6: ACCOUNTS RECEIVABLE GROWTH

As FTB maintains an inventory of accounts receivable, which is subject to collection efforts based on criteria including: the potential revenue, the probability of collection, and the costs of such collection efforts. FTB's accounts receivable inventory has increased steadily of the last three years—with personal income tax accounts receivable up by 25 percent and business entity up by 43 percent. In August 2009, the accounts receivable balance was $8.1 billion, of which $5.5 was deemed collectible.

The accounts receivable increase is due to a variety of factors, including:

- Staff reductions at FTB from the furloughs.
- Increase in taxpayers unable to pay their taxes.
- Reduction in the ability to resolve cases early in the process.
- Increase in the number of filing enforcement actions.

FTB's tax collection activities against accounts receivable include both an automatic billing system as well as staff administered activities. The automated system manages the collection process by issuing billings, notices, levies, and attachment of assets. FTB staff then follow-up on the cases that require addition work to reach resolution. In order to reduce the accounts receivable inventory to a reasonable level and maintain it, FTB proposes to maximize the use of data and enforcement tools, enhance the call center technology to resolve cases early in the process, and out-source certain cases to vendors

The request is for $8.2 million General Fund to for 11 permanent positions to reduce FTB's accounts receivable to a reasonable level and maintain it. Estimated revenues for the augmentation are $52.5 million in 2010-11 and $111 million in 2011-12. This would result in benefit:cost ratios for each of the respective years of 6.4:1 and 14:1.

STAFF COMMENTS

It is not clear why permanent positions are necessary for this activity. The increase in accounts receivable inventory appears to be the result of short-term economic and budgetary influences rather than long-term trends that have developed in accounts receivable. In addition, the staff that would be directed to this activity does not require the same type of training as other activities in the department that are of a more technical nature. This suggests that limited-term positions would be appropriate.

SUGGESTED QUESTION

1. **Given the amount of uncollectible accounts receivable, does FTB have any suggestions as to how the uncollected AR can be monetized, such as selling the uncollectible debt for a discounted value?**

Staff Recommendation: Approve, based on 2-year limited-term positions.

ISSUE 7: HOMEBUYER TAX CREDIT WORKLOAD

The Legislature adopted statutes that established a tax credit equal to the lesser of $10,000 or 5% of the home purchase price for first time homebuyers and purchasers of new homes. The FTB will administer the credit in a manner that will allow a total amount of credits not to exceed $200 million over the life of the program. Activities required of FTB to administer the program include maintaining credit reservations, accepting and reviewing credit applications, reviewing certifications of purchase contracts, accepting and reviewing settlement statements, and maintaining a waiting list. The program is similar too, but larger, than a similar tax credit program last year. FTB cites a number of higher cost factors in the new program and requests additional resources of $887,000 General Fund and 9 positions.

STAFF COMMENTS

The tax credit program replaces a $100 million credit program which was in effect last year. It seems as though FTB bore the costs of administering that program internally. Thus, it would seem reasonable to provide additional resources for any higher costs of a new program, but not full program costs. Also, it is not clear as to whether the positions will be limited term, even though the program is expected to last only through 2010-11 based on subscription activity.

Staff Recommendation: Hold Open.

ISSUE 8: OVERSIGHT—INDEPENDENT CONTRACTOR WITHHOLDING

Under existing law, employers are required to withhold a portion of wages paid to their employees and remit the withheld amounts to Employment Development Department (EDD), which administers the reporting, collection, and enforcement of specified state taxes subject to withholding. This withholding requirement greatly improves compliance with California's income tax law. The withholding requirement does not apply to payments made to independent contractors.

Businesses making payments to an independent contractor in excess of $600 per year are required to file Form 1099-MISC with the Internal Revenue Service (IRS). This information reporting source is not always accurate and is difficult for FTB to use to track instances of noncompliance. As a result, FTB and the IRS have identified noncompliance related to independent contractor payments as a significant contributor to the "Tax Gap"—the difference between taxes owed under federal or state laws and the taxes actually collected.

The Legislature has previously considered legislation that requires businesses and governmental entities to withhold 3% of payments they make to independent contractors exceeding $600 each year. The proposal would have primarily resulted in accelerated revenues, but withholding on independent contractors would also help address the Tax Gap related to these payments. According to FTB, the measure would increase income tax revenues by about $300 million per year over time, as a result of increased compliance.

Policy Issues. There are numerous concerns with withholding on payments to independent contractors, including the potential for over-withholding in the event that the percentage of withholding specified exceeds the liability of the independent contractor. The possibility of over-withholding creates a potential issue on the refund side as well, since it would require FTB to match refund claims with clear documentation of actual withholding. This would require additional technology and IT system improvements to FTB's current capabilities.

Pursuant to direction from the Legislature, the FTB, in consultation with EDD and the Legislative Analyst's Office (LAO), provided an analysis in 2005 of the independent contractor withholding issue. The report identifying problem areas related to independent contractor withholding and suggesting alternative means by which to address noncompliance in this area. Currently, the federal government does not require such withholding, although some states have experimented with additional withholding requirements for particular problem industries.

STAFF COMMENTS

Given the existing issues associated with payments to independent contractors, FTB staff and the LAO should comment on different options to approach the noncompliance issues associated with payments to independent contractors.

SUGGESTED QUESTIONS

Staff from FTB and LAO should address the following questions:

1. **What is the current status of IRS proposals with respect to establishing an independent contractor withholding requirement?**

2. **What has been the experience in other states regarding withholding on independent contractor payments?**

3. **What are the options for a pilot program that would focus on industries where there is significant non-compliance?**

    - **What components would be necessary for a successful pilot?**
    - **What could be learned from such a pilot program?**
    - **What would the rough costs be from a pilot program?**

4. **What additional reporting requirements for businesses making payments to independent contractors could assist in reducing noncompliance in this area?**

ISSUE 9: OVERSIGHT—LIKE-KIND EXCHANGES

California's income laws provide for "like-kind exchanges," which allow the owner of qualified business investment property (such as a building or equipment) to sell the property and purchase another similar property without incurring a tax on any capital gains. The capital gain under this type of exchange is typically carried-over to the new property. When the newly acquired property is sold, the gain on the original property is then subject to taxation. In this manner, the program acts as a means to defer the gain on the sale of property. Qualified property does not include property used for personal purposes (e.g. home or family car), inventories, securities, and other similar property. California conforms to federal law with respect to this program.

Policy Issues. The like-kind exchange program facilitates exchanges of business assets and puts owners of exchanged property on an equal basis with those who do not exchange. Without the program, some otherwise productive transactions might not be undertaken in order to avoid having any resulting capital gains subject to taxation. Thus, the program could facilitate a more efficient use of productive assets by allowing such exchanges to occur ex-tax.

There are significant policy and revenue implications of the program:

- By allowing investors to retain the lower basis in the property, the capital gains deferral in like-kind exchanges can increase the revenue loss of the "step-up" provision of the income tax. The step-up provision allows the basis of inherited property to increase for tax purposes to its fair market value at the time of death of the original owner.
- If the property owner exchanges California property for non-California property, California may never tax the full amount of the gain on the California property because of the inability to ensure income tax compliance with respect to any gain on a sale by a non-resident.
- Like any other deferral, to the extent taxes are finally imposed, no consideration is given regarding the loss of the use of revenues between the time of the transaction and the date the taxes are paid.

There appears to be an active market of brokers putting together parties interested in like-kind exchanges in order to avoid or defer taxation. The like-kind exchange can happen repeatedly and need not be on a one-for-one basis. Like-kind exchange of property only partially used for business is also allowed. If California were to alter or end this program, it would be out of conformity with federal law and potentially add substantial additional record keeping requirements for business. Separate property sales and purchase record would need to be maintained for state and federal purposes.

STAFF COMMENTS

The Legislative Analyst's Office (LAO) has urged the elimination of the like-kind exchange either in whole or in part. As part of its review of the 2008-09 budget, LAO called for limiting the like-kind exchange to in-state properties only. Subsequently, as part of its 2009-10 budget analysis series, LAO recommended a total elimination of the like-kind exchange.

FTB indicates that if the like-kind exchange were limited to in-state exchanges, the revenue gain would be $44 million in 2010-11, declining to $34 million by 2012-13. If California were to decouple from the federal program entirely, and eliminated all such like-kind exchanges, the revenue gain in 2010-11 would be $341 million and decline to $336 million in 2012-13.

Some analysts have raised the prospect that limiting like-kind exchanges to in-state properties may raise constitutional issues, in that it may result in disparate treatment of in-state and out-of-state businesses activity and interfere with interstate commerce. Alternative means by which to address the tax avoidance associated with like-kind exchanges have been suggested, including; (i) requiring a holding period on purchased or exchanged property and (ii) instituting an annual reporting requirement for taxpayers who engaged in a like-kind exchange (similar annual reporting is required of insurance companies regarding the transfer of certain assets).

SUGGESTED QUESTIONS

1. **FTB staff and LAO should comment on the policy and legal implications of either full elimination or partial elimination of like-kind exchanges.**

2. **What are the advantages and disadvantages of alternatives to address non-compliance resulting from this program, including the holding period and reporting options identified above?**

ISSUE 10: OVERSIGHT—TAX PLANNING AND SINGLE SALES FACTOR

Under California's corporation tax law, businesses that are multistate or multinational in their operations must apportion their income among the jurisdictions in which they do business. Currently, for most corporations, California uses a three-factor formula to determine how much income is attributable to California and subject to tax in this state. The three factors are payroll, property and sales, with the sales factor double-weighted. Certain agricultural, extractive and financial establishments use a simple three-factor formula, without double–weighting sales. Each factor represents the ratio of the California share of each measure to the total amount. The average of the ratios is applied to the corporation's total net income to compute income apportionable to California.

A component of the 2009-10 budget package permanently gives multistate and multinational corporations an additional option for determining the proportion of income that is subject to taxation in California. The legislation allows companies the option to use only a sales factor to determine the amount of income attributable to California. This so-called "single sales factor" (SSF) option becomes effective for the 2011 tax year. When it becomes effective, the change is expected to reduce revenues by approximately $200 million in 2011-12, and reaching in the neighborhood of $900 million in the long term.

Many states have changed their apportionment method to reflect a single sales factor formulation. Although there is a range of opinion as to the effect of such a change, the argument for adopting such an apportionment method is that it encourages businesses to locate or expand property and payroll in the state, since these activities are not factors in the ultimate taxation of any income. Other states that allow for a single sales factor apportionment do not generally allow an election of such a method. California's only other filing election for corporations is an option to include either its worldwide or water's edge income in the reporting group. Unlike the annual option for SSF, water's-edge/worldwide election is for a seven-year period.

STAFF COMMENTS

If the goal of single-sales factor apportionment is to encourage location and expansion of business in California, the "option" of using such a formula or not would—to some extent—appear to work against this goal. Under a mandatory SSF, an out-of-state company would be taxed on income relating to California sales, and an in-state company would not have its property and payroll included in determining California income. By adding the option of the three factor formula, the out-of-state company could reduce its level of taxation to the extent that it expanded its property and payroll outside the state. Thus, for these companies, the optional component removes any incentive to locate or expand in California.

Tax planning and manipulation activities are inherent in an optional SSF apportionment. A notable example is when a company has losses one year and income the next. During a loss year, it would choose to maximize the loss apportionable to California by using which ever apportionment method resulted in the greatest loss. In the subsequent year, if it had positive income, it would use the formula that minimize its taxable income in California. The corporation could then use the losses from the prior year to offset any or all of its income in the positive income year. The provision for allowing credit-sharing among members of a combined group expands further the opportunities for tax planning.

SUGGESTED QUESTIONS

1. **FTB and LAO should comment regarding tax planning activities that stem from the optional SSF.**

2. **What are the various means by which the Legislature could address these issues?**