

AGENDA
ASSEMBLY BUDGET SUBCOMMITTEE NO. 4
ON STATE ADMINISTRATION

Assemblymember Juan Arambula, Chair

TUESDAY, MAY 8, 2007, 1:30 PM
STATE CAPITOL, ROOM 447

ITEMS TO BE HEARD

ITEM	DESCRIPTION	PAGE
0860	STATE BOARD OF EQUALIZATION	2
ISSUE 1	SAVINGS FROM ELECTRONIC FILING	2
ISSUE 2	MAINTENANCE AND REPAIR COSTS—FINANCE LETTER	4
1730	FRANCHISE TAX BOARD	5
ISSUE 1	PROPOSALS TO REDUCE THE TAX GAP	5
ISSUE 2	LEGAL SUPPORT FOR COMBATING ABUSIVE TAX SHELTERS	9
ISSUE 3	IMPROVEMENT OF TELEPHONE CUSTOMER SERVICE	10
ISSUE 4	PUBLIC DISCLOSURE OF DELINQUENT TAXPAYERS	13
ISSUE 5	CHILD SUPPORT AUTOMATION—FINANCE LETTER REQUEST	14

Items to be heard

ITEM 0860 STATE BOARD OF EQUALIZATION

ISSUE 1: SAVINGS FROM ELECTRONIC FILING

The Subcommittee first heard this issue on March 13th and held it open pending additional information and analysis by LAO. At that time LAO withheld recommendation on the board's electronic filing infrastructure enhancements and recommended that the board report at budget hearings regarding the status of efforts to develop a cost-savings model, together with estimates of medium- and long-term savings and costs associated with increased conversion of existing registrations, tax filings, and manual processing to electronic systems.

The Board of Equalization (BOE) has since provided legislative staff with the following table of potential savings estimates:

Fiscal Year	Participation Level	Potential Savings	Staff	Potential Direct OE&E Savings	Potential Total Savings
2008-09	10%	\$794,897		\$132,565	\$927,462
2009-10	20%	1,589,794		265,130	1,854,924

The BOE is still unwilling to identify potential savings in 2007-08 because the program is still in its early stages and data is unreliable; however, the BOE indicates that beginning in 2008 e-filers will have the option of remitting payment by check (currently they must use e-payment), and this is anticipated to have a marked impact on participation levels. For example, the e-filing participation rate is currently 2.5 percent, but the BOE expects it to quadruple by 2008-09 as the result of the new remittance policy combined with the following *filing strategies the department intends to pursue to market e-filing*:

- **Combine Seller's Permit and E-Client Registration Process.** Individuals selling tangible personal property in California must register for a seller's permit with the BOE. At the time of registration for a seller's permit, the BOE plans to also register taxpayers for e-filing.
- **Discontinue Sending Paper Tax Returns.** Paper tax returns are sent to sales and use taxpayers that report either on a monthly, quarterly, fiscal yearly or calendar yearly basis whether or not they e-file (unless the taxpayer has elected to no longer receive paper returns). The BOE is developing a pilot project to discontinue sending paper returns to certain taxpayer groups.

- **Outreach Efforts.** The BOE has developed an Outreach Plan that will focus on new and innovative approaches to marketing e-services, such as on-line tutorials/videos, focus groups and speaking engagements.

LAO Recommendation

The LAO now recommends approval of the BOE budget request to continue its e-filing efforts. However, LAO also recommends adoption of the following Budget Bill Language:

It is the intent of the Legislature that the funds appropriated for the Board of Equalization Electronic Filing Infrastructure Project be used to improve the State's efficiencies in tax administration. The Board of Equalization shall report to the Department of Finance and the appropriate fiscal committees of the Legislature on March 1, 2008 and March 1, 2009 on the status of Electronic Filing at the Board of Equalization, including the following:

- The current level of Electronic Filing participation;
- Any revised estimates of future Electronic Filing participation, including progress in reaching 10 percent participation in 2008-09 and 20 percent in 2009-10.
- The department's estimate of current and future annual savings associated with increased use of Electronic Services at the Board of Equalization.
- Any identified implementation problems or barriers to additional participation.

COMMENTS

The LAO indicates that the BOE and the Department of Finance do not object to their recommended language.

ISSUE 2: MAINTENANCE AND REPAIR COSTS—FINANCE LETTER

In a letter dated March 29th, the Director of Finance requested an augmentation totaling \$524,000 (\$300,000 General Fund) for building maintenance and repair costs identified by the Department of General Services. The amount consists of \$163,000 for fire and life safety systems, including elevators, and \$361,000 for cyclical repairs, such as roof replacement and periodic maintenance of the window wall at the Sacramento headquarters.

COMMENTS

No issues have been raised regarding this request.

ITEM 1730 FRANCHISE TAX BOARD

ISSUE 1: PROPOSALS TO REDUCE THE TAX GAP

The Governor's budget proposes \$19.6 million (General Fund) and 230 positions for various efforts to close the state's estimated \$6.5 billion tax gap. Of the proposed resources, \$13.6 million and 180.5 positions continue six existing pilot programs proposed for permanent establishment. The existing programs concentrate on detecting non-filers and filers of fraudulent returns and on audit and collections activities. The FTB estimates that these programs will generate \$64.7 million in revenues in 2007-08, and \$68.5 million in revenues in 2008-09. The remaining \$6 million and 49.5 positions are for new initiatives to educate independent contractors about filing requirements, expand the corporate non-filer program, address out-of-state tax avoidance, and increase investigations of persons who fail to file a return, or who file fraudulent returns. The budget estimates that these new initiatives will generate additional revenues of \$12.8 million in 2007-08, and \$29.8 million in 2008-09.

Background on the Tax Gap

The Franchise Tax Board (FTB) estimates that the tax gap, the difference between what taxpayers actually pay and what they owe, is around \$6.5 billion annually for the Personal Income Tax (PIT) and the Corporation Tax (CT). In a typical tax year approximately 89 percent of all taxes owed are ultimately paid, with the remaining 11 percent constituting the tax gap. The tax gap results in lost revenue and therefore less ability to support public programs under the existing tax structure. Furthermore, it is harmful to those who do pay their taxes fully because their taxes end up being higher than they otherwise would have to be to generate current revenues, and the tax gap undermines public perceptions of the fairness of the tax system. The tax gap is manifested in three ways: Improper filing by underreporting income and overstating deductions and credits, non-filing of tax returns, and underpayment of amounts owed. Improper filing is by far the most common form (80 percent of total) with non-filing and underpayments making up the remaining causes (about 10 percent each), according to the FTB.

Continuation of Recent Pilot Programs

In the 2005-06 Budget Act, the Legislature approved six two-year pilot programs (at a cost of \$13.6 million and with 175.5 positions), that expanded FTB's ongoing efforts in the following areas: (1) detecting tax preparers filing fraudulent returns with fictitious refundable credits, (2) developing additional information to detect PIT non-filers, (3) conducting underground economy criminal investigations, (4) pursuing audit cases down to a 4-to-1 benefit-cost ratio (BCR)—versus the former 5-to-1 ratio, (5) targeting collection enforcement activities down to a 3-to-1 BCR, and (6) engaging in discovery audits to detect new forms of tax evasion or areas of confusion for law-abiding taxpayers. The pilot programs were successful at bringing in \$56.3 million of additional General Fund revenue in 2005-06, an increase of \$4.5 million over the original estimates. The 2007-08 budget proposes to make these pilot programs permanent. The FTB projects that these programs will produce \$64.7 million in revenue at a cost of \$13.6 million and 180.5 positions in 2007-08.

New Initiatives for 2007-08

The Administration proposes four new tax gap initiatives for the budget year. These proposals would add 49.5 positions, at a General Fund cost of \$6 million. The four new initiatives are projected to generate \$12.8 million in additional revenue in 2007-08, tripling to almost \$40 million by 2009-10.

The new initiatives consist of the following four programs:

- ***Focus on Independent Contractors.*** This proposal targets independent contractors who do not fully report income or who deduct more than allowable expenses on their tax returns. (The FTB estimates that approximately \$3.5 billion of the state's tax gap is attributable to sole proprietors, many of whom are independent contractors). The proposal would fund six new positions at a cost of \$581,000 in 2007-08. The funds would be used both for education and outreach, and increased audits of noncompliant taxpayers. The FTB estimates the program would raise \$1.5 million in 2007-08, increasing to \$5.9 million in 2008-09.

- **Expand the Corporate Non-filer Program.** This proposal focuses on noncompliance of certain business-entity non-filers by augmenting FTB's Integrated Non-Filer Compliance System. The funds would allow FTB to access more data sources to identify business non-filers. Additional data sources include federal 1099 and 1098 tax forms and various California business-related tax forms. (The FTB estimates that approximately 5,900 additional non-filers could be identified if these data sources were available). The proposal would fund 7.5 new positions at a cost of \$1.3 million in 2007-08. The FTB estimates that this program would raise \$900,000 in 2007-08, for a net loss of about \$400,000, but the investment would produce a rapidly growing return, reaching \$8.4 million in 2009-10.
- **Out-of-State Tax Avoidance.** This proposal targets out-of-state taxpayers who intentionally avoid California income taxes. In particular, it would focus on taxpayers who use a series of transactions often referred to as tax schemes (including sham corporations), promoters of tax schemes, California residents filing as nonresidents, and noncompliance in the entertainment industry. Additionally, the proposal would enable FTB to identify and pursue those individuals who promote tax schemes and assess penalties for tax avoidance where appropriate. Finally, this measure would provide expanded education and outreach programs for tax practitioners and others who deal with out-of-state taxpayers. The proposal would fund 23 new positions, at a cost of \$2.3 million in 2007-08. The FTB estimates it would raise \$10.4 million in 2007-08, increasing to \$16.8 million in 2008-09.
- **Expand Investigation Workloads.** This proposal expands identification, investigation, and prosecution of taxpayers who fail to file a return or who submit a false return to the state. Based on historical modeling and future projections, FTB investigations staff have identified 148 additional cases that could be opened immediately, involving more than \$98 million in unreported income. The proposal would fund 13 new positions at a cost of \$1.8 million in 2007-08. The FTB estimates that increased enforcement not only will result in collections from the prosecuted cases, but that it also will result in increased voluntary compliance. The FTB estimates that this increased voluntary compliance will generate \$13 million in annual revenue beginning in 2009-10.

Legislative Analyst's Office (LAO) Recommendation

In its analysis of the Governor's budget, the LAO noted concerns with this proposal and recommended redirecting some of the proposed funding to tax gap enforcement activities with a higher benefit-to-cost ratio. Based on additional information from the FTB, the LAO now has revised their recommendation as follows:

- Reallocate \$865,000 from the proposed Underground Economy Criminal Investigations program, with \$615,000 directed to augment the Corporate Non-filer program (which has a significantly higher benefit-cost ratio), and reserve \$250,000 to pay a portion of contractor expenses associated with assessment of a "software overlay" approach for the three tax agencies (per LAO's Report on Tax Agency Information and Data Exchange).
- Given the low benefit-cost ratio (BCR) of 2.2-to-1 reported for the Underground Economy Criminal Investigations program up to this point, LAO recommends continuing the program on a two-year limited-term basis to provide for a reevaluation.

The LAO estimates the above recommended changes to the proposed tax gap initiatives would generate approximately \$2 million of additional General Fund revenue in the budget year at the same overall level of expenditures contained in the Governor's budget.

COMMENTS

- About half of the current funding level would still remain (about \$900,000) for underground economy criminal investigations after the LAO's recommended redirection of funding to higher-payoff activities and the tax agency information sharing project.

ISSUE 2: LEGAL SUPPORT FOR COMBATING ABUSIVE TAX SHELTERS

The Governor's budget requests \$1.3 million (General Fund) and 10 new positions to address Abusive Tax Shelter workloads.

The FTB believes that there is sufficient workload to merit the staffing requested and that this investment will result in additional revenues of approximately \$1.4 billion [above and beyond the \$1.4 billion collected during the former Voluntary Compliance Initiative (VCI), but inclusive of the additional \$348 million in subsequent tax shelter assessments]. Given the extreme complexity of abusive tax shelter cases, the combativeness of representatives and investors, and the fact that the VCI accelerated the easiest cases, the FTB has estimated that it may take up to eight years to collect this revenue.

According to the FTB, while the Abusive Tax Shelter program has been a success, there is no indication that abusive tax shelters will go away at any time in the near future. The FTB expects that as California's economy continues to grow and global competition increases, individuals, and companies will continue to seek ways to minimize their tax burden, and the products available will constantly seek to push, and ultimately step over, the line between tax planning and tax abuse. For example, even after nearly a decade of discussion and calls for better enforcement at the federal level, the U.S. Senate Permanent Subcommittee on Investigations reported, in August 2006, a federal tax loss of over \$100 billion annually from offshore tax havens and tax shelter abuses. The FTB believes that high profile enforcement and public disclosure will continue to discourage abusive tax shelter investments and discourage investors from considering abusive schemes; however, constant vigilance will be the only mechanism to successfully control the proliferation of new iterations of tax shelter schemes.

The FTB does not project that additional auditor, attorney, or collector position requests will be made in the future to produce the \$1.4 billion in revenue currently estimated to be realized from the abusive tax shelter program. Should the FTB's efforts identify a new inventory of tax shelter cases, which will generate additional revenues and require resources, the department would redirect resources from lower cost-benefit workloads and/or present the Legislature with the opportunity to fund those workloads.

LAO Now Recommends Approval. The LAO previously articulated concern over the future staffing needs of this program, noting that while attorneys may be necessary to process the up-front workload, collectors and auditors would likely be necessary as well. However, the FTB has clarified that while the targets of the requested attorneys are generally well-funded; they are relatively few in number. Thus, the FTB expects that audits and collections activities could be handled within existing resources. Given this clarification, the LAO now recommends approval.

ISSUE 3: IMPROVEMENT OF TELEPHONE CUSTOMER SERVICE

The Governor's budget requests \$1.3 million (General Fund) and 27 positions to restore staffing levels in the Franchise Tax Board's Contact Centers and related supporting workloads. These call center positions were eliminated in recent years to meet budget reduction targets and the department now asks that they be restored in order to meet a response target of responding to 95 percent of all calls with 80 percent answered within 2 minutes.

Current Level of Telephone Customer Service

The FTB provided the tables below, which reflect the Level of Access (LOA), Level of Service (LOS), and Average Wait Times associated with current and proposed staffing levels. The LOA represents the percentage of calls the answered by an FTB Customer Service Representative (CSR) compared to total calls received, while the LOS represents the percentage calls answered within the FTB's two-minute target time period. The Average Wait Time represents the time a caller spends on hold waiting to talk to a live agent after their call has been received by the Interactive Voice Response (IVR) system and they have made a selection to request to speak to a CSR. Staff notes, the amount of time a caller spends "surfing" the IVR is not included in these statistics, nor does the FTB record this data.

Existing staff levels provided an average LOA of approximately 67 percent in 2006, meaning that 33 percent of callers (nearly 700,000) seeking to speak to a CSR failed to do so. Unsurprisingly, the highest LOA corresponds to the lowest level of calls (in December) and the lowest LOA corresponds to the highest level of calls (in May, when taxpayers call about refund status). However, the LOA remains relatively low (hovering between 50 and 60 percent) throughout the months of June, July, and August, even as calls decline by almost 50 percent.

Table 1 below breaks down the LOA into Peak and Non-Peak averages, and additionally shows the LOS and Average Wait Time associated with these periods. The FTB defines the Peak period as January through June, thus, the relatively low LOA of 72.6 percent for the Non-Peak period is due to the fact that the averages for July and August (approximately 52 percent and 56 percent, respectively) skew the average for the remainder of the months (which tend to hover in the vicinity of 90 percent). Table 1 indicates that during the Peak period only 15 percent of callers requiring a human response made contact with a CSR within 2 minutes, and in fact, the *Average Wait Time was over 6 minutes*. During the Non-Peak period, customer service improved to 40 percent of calls answered by a CSR within 2 minutes and an average wait of approximately *4 minutes*.

Table 1 – Level of Access (LOA), Level of Service (LOS), and Wait Times Over Peak and Non-Peak Periods for 2006.

Level of Access			Level of Service			Average Wait Time	
Peak	Non-Peak	Total Average	Peak ¹	Non-Peak ¹	Total Average ¹	Peak ²	Non-Peak ²
64.5%	72.6%	67.1%	15.2%	40.6%	24.1%	6:17	4:08

[1] This percentage is a weighted average. [2] Although this is the average wait time, some callers waited 30-40 minutes to speak with an agent.

How Much Improvement Would the Additional Staff Achieve?

Based on call volumes similar to 2006, the FTB expects the requested \$1.3 million augmentation to enable it to answer approximately 14 percent more calls (or 294,000) over the course of the year. This equates to a cost of \$4.42 per additional call answered.

Table 2 below breaks the projected 2007-08 customer service performance into Peak and Non-Peak and displays the LOS and Average Wait Time for these periods. As compared to Table 1, the proposal would improve Peak LOS by approximately 25 percent and decrease Average Wait Time during peak months by approximately 1 minute and 45 seconds. During the Non-Peak period, the proposal would increase LOS by approximately 25 percent, but Average Wait Time would remain relatively constant at 4 minutes per call. This last conclusion appears counter-intuitive, but would seem to suggest that despite fewer calls during the Non-Peak period, the length of the average call (perhaps due to the complexity of questions) increases significantly.

Table 2 – Projected Customer Service Levels in 2007-08

PEAK	Offered	Answered	LOA	LOS	Avg. Wait Time
Jan-Jun	1,438,919	1,139,476	79.19%	40%	4:30
NON-PEAK	Offered	Answered	LOA	LOS	Avg. Wait Time
Jul-Dec	699,088	589,886	84.38%	65%	4:00

Overall, this proposal would provide an incremental increase in calls answered (at a cost of approximately \$4.42 per call) and a reduction in wait times during the Peak period of the year. The optimal or desirable level of service to provide to FTB customers is a policy decision that must be weighed against other pressures on the General Fund; however, based on the FTB’s own criteria, this proposal would result in progress toward achieving the department’s customer service goals. If the Subcommittee decides to approve this proposal, it may wish to require the FTB to report on actual customer service outcomes in order to better inform future deliberations on customer service should those discussions arise.

LAO Now Recommends Approval. The LAO originally recommended reducing this proposal by about half due to concerns that the need for additional staffing was mostly seasonal. Based on the additional information provided by the FTB, LAO now recommends approval of the request and the adoption of language for a report on actual service outcomes by October 1, 2008.

COMMENTS

- ***Internet is Now Primary Source of Information.*** The Internet has become the primary communications medium between the FTB and taxpayers. Accordingly, improving telephone service, while desirable, is not as crucial as it once might have been.
- ***No Bright Line.*** The optimal or desirable level of telephone service to provide to FTB taxpayers is a policy decision that must be weighed against other pressures on the General Fund. However, based on the FTB's own criteria, this proposal would result in some progress toward achieving the department's customer service goals, but it still would fall short of achieving them.

ISSUE 4: PUBLIC DISCLOSURE OF DELINQUENT TAXPAYERS

The budget requests one limited-term position and \$144,000 (General Fund) to implement AB 1418 (Horton) of 2006. This legislation requires the FTB to compile a list of 250 taxpayers with the largest delinquencies over \$100,000 and to make the list public on a quarterly basis (the same requirement also applies to BOE). The FTB estimates that this action will result in collection of \$30 million of additional General Fund revenue in 2007-08 and \$5 million annually thereafter.

COMMENTS

The Subcommittee held this issue open at its March 13th hearing pending FTB response to Mr. DeVore's request for additional information. The FTB has provided that information.

ISSUE 5: CHILD SUPPORT AUTOMATION—FIANCE LETTER REQUEST

In a letter dated March 29th, the Director of Finance requested the following adjustments to the FTB budget related to the FTB's role as the information systems developer for the California Child Support Automation System Project:

California Child Support Automation System (CCSAS) Project Funding

Shift (Issue 029)—It is requested that Franchise Tax Board (FTB) shift \$30.0 million of a scheduled \$80.0 million business partner payment from 2008-09 to 2007-08 to fund changes in the CCSAS project schedule and the business partner's scope of work. Project staff notes the changes in schedule and scope are necessary to complete the federal certification process and relieve the state from further federal penalties. The Department of Child Support Services proposes to fund the \$30.0 million reimbursement to FTB from reappropriated federal and General Fund monies. FTB will fund a required additional \$3,947,000, by increasing Item 1730-001-0001 by \$1,342,000 and Reimbursements by \$32,605,000.

Franchise Tax Board Provisional Language for Unanticipated Funding Needs for the CCSAS Project (Issue 030)—It is requested that provisional language be added to Item 1730-001-0001 that presently is contained in Provision 8 of Item 1730-001-0001 of the Budget Act of 2006. The recommended Budget Bill language is:

Notwithstanding any other provision of law, upon request of the Franchise Tax Board, the Department of Finance may transfer any amounts not fully expended in Schedule (4)—Child Support Automation, to the Department of Child Support Services to provide for unanticipated costs associated with the California Child Support Automation System project. This provision may become effective no sooner than 30 days after providing notification in writing to the chairpersons of the fiscal committees of each house of the Legislature and the Chairperson of the Joint Legislative Budget Committee, or not sooner than whatever lesser time the chairperson of the joint committee, or his or her designee, may in each instance determine.

COMMENTS

This request is consistent with revisions to the budget of the Department of Child Support Services, and is necessary to keep the project on schedule and avoid substantial federal penalties against the state.