SUBCOMMITTEE NO. 4 Agenda

Senator Richard Roth, Chair
Senator Tom Berryhill
Senator Norma Torres

Thursday, March 20, 2014
9:30 a.m. or Upon Adjournment of Session
Room 2040

Consultant: Mark Ibele

Agenda - Part B

State Finance and Administration

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Items for Vote-Only

0509 Governor's Office of Business and Economic Development

Issue 1: Made in California (Governor's Budget BCP 3)

The Governor's budget calls for three positions and $500,000 (one-time) to meet the requirements of SB 12 (Corbett), Chapter 541, Statutes of 2013. SB 12 creates a labeling program in California and makes it illegal for products to be represented as "Made in California" unless the product is substantially made in the state, as represented by at least 51 percent of the wholesale value. Companies that wish to participate in the Made in California program are required to be registered with the Governor's Office of Business and Economic Development (GO-Biz) to use the designated label. The program is designed to leverage a return by generating additional sales, the taxes on which would benefit the General Fund. Opportunities for generating direct revenue from the program—either through fees or marketing agreements—are available, but not actually required. Thus, while the appropriation for one year of funding is made available through this proposal, the source of additional years' funding is not yet developed. The initial year of funding allows for the required implementation of the statute.

Staff Comments: None

Staff Recommendation: Approve the proposal for positions and one-time funding.

VOTE:

0860 Board of Equalization

Issue 2: Intrusion Prevention and Detection System (Governor's Budget BCP 3)

The Governor's budget calls for $285,000 ($186,000 GF) and two permanent positions to administer, maintain, inspect the network security solutions for the Board of Equalization (BOE) that comply with Internal Revenue System (IRS) requirements for agencies that have access to IRS data and information. The ongoing annual costs, beginning in 2015-16, will be $255,000. Periodically, the IRS reviews BOE's safeguards in place to ensure compliance. In its last review of BOE's systems, the IRS determined that the existing safeguards need to be enhanced in order to be fully compliant with its security requirements. The proposal will allow the BOE to reconfigure its system, resulting in improved detection and prevention of identified intrusion risks. Additional personnel are required to continuously support, monitor, and audit the network security solutions and safeguard practices.

Staff Comments: Staff has no concern with this proposal.

Staff Recommendation: Approve as budgeted.

VOTE:

7730 Franchise Tax Board

Issue 3: Asset Forfeiture Accounts (Governor's Budget BCP 7)

The Administration requests approval of $150,000 per fiscal year, in special funds from the Asset Forfeiture Account, to provide for costs associated with criminal investigation law enforcement activities. In addition, the proposal calls for budget bill language (BBL) to allow the DOF to increase the amount of funds, upon 30-day notice to the Joint Legislative Budget Committee (JLBC). Franchise Tax Board's (FTB's) Criminal Investigation Bureau participates in three assets forfeiture programs with the following agencies: U.S. Department of Justice, U.S. Department of Treasury, and California Department of Justice. The current balance in the assets forfeiture fund is approximately $326,000, which may only be used for criminal investigation law enforcement activities, such as associated equipment and training. Pursuant to signed agreements, the funds may not be used to supplant General Fund support for the program.

Staff Comments: None

Staff Recommendation: Approve as budgeted.

VOTE:

Items for Discussion and Vote

0509 Governor's Office of Business and Economic Development

Department Overview: The Governor's Office of Business and Economic Development (GO-Biz) was created to serve as a single point of contact for economic development and job creation efforts. The department offers a range of services to businesses, including: business attraction, retention and expansion services; site location selection; permit assistance; regulatory filing and approval assistance; small business assistance; international trade development; and, assistance with state government. Under the Governor's Reorganization Plan No. 2 (GRP 2), the Infrastructure Development Bank, the California Film Commission, the Office of Tourism, and the Small Business Loan Guarantee Program were transitioned from the Business, Transportation and Housing Agency (BT&H) to GO-Biz, effective July 1, 2013.

Background: As part of last year's budget package, the Legislature approved AB 93 (Committee on Budget), Chapter 69, Statutes of 2013 and SB 90 (Galgiani), Chapter 70, Statutes of 2013, which together formed the basis of the revisions to local economic development programs. This legislative package included the elimination of enterprise zone programs, and enactment of a sales tax exemption for certain capital purchases, a geographic specific hiring credit, and a targeted tax credit for specific businesses. The sales tax exemption is administered by the Board of Equalization and the hiring credit by the Franchise Tax Board. The targeted tax credit—termed the California Competes Tax Credit (CCTC)—is administered by GO-Biz and the Franchise Tax Board (FTB).

The purpose of the CCTC is to attract, expand, and retain businesses in California. The businesses that apply for the credit will be evaluated on the basis of number of employees; jobs created or retained; location of the company in the state; and magnitude of investment by the business. The tax credit package will be negotiated between the business and the Administration (GO-Biz) and then voted on by the GO-Biz committee, consisting of the Director of GO-Biz, the Director of Finance, the State Treasurer, and one appointee each from the Senate and the Assembly.

Taxpayers may receive a maximum of 20 percent of the total amount of credits available for a particular year. In addition, 25 percent of the available credits must be provided to small businesses (companies with gross receipts of $2 million or less). The amount of credits that can be allocated is up to $30 million in 2013-14, $150 million in 2014-15 and $200 million for years 2015-16 through 2017-18. These amounts may be reduced in order to ensure the total amount of tax reductions resulting from the three tax preference programs described above is no greater than $750 million in a fiscal year.

Budget Overview: In the current year, the department is budgeted for $20.7 million and 74 positions. This represented a significant increase in funding and positions over 2012-13, due largely to the shift of departments and programs from BT&H to GO-Biz. With the shift of programs and personnel, most of the funding (44 percent) is derived from California Infrastructure and Economic Development Bank Fund, with an additional 37 percent coming from the General Fund. For 2014-15, GO-Biz is proposed to be funded at $22.1 million, representing an increase deemed necessary to fund additional positions to administer the programs approved by the Legislature last year.

Issues Proposed for Discussion

Issue 1: Oversight of Program Development (Informational Issue)

GO-Biz is the responsible agency for administering an entirely new program that will potentially involve a sizeable commitment of state funds, in the form of revenues foregone, over several years. The funds will ‘flow’ based on negotiated contracts with private companies. While similar programs are used in other states with varying degrees of success, this approach to business development and assistance is not one that California has used in the past. Given this new approach to awarding tax credits, it is important that the Legislature be vigilant in its oversight of the program, to ensure that the program is implemented in the most effective manner possible. The committee may wish to have the GO-Biz provide an update on the development and implementation of the program. Of particular interest is the ability of the FTB, which will audit the agreements and ensure compliance, will have sufficient information available to them to ascertain if the participating businesses are fulfilling their side of the bargain. Its active participation in assisting in the structure of the agreements is crucial.

Issues Proposed for Discussion and Vote

Issue 2: Additional Funding and Positions (Governor’s Budget BCP 2)

The Governor’s budget calls for ten limited-term positions for activities associated with the GO-Biz program. The request calls for $965,000 in on-going funding and $30,000 in one-time funding. The department is hiring for six to seven of these positions in the current year, and the BCP would allow for the continued funding of these positions in the budget year. The proposal would allow for the funding of an additional three to four positions. The new positions would represent a full ramp-up in the administrative staffing for the program. The ten positions will include a deputy director for California Competes, a staff attorney, six analytical staff, a software specialist, and a technical support staff.

Background: The department has relied upon existing resources for necessary administrative duties during the initial year of the program. Program activities are expected to increase dramatically over the next two years, which will necessitate additional staffing. The department indicates that continued reliance on existing staff would impair other GO-Biz programs and borrowing from other departments would be inefficient and work to the detriment of the overall effectiveness of the program.

The activities of the proposed staff will include a detailed examination and analysis of the application, including employment and income impacts, type, size and duration of investment, nature of business activities, socio-economic characteristics of business location, other incentives available in California and other states, opportunities for future business growth, overall economic impact, and anticipated net benefits to the state. In addition, the staff will be responsible for establishing the terms and conditions of the contract such that the state's interest and investments are protected.

Staff Comments and Questions: It is somewhat unclear from the proposal and discussions with GO-Biz and DOF the validity of the timing of the hiring and the duration of the limited-term positions. GO-Biz has managed to administer the program for the first year without the full resources and the program does not fully ramp up until 2015-16. In addition, it appears that the contracts for the current year may be delayed, which would push back the full roll-out of the program. More fundamentally, given that revenue impacts tax preferences from the three tax programs identified above may not exceed $750 million annually, the CCTC may never actually realize its maximum allocated cap. Therefore, full staffing may not be necessary at this time. On the other hand, since the state has decided to move in the direction of negotiated agreements, it is important that adequate staffing be provided to oversee and ensure the integrity of the program. An alternative approach the committee may wish to consider is to approve funding for the six or seven current year positions, along with BBL that could provide for a limited augmentation for additional positions upon 30 day notification to the JLBC. The resources for this activity should conform to those for Item 7730, Franchise Tax Board, discussed in Issue 4 of that item.

As part of the staffing analysis, it would be beneficial to have access to data from other states regarding their administrative designs for similar programs. Last year, GO-Biz was provided funding for a deputy director for legal affairs and a systems software specialist, positions that would seem to overlap with the current request. The committee may wish to ask the department for further justification for the additional positions in these areas. GO-Biz also estimates that a large percentage of its activities will relate to small business applications and that "the majority" of small businesses in the state will apply for the credits. The basis of this claim may be of interest to the committee.

Questions for the Department or DOF:

1. *How can we ensure that the contracts and agreements with businesses will be constructed in a fashion that will lend them to being auditable? Will the FTB participate in the design of the contract?*

2. *Given that GO-Biz has not yet structured any agreements, is it pre-mature to establish new positions—of a rather specialized nature—prior to having any sense of how complex such agreements are likely to be? Does it make sense to survey other states regarding the likely number and complexity of the deals?*

3. *How did you arrive at the estimate for the receipt of applications from small businesses? How much of the estimated workload is driven by the sheer volume of anticipated applications?*

Staff Recommendation: Hold open.

VOTE:

0860 Board of Equalization

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

Budget Overview: The Governor's budget proposes resource support of $564.7 million ($317.2 million General Fund), and 4,848 positions for the BOE in fiscal year 2014-15. The budget proposes a total funding increase of $2.1 million (0.4 percent) and a very slight General Fund support increase, compared with spending estimates for the current year. Proposed staffing in the budget would increase by just three positions from the current-year estimate. The department received much higher increases in funding during the current year, compared to 2012-13.

Items Proposed for Discussion and Vote

Issue 1: Narrowing the Tax Gap (Informational Issue)

The tax gap is defined as the difference between the amount of tax lawfully owed and the amount actually collected. Both BOE and FTB have estimated tax gap amounts over the last few years. BOE estimates the current gap for taxes that it administers at approximately $2.3 billion in lost revenues annually due to noncompliance, with General Fund reductions well in excess of about $1.0 billion annually. The major components of the tax gap are: (1) use tax liabilities of businesses and individual consumers; (2) tax evasion by non-filers; and (3) 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 Statewide Compliance and Outreach Program. BOE has a number of additional tax gap initiatives currently in place. These programs include more effective use of software applications, utilizing North American Industry Classification System (NAICS) codes, investigating misuse of resale certificates, and conducting special audits of auto auctions and gas stations. These programs are generally outlined in BOE's report to the Legislature on compliance and audit activities provided in December of each year. In addition, this report includes information regarding BOE's Enhancing Tax Compliance Program. Current tax gap activities and revenue impacts are listed below.

Board of Equalization
Tax Gap Initiatives
(Dollars in Millions)

Tax Gap Program	2012-13 Estimated Revenue	2012-13 Actual Revenue
US Customs	$14.4	$13.0
Agriculture Station Inspection	44.0	60.9
AB4X 18 Qualified Purchaser	51.3	50.4
Statewide Compliance and Outreach	68.2	85.9
Instate Service	34.2	36.0
Tax Gap II	15.0	9.5
Out of State 1032 Audits	20.0	28.9
Enhancing Tax Compliance	107.6	140.5

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, the overall success of the program, and any impact of budget reductions on strategic planning for its Tax Gap initiatives, including the impact of the personal leave program.

Staff Comment: The department should outline its current approach to narrowing the tax gap, and in particular, its progress in coordinating with other state agencies—as well as other states—in these activities. The committee may want to pursue questions relating to audit selection and any new tax gap programs that are currently being designed or pursued, including those identified above, as well as how the department's Centralized Revenue Opportunity System (CROS) will assist in efforts to reduce the tax gap.

Staff Recommendation: Informational item.

Issue 2: Southern California Appeals and Settlement Unit (Governor's Budget BCP 1)

The Governor's Budget proposes $3.6 million ($2.4 General Fund and $1.2 million reimbursements) and the continuation of 22 two-year limited-term positions, to continue the Southern California Appeals and Settlement Unit (SCAS). The unit was started in 2010 in response to an increasing backlog of cases in the settlement and appeals, and consisted of limited-term positions. This proposal would continue funding those positions. The positions consist of attorneys and business tax specialists, and funding would result in the acceleration of an additional 868 cases and $84.9 million in accelerated revenue.

Background: The funding for SCAS was initiated in response to rising appeals and settlement cases as a result of changes in the economy, specifically the deterioration in business conditions associated with the recession. Taxpayers began to file an increasing number of appeals and requests for settlement that placed additional burdens on existing staff. From 2007-08 to 2009-10, appeals increased 32 percent and settlement proposals by roughly 100 percent. Resources devoted to the program resulted in accelerated revenue (actual revenues moved to a collectible state) of $195.1 million, and exceeded the initial estimates for the program in the first three years of the program. Specifically, actuals (estimates) were: $11.4 million ($5.1 million) in 2010-11, $85.5 million ($57.0 million) in 2011-12 and $98.2 million ($84.9 million) in 2012-13. For 2013-14, the BOE expects to accelerate $84.9 million into the current year, compared to what would have been received without the program.

Staff Comment and Questions: The department has provided data related to the prior three years of funding for the program that would indicate that continued resources are warranted. It may interest the committee to know when the backlog in the appeals and settlement units will be reduced to the level that additional resources are not needed, or if this level of appeals and settlement activity is the new normal. According to the department, settlement inventories are not decreasing and demand for these are actually on the rise. The number of appeals cases appears to have stabilized.

Questions for the Department or DOF:

1. *Are the current levels of activity for appeals and settlement likely to continue for the indefinite future? Is this the result of structural changes?*

2. *What is the current average settlement as a proportion of tax liability? Has this increased or decreased as a result of recent effort, and if so, why?*

Staff Recommendation: Approve as budgeted.

VOTE:

Issue 3: Centralized Revenue Opportunity System (Governor's Budget; Proposed Budget Bill Language)

The Administration has proposed budget bill language (BBL) that would add to the administrative flexibility of the department in bring the Centralize Revenue Opportunity System (CROS) on-line. Specifically the proposed BBL states:

> *The Department of Finance may augment the amount appropriated in Schedule (2) for support of the Centralized Revenue Opportunity System (CROS) project to provide for contractually required, benefit-based, vendor compensation payments and vendor support requirements. The Director of Finance may authorize the augmentation not sooner than 30 days after notification in writing to the Joint Legislative Budget Committee. This provision shall apply to any item currently assessed for the support of the CROS project. Any funds provided that are not expressly used for the specified purposes shall revert to the fund from which they were appropriated.*

Background: BOE is in the process of consolidating and modernizing its existing taxpayer information systems through the CROS project. As designed, CROS would replace the BOE's existing two systems of tax information and return management, expand online business and taxpayer services, and provide an agency-wide data warehouse.

The acquisition of CROS will be achieved through a performance-based, benefits funded procurement approach. This approach is similar to that used by the Franchise Tax Board (FTB) and the Employment Development Department (EDD) for their respective information and data management systems. The approach does not require up-front vendor funding, as the development and implementation costs are paid under a benefits-funded contract, with payment allowed only when increased revenues are received. Contractor payments would be dependent on the generation of additional revenues attributable to the project and would be capped overall.

Following approval from the DOF and the Department of Technology, the BOE published a Request for Proposals on July 1, 2013, and held a bidders conference the next month. The BOE expects draft proposals in February 2014 and final proposals in August 2014. The CROS project expects to award a vendor contract in March 2015. The final date of the contract upon completion of the CROS project is expected to be June 2020. The project generated $38.7 million of additional revenue in 2012-13 and is expected to generate revenues of $66.5 million in 2013-14.

Staff Comment and Questions: The proposed budget bill language (BBL) is a reasonable means to grant additional flexibility for a project of this scale, especially given the uncertainties and intricacies of technology projects. However, the committee may want to explore establishing a ceiling on the funding acceleration that could occur through notification to the JLBC, or indicate the aspects of the contract that could be augmented. For example, similar language for Franchise Tax Board's Enterprise Data to Revenue project includes an augmentation ceiling of $3.0 million.

Staff Recommendation: Hold Open.

VOTE:

Issue 4: Fire Prevention Fee (Governor's Budget BCP 2)

The Administration proposes to continue funding 54.0 limited-term positions for the processing of workload associated with collection of the State Responsibility Area (SRA) Fire Prevention fee. In addition, the proposal would establish an addition 9.0 two-year, limited-term positions and 9.7 one-year, temporary staff positions. The 2014-15 cost would be $7.3 million (Special Fund), declining to $6.7 million in 2015-16. Fee revenues are expected to be $90.8 million annually.

Background: Effective July 1, 2011, the state imposed fire prevention fees on the owners of habitable structures in SRAs beginning in 2011-12. This fee was imposed pursuant to AB 29 X1 (Budget Committee), Chapter 8, Statutes of 2011, which requires the fee of $150 per structure to be used to support the fire prevention activities of the Board of Forestry and the California Department of Forestry and Fire Prevention. Under the legislation, the BOE is assigned the responsibility of collecting the fee and remitting the proceeds, upon legislative appropriation, to the agencies named above.

The administrative activities associated with the SRA fee include registering accounts, annual issuances of notices of determination, collection of past due fees, and processing refunds, and notices of redetermination. In addition, the agency notes that there would be additional fee payer assistance measures, increased mail inquiries, cashiering and key entry, account maintenance, and reconciliation, and ongoing IT costs given the volume of the new fee base. Technology appears to be a continuing issue based on the complexity of BOE's legacy systems.

LAO Perspective: The LAO concurs with the Administration regarding the total number of positions for this program in 2014-15. However, they indicate that in subsequent years the number of fee payer calls to BOE will likely decline by more than one-third. Given this potential decline in workload, they recommend that the Legislature shift 12 proposed phone-related positions from permanent to two-year limited term. Overall, they recommend that the Legislature establish 42 permanent positions, 21 two-year limited-term positions, and 9.7 one-year temporary positions. Should telephone workloads not decline as projected, the Legislature could revisit this issue when the limited-term positions expire.

Staff Comment: There is a substantial effort and resource requirements for implementing a new tax or fee, particularly in cases with a broad base of fee payers. This is certainly the case with the SRA fee. After the initial investment in the program however, personnel costs and IT costs should generally decline. The committee may want to ask the department whether a decline in personnel is expected in the out years and any drawback associated with limited-term positions rather than permanent. Given that the implementation is largely complete and necessary fee-payer assistance should be declining, the need for permanent staff is questionable. In addition, with the relatively small number of annual property turnovers, it may be that personnel requirements would drop in the future. The committee may want the department to restructure the proposal based on a portion of the positions being limited-term.

Questions for the Department or DOF:

1. *Would the LAO adjustment, which would allow for more limited-term positions and fewer permanent positions, address workload issues?*

2. *Can you provide data on phone-calls and inquires related to the fee since it was established? What is the current compliance rate with the tax currently?*

Staff Recommendation: Adopt LAO alternative staffing proposal.

VOTE:

7730 Franchise Tax Board

Department Overview: The Franchise Tax Board (FTB) is one of the state’s two major tax collection agencies and 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 of 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.

Budget Overview: The Governor's Budget proposes expenditures of $689.5 million ($656.6 million General Fund) and 5,818 positions for FTB. This represents a continuation of a substantial increase in support for the agency compared to the 2009-10 fiscal year. This is somewhat of a decline from the current year funding level of $760.9 million. Expenditures grew from $533.1 million in 2009-10 due primarily to reinstating some of the budget reductions from earlier years as well as new programs. The budget reinstatements were made to reverse negative revenue impacts of the prior Administration’s statewide cuts and furloughs, which included the state's tax collection agencies. In addition, the budget calls for augmentations for specific tax compliance programs and technology improvements related to the department's revenue collection activities. Recent budget increases have also been the result of funding for the Enterprise Date to Revenue (EDR) project, a benefits-funded project discussed below.

Items Proposed for Discussion and Vote

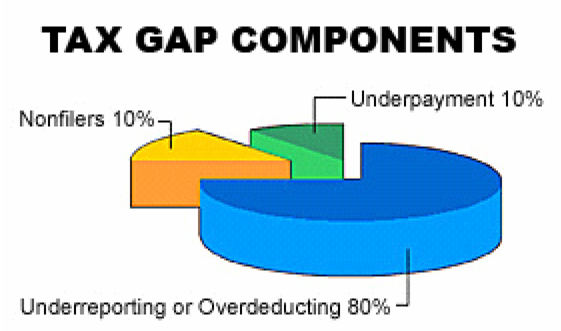
Issue 1: Tax Gap Related Policies (Informational Item)

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 laws, either through intentional disregard or unintentional means. 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. The FTB estimates the current annual tax gap to be $10 billion ($8 billion personal income tax and $2 billion corporation tax)—or roughly 15 percent of total taxes that should be collected from these sources.

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 to adopted laws.

In general, the efforts and programs of FTB are designed to address the following components of the tax gap:

- Non-filers—Entities that simply avoid filing required income tax forms.
- Under-reporters/Over-reporters—Entities that under-report the amount of income or over-report income deductions or tax credits.
- Non-Payers—Entities that file but do not remit tax owed.



Tax enforcement and compliance has become increasingly driven by information, data, and technology over the last couple of decades. The FTB processes more than 15 million personal income tax returns and one million business enterprise returns annually. Given the volume and complexity of tax returns, filings and programs, it has become imperative that tax agencies remain current in information technology in order to access and exchange information. FTB's operations are heavily reliant on effective storage and use of data from a variety of sources, in order to maintain adequate compliance and enforcement activities. The FTB has made significant progress in this area, and this continues to be a focus of its activities (see discussion under EDR issue). These efforts can also have a positive impact on reducing the tax gap.

FTB's Tax Gap Action Committee (TGAC) identifies specific tax gap-related initiatives and recommends efforts to pursue remedial actions. Currently, TGAC's key initiatives are:

- Provide background information on the underground and illegal economies. Continue partnerships with California agencies to improve compliance with tax and related laws.

- Increase FTB's ability to identify fraudulent refund claims and prevent the issuance of erroneous refunds when the claim is the result of a thief using a real taxpayer's information to file a false claim.[1]

[1] In a related refund issue, as part of the 2012-13 Budget, statutory language was proposed that would have imposed a penalty on certain erroneous refund claims. The language imposing a penalty on these erroneous refund claims, when there is no reasonable basis, was not approved, thus allowing non-compliant taxpayers the opportunity to play 'audit roulette.' The language would provide additional conformity with federal law. The corresponding federal treatment imposes a penalty if a claim for refund is made for an excessive amount unless there is a reasonable basis for the claim. The proposal would have closed a loophole in the general accuracy-related penalty framework by imposing a penalty equal to 20 percent of the excessive amount.

Staff Comment and Questions: The department should provide background information to the committee regarding the status of tax gap efforts, and provide any updates from prior years. This update should include results from discreet programs as well as general successes in narrowing the tax gap through increased data sharing and advances in technological capabilities. The LAO should provide comments regarding the department's efforts in this regard and any additional measures that the department could take to improve compliance.

<u>*Questions for the Department or DOF:*</u>

1. *What new tax gap initiatives has the department embarked upon?*

Staff Recommendation: Informational item.

Issue 2: Enterprise Data to Revenue Project (Governor's Budget BCP 1 and Budget Bill Language)

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 fourth 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 $75.1 million General Fund and 23 permanent positions, 42 limited-term positions, and 6 temporary help positions in 2014-15. Of the $75.1 million, $68.5 million is the payment to the vendor for the project. The proposal also includes a placeholder for the department's anticipated 2015-16 resource needs of 3 positions and $47.5 million ($41.2 million vendor payment). In addition, the department requests approval of BBL that would allow DOF to augment the budget for the project by up to $3.0 million upon notification to the JLBC. EDR is a fixed-price, benefits-funded project in that timing of the vendor payment is contingent on the state receiving additional revenues attributable to the project. Anticipated revenue attributable to EDR is between $519.2 million and $684.6 million in 2014-15 and between $800.5 million and $1.1 billion in 2015-16.

Details of the Project: EDR will replace several older FTB information technology systems and streamline other existing systems. Over the long term, the project is expected to annually 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 and related activities generated $7.5 million in revenues in 2009-10, $25.4 million in 2010-11, $115.7 million in 2011-12, and $338.5 million in 2012-13. The amounts projected for each of these years were $3.8 million, $13.7 million, $65.3 million and $187.7 million, respectively. Total cost of the project through 2017-18 is estimated to be $746.0 million, with approximately $537.7 million for the IT component cost. Total revenue generated by the EDR project over this period is expected to be roughly $4.7 billion, for a benefit cost ratio of 6.3:1.

The continuation of the EDR project is expected to fund the technology-intensive portion of the project. FTB indicates that the initial revenues generated by the EDR project were primarily from adding staff to process the current backlog of business entity returns and begin collection correspondence in order to accelerate revenue. Beginning in 2011-12, substantial revenues were generated by the EDR project proper.

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.

Benefits-Funded Approach: Contractor payment for system development and implementation are 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 made use of revenue gains from reducing the business entity backlog to more than offset costs in 2009-10 through 2012-13. Cleaning up the backlog was a necessary condition to efficient project development. In subsequent years, there have been large increases in annual revenue gains that are directly attributable to the IT project. From 2011-12 to 2015-16, annual revenue gains are estimated to increase from $115.7 million to $1.2 billion. IT project implementation costs are expected to increase from $37.0 million in 2011-12 to a peak of $144.9 million in 2013-14 and then decline to $55.8 million by 2015-16. The benefits method of financing EDR is similar to that used by the Employment Development Department and Board of Equalization for certain technology projects.

LAO Perspective: The LAO has no fundamental disagreement with the request related to EDR, but does recommend certain alterations to the proposal. Specifically, they recommend that the Legislature increase the number of new permanent positions the FTB is allowed to establish in order to better retain staff to those positions. In other instances, however, they recommend the Legislature only authorize certain positions on a two-year limited-term basis until a sufficient workload history has been established. LAO's specific recommendations are as follows:

- Approve six audit positions on a limited-term basis and nine positions permanently.
- Approve two fraud and discovery positions on a limited-term basis, four positions permanently.
- Approve three business entities section positions on a limited-term basis, three positions permanently.
- Approve data inspection and information capture activities as permanent rather than temporary.
- Approve web business services position as permanent rather than temporary.

Staff Comment: The net benefit of this project (as estimated in the FSR) ramps up quickly. As noted above, the project began to produce significant net revenues starting in 2011-12. 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 delays and cost increases in certain phases, although these problems generally have not prevented successful completion of project phases. Generally, the project has come on-line faster than anticipated. Existing Supplemental Report Language requires FTB to report to the Legislature when revenue, costs, scope, or schedule variances exceed 10 percent. The committee may ask the LAO and the California Technology Agency (CTA) to comment on the project.

Questions for the Department or DOF:

1. *Would the LAO adjustment, which would shift the distribution of permanent and limited-term positions, address workload issues?*

2. *How will the project benefit the state's other tax agencies—EDD and BOE? If there are revenue impacts, have these been incorporated in the revenue estimates?*

Staff Recommendation: Adopt LAO alternative staffing proposal and adopt proposed BBL.

VOTE:

Issue 3: Accounts Receivable Management Program (Governor Budget BCP 2)

FTB requests $7.7 million (General Fund) and the continuation of 101 two-year, limited-term positions associated with working down the existing inventory of accounts receivable (AR). The current positions will expire June 30, 2014. These positions were originally approved on a two-year, limited-term basis in 2010-11. The revenue resulting from the continuation of these positions for an additional two years is expected to be $108.0 million in 2014-15 and $108.0 million in 2015-16.

FTB's tax collection activities involve collection against accounts receivable, and include automated billing and collection activities, notices, levies, attachment of assets, and routing accounts to collector. FTB's accounts receivable inventory has increased substantially over the last few years, from $5.4 billion in 2007 to $8.5 billion in 2011; as of July 1, 2013, inventory remained at about this level. The inventory in accounts receivable increased substantially during the years when the agency's resources were curtailed due to furloughs, work force reductions, and other types of retrenchment during the previous Administration.

Staff Comments: The department has provided data and other information justifying the need for continued enhanced accounts receivable resources. When these positions were extended in 2012, FTB indicated that it expected efficiency improvements to occur in the future. FTB has noted previously that continuing efforts will reduce the accounts receivable inventory through: (1) technology, including EDR (discussed above), the recently instituted Federal Treasury Offset Program (FTOP); (2) partnering with other agencies and additional data sharing; and, (3) outsourcing particular collection activities. As these improvements to the existing system have come on line, there should have been a reduced need for additional personnel resources; however, AR inventory has not been appreciably reduced. Given this, the committee may want to question the department regarding the future design of its AR program and, in particular, how technology improvements can address the inventory build-up.

Staff Recommendation: Approve as budgeted.

VOTE:

Issue 4: Additional Staffing for New Legislation (Governor's Budget BCP 4)

The department requests an augmentation in the budget year and budget year plus one for additional staff and overtime to administer three new tax components: the California Competes Tax Credits, New Employment Tax Credit, and Like-Kind Exchange Information Reporting. The request is for $954,000 and six two-year, limited-term positions in 2014-15 and $961,000 and eight two-year, limited-term positions in 2015-16. The request also includes a request for $579,000 in overtime costs.

Background: As part of last year's budget package, the Legislature approved AB 93 and SB 90, which together formed the basis of the revisions to local economic development programs. This legislative package included the elimination of enterprise zone programs, and enactment of a sales tax exemption for certain capital purchases, a geographic specific hiring credit, and a targeted tax credit for specific businesses. The sales tax exemption is administered by the Board of Equalization and the hiring credit—the New Employment Tax Credit (NETC)—by the Franchise Tax Board. The targeted tax credit—termed the California Competes Tax Credit (CCTC)—is administered by GO-Biz. Additional information about these legislative changes is provided under Item 0590.

- Under the NETC, effective from January 1, 2014, through January 1, 2021, participating companies must hire qualified, full-time employee and pay wages for work performed in an eligible census tract or former enterprise zone. As part of the process, a tentative credit must be requested from FTB. FTB must process the tentative credit request, provide a data base for the credits, develop guidelines and regulations for the program, verify compliance, and engage in other activities to effectively administer the program.

- Under the CCTC, agreements will be struck between the state and selected businesses that would provide for tax credits related to investments and employment in the state. The credits would be awarded through December 31, 2020. FTB's four requested audit positions would review the proposed contract agreements, review books and records of the businesses to ensure compliance, inform GO-Biz of any potential contract breeches, and recapture any credits claimed but not earned.

- Under the Like-Kind Exchange Information Reporting, FTB staff will provide outreach to businesses, and engage in administrative support to gather data from the filed forms, and validate and document the information provided. Like-Kind Exchanges provide a mechanism to delay the payment of tax on capital gains generated by the sale of business property when replacement property is purchased from the sale proceeds. The reporting requirement will provide a mechanism to collect taxes owed when a final sale of such exchanged property occurs.

Staff Comment: The California Competes Tax Credit is an entirely new program for the state and will involve highly detailed agreements between the state and businesses. The program will be operated in tandem with GO-Biz and will involve the commitment of substantial resources in the form of foregone revenues. Over the five year period of time of the program, almost $800 million could be allocated to the awarded tax credits. Given that GO-Biz has no experience in drawing up contracts of the type anticipated under the program, it is vital that sufficient oversight be exercised over the program. FTB has considerable experience with auditing tax returns and ascertaining whether requirements of a particular tax program have been met. For adequate auditing to occur, the agreements must require quantitative measures and the requested data must be available to FTB. Consequently, it is important that FTB be involved in structuring the more technical requirements of the agreements to guarantee that adequate audits can be conducted. Staff concerns with the proposal are similar to those for the California Competes Tax Credit, discussed under Issue 2, Item 0509, Governor's Office of Business and Economic Development, relating to the need for a full complement of resources at this time. FTB's resource requirements should conform to those for GO-Biz.

Staff Recommendation: Hold open.

VOTE:

Issue 5: Tax Program Data Security (Governor's Budget BCP 5)

The Administration has proposed additional funding for security data systems and personnel for the FTB. The BCP calls for $2.6 million and seven positions to accommodate workload growth and to implement new security systems at the agency. Of the proposed 2014-15 request, $1.8 million is one-time funding to procure and install a data security monitoring and auditing system (ongoing funding for this beginning in 2015-16 will be $526,000 annually for two positions), and $800,000 for the seven positions to secure critical assets and safeguard taxpayer information.

Background: FTB has in place multiple layers of overlapping security software and an intrusion detection and prevention system to safeguard information. These consist of protection mechanisms, oversight, procedures, and policies for the purposes of ensuring confidentiality, integrity, and availability of FTB's IT systems and assets. These systems prevent accidental or unauthorized access, modification, destruction, or misuse of data. The sole purpose is to prevent security breaches, fraud, and detect and respond to an attack, thereby reducing and mitigating consequences associated with a breach of confidential information.

As shown in the table below, FTB has steadily increased the resources going to data security and integrity over the years, as intrusion attempts have increased in frequency and sophistication. The proposal will give a significant resource boost to the program. FTB provides information to, and maintains information for, various state departments that require data security and integrity, including Board of Equalization, Employment Development Department, and Department of Child Support Services. In addition, FTB receives confidential data from the Internal Revenue Service (IRS) which maintains rigorous security standards for data sharing programs.

Franchise Tax Board
Security Resources
(Dollars in Thousands)

Program Budget	2008-09	2009-10	2010-11	2011-12	2012-13
Authorized Expenditures	$3,568	$3,239	$3,865	$4,005	$4,396
Actual Expenditures	$2,990	$3,212	$3,677	$3,971	$4,081
Authorized Positions	35	34	37	38	38
Filled Positions	30	34	34	36	38
Vacancies	5	0	3	2	0

Additional resources will be used for the new data security tool, as well as funding for an information security oversight specialist, an intrusion detection response specialist, an information security compliance specialist, a penetration testing specialist, two internal investigation specialists, and a worksite security staff.

Staff Comment: Staff has no concerns with this proposal.

Staff Recommendation: Recommend approval of the request.

VOTE: