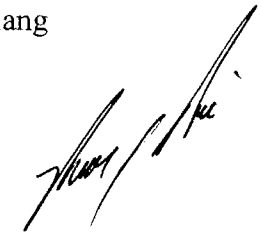
State of California | Board of Equalization

Memorandum

To : Honorable Betty T. Yee, Chairwoman
Honorable Judy Chu, Ph.D., Vice-Chair
Honorable Bill Leonard
Honorable Michelle Steel
Honorable John Chiang

Date: July 6, 2007

From : Ramon J. Hirsig
Executive Director



Subject : **Status Report - Tax Gap Proposal**

At the Board hearing on April 25, 2007, you were provided a copy of a proposed Sales and Use Tax Gap Plan (http://www.boe.ca.gov/news/tax_gap.htm). The proposals are contingent upon funding approval where resources are needed. The Implementation Plan contained proposals that if approved, would be adopted over the next three years. At your request, we are providing additional information related to those proposals and an update on the public input received.

Background

The tax gap, the difference between the amount of taxes owed and the amount paid, is estimated to only be about 4% of total sales and use tax revenues. Yet even at this 96% compliance rate which produces about $50 billion in revenue annually, the tax gap is estimated to be approximately $2 billion: $1.2 billion related to use tax; $450 million related to nonfilers/tax evasion, and $400 million related to registered taxpayers. Staff recognizes that we will not be able to completely close the tax gap, however, we believe that with a comprehensive plan, at full implementation, the BOE can cost effectively narrow the gap by 10%. To accomplish this goal, staff has taken the information presented at the April meeting and public comments, and developed a plan that breaks down the proposed efforts into ten initiatives under the three major segments of non-compliance:

Use Tax Efforts	Registered Taxpayer Efforts	Non-Filer/Evader Efforts
• In–State Service Businesses	• Audit Program Improvements	• Internet Sales
• Out-of-State Sellers	• Collection Program Improvements	• Itinerant Vendors
• Individual Consumers	• Expanded Bankruptcy and Out-of-State Collections	• Cash Based Businesses
	• Contracting Out Some Collections	

Summaries Attached

Attached are summary explanations of how staff proposes to address each segment of the gap including preliminary revenue estimates (see exhibit 1). Staff is in the process of refining the revenue and cost estimates for each of the proposed initiatives to verify that only cost effective proposals are included in the future tax gap budget change proposal (BCP).

Also attached are the public comments received from the posting of the tax gap proposal on the BOE website. Submissions were received from Spidell Publishing; the California Taxpayers' Association; the California Taxpayers' Association collectively with the California Chamber of Commerce, the Silicon Valley Leadership Group, the California Manufacturers & Technology Association, the Motion Picture Association of America, the American Electronics Association, and TechNet; and the Johan Klehs & Company (see exhibit 2).

Staff has reviewed all of the comments and has met informally with Cal-Tax. Staff welcomes ongoing public dialog and will continue to give consideration to the information received. The initiatives will go through the BCP process with some proposals moving to additional formal processes such as the legislative committee hearings. Some of these formal processes will provide the public an opportunity to directly comment and participate in the development of the proposal.

Industry Concerns

With regard to industry's concerns regarding privacy and intrusiveness, staff will strive to implement processes that are as unobtrusive as possible, including working cooperatively with industry to establish procedures that minimize reporting burdens. BOE is governed by, and in compliance with strict safeguard and confidentiality laws. Staff goes to great lengths to protect all confidential and proprietary information obtained. We use technology to protect stored information and train all employees to recognize and secure confidential data. Any new information obtained through the proposed initiatives would be protected by these standards.

Best Practices Considered

Many of the proposed initiatives are modeled after similar successful efforts already implemented in other states. For example, several states use an automated lien process or external collection agencies to collect past due receivables. Washington state's education effort targeted at use tax collection from service businesses is very similar to staff's proposal in that area. Staff will continue to communicate with other states to research best practices as well as lessons learned to identify new opportunities and modify processes where appropriate.

Plan Is Not Static

As explained in the initial draft of the plan, the proposals included in the Implementation Plan are dynamic. The plan is designed to be flexible in order to accommodate changes in taxpayer behavior, to respond to results of different approaches, and to pursue new ideas. For example, since releasing the draft plan, proposals enhancing the out-of-state collection and bankruptcy programs and augmenting the out-of-state audit staff have been added to the Registered Taxpayer efforts listed in the plan.

Previous Efforts

The BOE has already undertaken several efforts that address pieces of the tax gap such as the U.S. Customs Program, the Business License Inspection Program, and the Agricultural Inspection Station Program. While the BOE continuously seeks to improve processes and efficiencies, the proposals contain specific areas that address tax gap components. Several of these elements can be undertaken at current staffing levels including improving audit selection, reviewing audit and compliance procedures, and encouraging out-of-state retailers that do not have nexus in California to voluntarily register to report use tax. However, to effectively narrow the gap the BOE must devise and implement a comprehensive, cost-effective plan to improve compliance in the main segments of the gap: unreported use tax, under-reporting and non-payment by registered taxpayers, and unregistered nonfilers/evaders. These new efforts require new personnel and funding for education and outreach. Staff plans to present these resource requests in the tax gap BCP at the August 14, 2007 Board Meeting, with a draft copy of the BCP to Board Members by July 31, 2007.

RJH:lw

Attachments

cc: Mr. Larry Bergkamp
Mr. Mark Ibele
Mr. Steve Shea
Ms. Barbara Alby
Mr. Erik Caldwell
Ms. Marcy Jo Mandel

Addressing the Tax Gap
Proposal to Improve Use Tax Collection

Background

The use tax portion of the tax gap is believed to contribute about $1.2 billion or 57.6% of the overall tax gap. Staff estimates the use tax portion of the gap is owed partially by individual consumers ($480 million) and unregistered businesses ($680 million). Staff proposes three initiatives to address this portion of the tax gap:

- **In-state service businesses** – improve reporting of equipment and consumable supplies subject to use tax by California businesses that are not required to hold seller's permits. Efforts will include contacting service industries most likely to have use tax liability and educating them about their responsibility to report use tax and encouraging voluntary compliance. Businesses that routinely purchase property from out-of-state will be encouraged to obtain consumer use tax permits.
- **Out-of-state sellers** – encouraging out-of-state retailers that do not have nexus in California to voluntarily register to report use tax from their California customers.
- **Individual consumers** – improving reporting on the use tax line on state income tax returns through education/outreach. Efforts also include pursing legislation to improve reporting by individuals who use a paid preparer to file income tax returns. The legislative process would provide for public input on these proposals.

Business Opportunity

This opportunity will allow the BOE to focus efforts in an area of non-compliance that continues to grow. The proposed efforts will allow us to educate the public at large about their roles and responsibilities in reporting use tax. Additionally, the efforts will allow the BOE to provide the information and tools necessary to encourage voluntary compliance and to enforce the current laws with businesses and individuals that have a legal financial obligation to the State of California.

Strategic Fit

This proposal is directly tied to the BOE's Strategic Plan Goal 1: Maximize Voluntary Compliance in BOE's Programs, Goal 2: Improve the Efficiency of BOE's Tax and Fee Programs, and Goal 4: Create an Expanded and Responsive Infrastructure.

Resources Required

Personnel, related equipment, additional facilities, and funding for education and outreach.

Preliminary Revenue Estimates

- FY 08/09 $15,700,000
- FY 09/10 $35,000,000
- FY 10/11 $48,000,000

Revenue estimates are based on discovery of use tax liabilities from service businesses, individuals, construction contractors, and other consumers not registered with the Board to report tax. Final revenue estimates will be presented in the Tax Gap BCP.

Costs are currently under development and will be presented in the related Tax Gap BCP.

Project Deliverables

With implementation of the various components of this project, there will be an increase in voluntary compliance, new enforcement efforts, and an overall increase in amount of use tax revenue.

Outcomes

- Increase the number of use tax permit holders.
- Increase reporting of use tax on income tax returns by individuals.
- Increase reporting of use tax on income tax returns by businesses that do not hold seller's permits.
- Increase in audit assessments related to use tax.
- Increase in use tax reporting by in-state services businesses.

Addressing the Tax Gap
Proposal to Reduce Non-filers and Evasion

Background

Non-Filers and Tax Evaders are believed to contribute about $450 million or 22.4% of the overall tax gap. Staff proposes three initiatives to address this portion of the tax gap:

- **Internet sales** – registering California sellers who sell through the internet and require a permit, but do not hold one. Efforts will involve working cooperatively with on-line marketplaces to find and educate sellers about their reporting responsibilities.
- **Itinerant vendors** – registering and verifying reported amounts by out-of-state retailers that come into California for a short period of time to make sales (e.g., trade show participants, Christmas tree retailers). This area also includes California sellers who only sell periodically and may not be aware of their requirement to report sales tax (e.g., animal breeders). Efforts will involve identifying sellers through data matching using existing data sources and discovering new data sources.
- **Cash based businesses** – improving audit and collection techniques particular to businesses that primarily have cash transactions. Work cooperatively with other taxing agencies to bring these businesses into the system and ensure proper reporting.

Business Opportunity

This will allow the BOE to focus efforts in an area of non-compliance that is of great concern to the law abiding businesses that make up the majority within California. The proposed efforts will allow BOE to help to level the playing field for all businesses to ensure that some businesses are not provided an unfair competitive advantage.

Strategic Fit

This proposal is directly tied to the BOE's Strategic Plan Goal 1: Maximize Voluntary Compliance in BOE's Programs, Goal 2: Improve the Efficiency of BOE's Tax and Fee Programs, and Goal 4: Create an Expanded and Responsive Infrastructure.

Resources Required

Personnel, related equipment, additional facilities, and funding for education and outreach.

Preliminary Revenue Estimates

- **FY 08/09** $1,800,000
- **FY 09/10** $4,400,000
- **FY 10/11** $7,700,000

Revenue estimates are based on finding and registering internet and itinerant sellers. Final revenue estimates will be presented in the Tax Gap BCP.

Costs are currently under development and will be presented in the related Tax Gap BCP.

Project Deliverables

With implementation of the various components of this project, there will be increased enforcement efforts resulting in additional audits and revenues. As a result, voluntary compliance will also rise.

Outcomes

- Increase the number of permit holders that conduct internet sales.
- Increase in related revenues from internet sellers.
- Increase in reporting and revenues from itinerant vendors.
- Improvement in reporting from cash based businesses.

Addressing the Tax Gap
Proposal to Improve Collection from Registered Taxpayers

Background

Registered taxpayers are believed to contribute about $400 million or 20% of the overall gap. Staff estimates this portion of the tax gap comes from underreporting (12%) and non-payment (8%). Staff proposes four initiatives to address this portion of the tax gap:

- **Audit program improvements** - improving efficiencies in audit selection, auditing more of the tax base with an emphasis on auditing out-of-state accounts (which historically have higher assessments), and implementing new audit techniques.
- **Collection program improvements** – automating manual collection processes including issuing automatic liens and levies, reviewing current policies and procedures to improve efficiency, and increasing the number of collectors.
- **Expanded bankruptcy and out-of-state collections** – Work cooperatively with FTB to obtain electronic matches of bankruptcy information in place of current manual matching. Also, populate BOE's system with FEINs with the long term goal of performing the match internally. This will improve our ability to timely engage in bankruptcy proceedings. Also, obtain information to identify out-of-state companies that may be liquidating assets within California and provide information related to the tax consequences.
- **Contracting out collection** – exploring the use of an external collection agency for certain accounts receivable.

Business Opportunity

This opportunity will allow the BOE to review our current policies and practices and recommend changes that will improve our current audit and collection programs. In addition, we can direct new resources to positions where we know potential for cost-effective revenue collection exists.

Strategic Fit

This proposal is directly tied to the BOE's Strategic Plan Goal 1: Maximize Voluntary Compliance in BOE's Programs, Goal 2: Improve the Efficiency of BOE's Tax and Fee Programs, Goal 4: Create an Expanded and Responsive Infrastructure, and Goal 5: Foster a Skilled, Motivated, and Diverse Workforce.

Resources Required

Personnel, related equipment, additional facilities, and funding for education and outreach.

Preliminary Revenue Estimates

- FY 08/09 $17,300,000
- FY 09/10 $25,400,000
- FY 10/11 $34,000,000

Revenue estimates are based upon improved audit and collection efforts. Final revenue estimates will be presented in the Tax Gap BCP.

Costs are currently under development and will be presented in the related Tax Gap BCP.

Project Deliverables

With implementation of the various components of this project, there will be an increase in voluntary compliance, new enforcement efforts, and a decrease in the accounts receivable totals.

Outcomes

- Increase in collection from out-of-state and bankrupt retailers.
- Increase in audit efficiencies (overall dollars assessed).
- Decrease in accounts receivable totals.
- Increase in collections from use of an external collection agency.

From: Gina Rodriquez, EA [mailto:gina@spidell.com]
Sent: Thursday, June 14, 2007 8:53 AM
To: 'Executive Director'
Cc: Tim Hilger, CPA; Lynn Freer; Renee Rodda
Subject: RE: Addressing the Tax Gap

Ray,

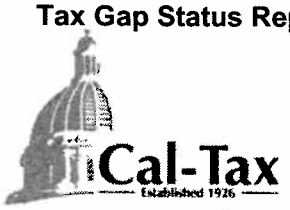
Thank you for the opportunity to review your plan (attached) to address the state's tax gap. As you know, Spidell's editors advocate fairness in taxation and work very closely with the tax practitioner community. As such, we are concerned about Proposal 1.2(d), which would seek legislation to impose preparer penalties for negligence as a way to address use tax noncompliance. Frankly, with the state's lackadaisical approach to use tax education for the past several decades, any negligence penalties should be imposed on the state, not preparers or the tax paying public.

Spidell, in business since 1975, provides continuing professional education to about 30,000 tax professionals each year. Based on this experience, Spidell's editors have concluded that the use tax noncompliance problem is the result of a gross misunderstanding of the application of the use tax. It is not the result of an undermining tax savings strategy on the part of preparers.

Penalizing preparers will do nothing more than alienate the very people that you need to fight noncompliance and address the state's growing tax gap. Proposal 1.2(b), which would establish a comprehensive media campaign to explain use tax, will be a great start in the education process. The state must increase the public's understanding - starting with major newspaper editors – of use tax. A media campaign will help in this endeavor.

I look forward to working with you on this issue and other issues in the future. Please don't hesitate to contact me if you have any questions.

Gina Rodriquez, Sacramento Editor
Spidell Publishing, Inc.
530-676-0662



MOTION PICTURE ASSOCIATION
of America, Inc.

June 15, 2007

TO: The Honorable Betty Yee, Chair
The Honorable Judy Chu, Vice-Chair
The Honorable Bill Leonard, Member District 2
The Honorable Michelle Steel, Member District 3
The Honorable John Chiang, State Controller

FROM: The California Taxpayers' Association, the California Chamber of Commerce, the Silicon Valley Leadership Group, the California Manufacturers & Technology Association, the Motion Picture Association of America, the American Electronics Association, and TechNet

RE: Tax Gap Strategic Plan

At its hearing in April, 2007, the Board staff introduced a draft document entitled "Addressing the Tax Gap", which contained two sections: the first, a policy discussion about the various components of the tax gap and goals for addressing each of those components; and the second, an "Implementation Plan" with specific program proposals in furtherance of the Board's tax gap goals. At that hearing, representatives of the business community voiced concerns about the draft document, and suggested that greater public input should be gathered prior to adopting a strategy for addressing the tax gap. The groups represented on this document have met in the intervening time to discuss the proposal and collectively submit the following comments.

State Policy Requires a Balance Between Revenue Collection and the Rights and Interests of Its Citizens.

The business community shares the Board's stated goals of promoting fair, effective and efficient tax administration. Achieving these goals, however, demand more of the Board than simply a plan for more aggressive and more intrusive enforcement efforts. They require the Board to balance the needs of the agency's collection efforts with the rights of Californians to their privacy and property as well as the efficient use of taxpayer dollars in pursuit of those uncollected or un-remitted taxes.

This principle of "balance" in tax administration is engrained in the Revenue and Taxation Code:

> "7081. The Legislature finds and declares that taxes are the most sensitive point of contact between citizens and their government, and *that there is a delicate balance between revenue collection and freedom from government oppression.* It is the intent of the Legislature to place guarantees in California law *to ensure that the rights, privacy, and property of California taxpayers are adequately protected* during the process of the assessment and collection of taxes. (Emphasis added)"

Unfortunately, neither the tax gap goals nor the implementation plan engages in this balancing exercise presuming with little discussion that public and private administrative costs are no object, privacy no impediment, and that the amount of revenue at stake necessitates the actions proposed. The failure to balance these countervailing policy objectives has led to a draft plan which has serious deficiencies.

The Draft Plan Does Not Protect Consumer and Business Privacy Rights

California has always been at the forefront of privacy policy and the California Constitution contains an express right to privacy. (art. I, sec.1.) This right of privacy exists to prevent governmental intrusion, to inhibit the overly broad collection and retention of unnecessary personal information or the improper use of information properly obtained for a specific purpose, and to avoid the evils incident to lack of a reasonable check on the accuracy of existing records.

In furtherance of this right, the Legislature has moved decisively to implement numerous statutory protections for data gathered and held on California citizens by government and the business community. California is the first state to have an agency dedicated to promoting and protecting the privacy rights of consumers, the Office of Privacy Protection within the Department of Consumer Affairs. Their principles for privacy protection include openness, limitations on collection, purpose specification, use limitation, data quality, individual participation, security safeguards and accountability.[1] These basic principles have been the foundation for many laws in Canada and Europe in addition to the U.S. The federal government as well has a panoply of privacy laws including the recently enacted Gramm-Leach-Bliley Act governing the use of information within the financial services industry.

With this as background, the business community has great concerns that the staff's draft plan simply lacks the requisite balance between revenue collections on the one hand and privacy rights on the other. As technology continues to facilitate government and private collection and use of information, the Legislature and the public have been very concerned that information about Californians' health, what they buy, what they watch, what they read or listen to is closely protected by those that are in possession of that information. The staff's draft tax gap plan fails to adequately address these issues and the

---

[1]. See California Office of Privacy Protection Brochure: http://www.privacy.ca.gov/cover/copp_brochure.pdf

growing importance to the public and policy makers of providing safeguards for the protection of that information.

Major Policy Shift from Two-Party to Third Party Information Gathering

Tax Gap Goal #1 proposes to "develop new approaches and processes to address specific areas of non-compliance." The implementation of this goal, however, is built on a foundation of "new" information obtained from *third party* sources. This foundation, in turn, represents a fundamental policy change for the Board. Until now, when the Board has sought information from the business community, it has traditionally been from the taxpayer, or from someone who is directly engaged in a potentially taxable transaction with the taxpayer (i.e., a *second party*). For example, the Board may contact a vendor to verify the quantity of goods it has sold to a retailer. While these "two party" information requests also have issues associated with them, they are at least limited to parties directly involved in the transaction.

The implementation plan, without so much as a mention, abandons this practice and seeks unprecedented new information from *disinterested third parties* who merely provide communications services or a medium in which buyers and sellers may conduct their transactions. This paradigm shift carries with it major legal and policy considerations not at all addressed by the draft plan.

No Consideration for the Implications to the Third Party

Most of California's privacy laws which restrict the disclosure of information include exclusions for responses to *legitimate* government requests for information; however, there is no immunity from civil suit if the request from the government agency is not sanctioned by law. Our review of the Sales and Use Tax Law suggests that current statutes regarding Board access to business transaction information does *not* extend to information held by third parties. The business community is concerned about being caught between potential civil liabilities on the one hand, and having to legally contest third-party information requests from the Board. A great deal more research needs to be done on this issue before *any* policy is adopted by the Board.

No Plan for the Safe Guardianship of Information Obtained

An important aspect of any Board effort to "mine" data from outside sources is the concern over how that information will be protected, managed and used while in the Board's custody. The draft plan suggests that non-governmental employees be brought into the effort to close the tax gap plan (see section 3.6 and 3.7 of the Draft Implementation Plan). However, there have been numerous well publicized incidents of security breaches where such data has been compromised by such non-governmental parties, and social security numbers, accounts numbers and other highly sensitive data has found its way into the hands of unauthorized personnel, or worse, criminals. In 2004, reporters for a Columbus, Ohio, TV station WBNS discovered an unlocked dumpster full of unshredded documents containing private financial information on 449 people outside the offices of

GC Services, a collection agency charged with pursuing student loan and state tax debt. Yet the plan makes to mention of these issues or the steps that will be implemented to ensure the continued privacy of those about whom the Board collects data.

The draft plan proposes to put the Board in possession of a massive amount of highly sensitive new data not just about taxpayers, but the public in general, with no apparent specific plan to protect, manage and use that data. This is a serious concern that should be addressed before any plan goes forward.

No Consideration of Cost-Effectiveness or Intrusiveness

The draft Tax Gap plan suggests that 96% of current Sales and Use Tax obligations are being met. Certainly, the $2 billion that this 4% gap represents could well be used by the State to bridge its ongoing deficit between expenditures and revenues. But no one believes that this entire amount is collectible. The Executive Summary of the draft report suggests that a mere $400 million could be collected if the "enhanced enforcement efforts and improved voluntary compliance" initiatives are adopted. Even if as much as half the tax gap is realistically collectible, it raises serious questions about the necessity for pursuing such potentially intrusive and costly proposals as suggested by the implementation plan. The Board should be commended for its work to achieve a 96% compliance rate. Nevertheless, while there is little dispute that California has an obligation to pursue all those who are not paying what the law requires them to, that obligation must be balanced with the costs of implementing those efforts and their potential intrusiveness into the lives of Californians.

In this context, cost-effectiveness measures the relationship between possible revenue that might be gained, and the cost to business, consumers and the government of complying with the information request that is being measured. For example, the draft plan's Proposal 1.9 "Mandate third-party reporting" amounts to little more than a "fishing expedition". Such proposals would be burdensome and costly for business to comply with, and virtually impossible for the Board to use. Even if the Board were to invest significant funds in IT equipment to process the information, the amount of potential new revenue that would be identified could not justify the expenditure by either government or business. Nowhere in the plan are these trade-offs between costs of administration (for both taxpayers and government) and actual revenue collections discussed.

The other relevant consideration is "intrusiveness": the relationship between the amount of potential new revenue that might be identified through an information request and the "intrusiveness" on the privacy of the party about whom the information is sought, as well as the privacy of the party providing the information. This is similar to the inquiry of "cost effectiveness", but instead of balancing potential revenue gain with the cost of complying with the information request, this inquiry balances revenue and privacy directly. How much intrusion into the lives and businesses of citizens is the public willing to accept, or the Board to propose, for a given amount of revenue to be raised?
For example, collecting all data on transactions from third-party intermediaries (banks, credit card companies and payment processing companies) would put the Board in

possession of data showing the purchases and sales of most merchants and consumers. Aside from the impossibility of the Board being able to process that type and volume of information, it would provide a totally unacceptable intrusion into the financial lives and purchasing habits of California consumers. So, while there are scenarios in which the tax gap could be closed in short order, those scenarios involve an intrusion into the private lives of Californians that the public isn't likely to accept and may breach California's constitutional protections. The draft plan unfortunately doesn't balance these competing goals of revenue collection and privacy protection, because many of the proposals could only be considered as "highly intrusive", while at the same time not likely to identify significant amounts of new revenue left uncollected by the Board.

Nondiscrimination Between "Markets" and Participants Within Those Markets

The draft tax gap plan should also be evaluated in terms of whether it discriminates against certain types of "markets" and service providers. For example, the implementation plan proposes to request data from "on-line auctioneers". An on-line auctioneer is no different than any other third party that may be connecting buyers and sellers, such as telecommunications providers, newspapers that carry classified or display advertising or credit card companies that facilitate the financial arrangements of a sale. Yet by focusing on this one particular marketplace, the draft plan creates disincentives for buyers and sellers to use it because of the public's increased focus and concern about their privacy. These are not simply noncompliant taxpayers, but those who may not have *any* tax liability but are concerned about being swept up in such broad information requests by the State. This discrimination is undesirable to business, and not in the long-term economic interest of the state.

Within markets and marketplaces, moreover, the draft plan must be evaluated to ensure it does not discriminate between market *participants*. For example, returning to the proposal to request data from on-line auctioneers, the Board has no jurisdiction to request data from *out-of-state* on-line auctioneers, even with a statutory change. Therefore, the proposal creates a disincentive for customers concerned about privacy to use in-state services, and further creates an incentive for in-state services to move out-of-state. The risk of either is simply not justified given the amount of potential new revenue that could be collected.

Some Proposals are Not "Tax Gap" Proposals, But Disguised Expansion of the Tax Base

Finally, we are concerned that some revenue sought to be collected under the tax gap plan are not fairly characterized as "tax gap" revenues, but are in reality an expansion of the tax base. Tax gap is generally recognized, and in fact defined in the draft report, as the difference between what is legally owed and what is actually collected. The draft implementation plan, however, includes several proposals which shift the tax burden of taxpayer A onto a new taxpayer B who is not currently liable for the tax. For example,

many of the nexus proposals in the Implementation Plan propose to make out-of-state sellers not currently liable for use tax collection on their sales to California buyers responsible for collecting and remitting the use tax.

In this same vein, some of the nexus proposals have been considered and specifically rejected by prior Boards or the courts. For example, proposal 1.4(a), to amend Regulation 1684, is essentially an adoption of MTC Nexus Bulletin 95-1 (*third party* warranty repair service creates nexus for out-of-state retailers). Bulletin 95-1 was broadly criticized by taxpayers when presented to the Board as the "settled law" of California in 1996. In fact, California law did not and does not reach so far and was consequently rejected by the Board. Proposal 1.4(a) is, therefore, not a "tax gap" measure but a proposal to expand the underlying tax base of those who are obligated to collect and remit use taxes.

Aside from the Board's extensive history of unsuccessful litigation in the "expanded nexus" area, these "base expansion" proposals are simply not related to the tax gap and any movement to reopen these issues would be viewed with great dismay and suspicion by the business community.

Conclusions and Recommendations

The draft tax gap plan is "out of balance" because it was developed with only a single purpose in mind: revenue collection. State law, however, requires balancing this objective with other policy objectives: privacy and protection of property rights. In order to reach this balance, the draft needs to be re-examined in light of numerous other criteria: 1) protection of privacy rights; 2) the current legal scope of the Board's ability to request information from third parties; 3) cost effectiveness; 4) intrusiveness; 5) discrimination against markets and market participants; and 6) whether the proposal is a "tax gap" or "base expansion" proposal.

This is easier to do with the introductory and goals portion of the draft proposal. We recommend that the Board instruct staff to hold a single brief meeting with taxpayers and industry organizations to assess the plan's goals and objective in light of the criteria above and make changes to the language to balance the plan to reflect the considerations above.

Second, we recommend that the Board not proceed with the implementation plan as currently drafted. Instead, we recommend that the Board commit to a series of meetings between staff and industry focused on each program as it is developed, to ensure that the program reflects the balance that hopefully will be added to the goals, and to ensure that the Board's efforts are focused where they will do the most good.

We appreciate the opportunity to present our views to the Board.

cc: Mr. Ramon J. Hirsig, Executive Director

June 15, 2007

Honorable Betty Yee
Chair, State Board of Equalization
Board of Equalization Tax Policy Division MIC: 92
Sacramento, CA, 95814

RE: Comments on Tax Gap Implementation Plan

Dear Chair Yee:

We are writing to express concerns regarding the Board's Proposed Tax Gap Implementation Plan (Plan), produced in April of this year. Specifically, we ask that the Board refrain from adopting any of the proposals in the Plan without first engaging the public in an interested parties process whereby taxpayer concerns can be vetted and evaluated. Moreover, we ask that the Board withdraw several sections of the Plan due to their potential for unconstitutionality, burdensome reporting, inadequate notice, lack of fairness and due process, as well as infringement of privacy rights.

Affiliated Nexus – Sections 1.4(a) and 1.4(d): In addition to the problem of proposing tax base expansion, rather than how to collect taxes owed under current law, the proposals in Sections 1.4(a) and 1.4(d) of the plan are inconsistent with both prior Board policy and the decision of California's First District Court of Appeal in *Current, Inc. v. State Board of Equalization*, 24 Cal.App.4th 382 (1st Dist. 1994).

In the Executive Summary, the Board defines the term "tax gap" as "the difference between taxes owed and taxes paid." In the Plan, the Board proposes to modify existing laws and regulations to assert nexus over taxpayers that otherwise would not be subject to tax – tax base expansion. Moreover, the proposed modifications are inconsistent both with prior Board policy and federal and state case law interpreting the Commerce Clause. Rather than closing the "tax gap and encouraging taxpayers to pay taxes that already are owed, this Plan proposes to modify the law in a manner that is inconsistent with the United States Constitution.

The Plan proposes to "Amend Regulation 1684, *Collection of Use Tax by Retailers* to redefine the nexus issue as it relates to out-of-state retailers with California repair services so that repair service may establish nexus." This regulation interprets Revenue and Taxation Code Section 6203, which provides that "every retailer *engaged in business in this state* and making sales of tangible personal property for storage, use or other consumption in this state" (emphasis added) not otherwise exempted is liable for use tax.

Regulation 1684, which interprets Revenue and Taxation Code Section 6203, provides in relevant part:

> A retailer is **not** 'engaged in business in this state' based solely on its use of a representative or independent contractor in this state for purposes of performing warranty or repair services with respect to tangible personal property sold by the retailer, provided that the ultimate ownership of the representative or independent contractor so used and the retailer is not substantially similar. (emphasis added)

Thus, the Board would indeed be required to amend the Regulation before establishing nexus over computer companies who use third party contractors for warranty repairs for the purpose of collecting use tax.

The Board's proposal is a concept embodied in a 1995 Multistate Tax Commission Bulletin, Nexus Program Bulletin 95-1 (Bulletin), which suggested that the provision of in-state warranty repair services through third party repair service providers creates constitutional nexus under the Commerce Clause and Public Law 86-272 sufficient to impose use tax liability on all sales made to customers in that state. The Board rejected that Bulletin.

Numerous arguments were asserted against the Bulletin. First, opponents argued that expanding nexus to include out-of-state companies whose sole contact with the state was independently contracted warranty repair would backfire, as nexus is a two-way street. Opponents argued, and we agree, that expanding nexus would also reduce the application of throwback rules. If less is required to establish nexus in California, less is also required to establish nexus in other states, resulting in sales by California companies being allocated to other states, and less income being "thrown back" to California. California taxpayers also will intentionally reallocate sales to other states where the tax burden is lower. Thus, the resulting revenue loss would thwart any revenue gain from expanding nexus over out-of-state taxpayers.

Next, opponents distinguished the case on which the Bulletin relied, *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) and cited *Tyler Pipe Industries v. Washington Department of Revenue*, 483 U.S. 232 (1987), stating that, while these cases found that physical presence of independently contracted sales representatives in the taxing jurisdiction was sufficient to establish nexus, the cases are limited to selling activities, rather than after-market activities, such as warranty repair.

We also note that expansion of nexus by regulation in the case of warranty repair work would be inconsistent with Revenue and Taxation Code Section 6203(c)(2), which defines "retailer engaged in business in this state" as "any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of **selling, delivering, installing, assembling, or the taking of orders for any tangible personal property**." (emphasis added) Absent from this definition is an independent contractor under the authority of a retailer for the purpose of warranty repair work. Section 6203(C)(4)(A), which refers to "any retailer soliciting orders for tangible personal property by mail ...if the retailer

benefits from ... the location in this state of authorized installation, servicing, or repair facilities," may be consistent with establishing nexus through warranty repair work, but that section is inoperative as per Section 6203(c)(4)(B), which states that the section shall become operative upon enactment of a congressional act that authorizes states to compel the collection of state sales and use taxes by out-of-state retailers.

The Board recognized in 1996 that the foregoing arguments were correct, and rejected the Bulletin. The Board is now planning to revisit the issue by proposing to amend Regulation 1684 to establish nexus over out-of-state retailers that contract in-state for warranty repair. But the same arguments that applied against the Bulletin apply today. For the same reasons as applied in 1996, the Board should eliminate this proposal from the Plan.

In Section 1.4(e) of the Plan, the Board proposes to "seek legislation that would deem [nexus over] an out-of-state retailer that is owned in whole or in part by a California retailer, engaged in business if that retailer sells a similar line of products as the retailer maintain sales locations in California under the same or substantially similar business name." This concept is known as "affiliated nexus" and was rejected by California's First District Court of Appeal in *Current,* supra.

In *Current*, the court considered whether California could, under the Commerce Clause, establish nexus over a wholly-owned subsidiary of a Minnesota corporation which had nexus to California by virtue of the subsidiary's affiliation with the Minnesota corporation. The court found that both corporations engaged in different businesses and did not act as agents of the other. The subsidiary primarily sold novelty items, with a minor portion of its business being to sell novelty checks at retail. The parent corporation primarily sold checks at wholesale to banks and other financial institutions. The court concluded that the subsidiary's physical nexus with the State of California was insufficient to justify imposition of the use tax. Thus, the court struck down Section 6203(g) of the Revenue and Taxation Code as violating the Commerce Clause.

Section 1.4(e) proposes to reinstate the statute that the court struck down in *Current*. Pursuing such legislation can only result in litigation and the violation of taxpayer rights.

For the foregoing reasons, we respectfully request that the Board withdraw Sections 1.4(a) and (e) from its proposed Plan.

Burdensome Reporting/Inadequate Notice – Sections 1.1(a)-(d), 1.2(a)-(e), 1.2(g): Sections 1.1(a)-(d) of the Plan propose to target taxpayers that may owe use tax by identifying non-registered businesses with greatest capital equipment expenditures, requesting information on those businesses from the Franchise Tax Board and Employment Development Department, and sending letters to those taxpayers alerting them to potential use tax liability, including a return. The Plan also proposes to audit use tax returns to identify those with ongoing use tax liabilities and require them to register with the Board. The taxpayers targeted by this proposal are non-retail businesses with large amounts of

equipment, such as computers. These are not businesses that typically file sales and use tax returns. Thus, they likely are not educated with regard to the state's use tax requirements. Before the Board endeavors to send letters and returns to these businesses, the Board should consider a greater effort to educate the public regarding potential use tax liability and record-keeping that is required under the law.

While a letter to taxpayers alerts them to potential liability, they will already have purchased the equipment that may be subject to liability without keeping adequate documentation. Those taxpayers will be disadvantaged if the Board pursues this proposal without first engaging in outreach efforts to alert taxpayers as to items that may be subject to liability, as well as to alert them regarding the required documentation to support their position on audit.

Similarly, in Section 1.2(a) the Board proposes to seek legislation that would delete the sunset date for the use tax line on the income tax return and make use tax reporting mandatory. In fact, the Board is sponsoring AB 969(Eng), which would enact this proposal into law. AB 969 has passed the Assembly and is awaiting hearing in the Senate. Section 1.2(b) proposes to establish an outreach campaign to explain use tax liabilities and reporting requirements, and Section 1.2(c) proposes legislation to require use tax education for tax professionals. The outreach and educational elements of the Plan are laudable. However, before taxpayers can follow the law, which will become mandatory under AB 969, they will need education, not only with regard to potential liability, but also regarding: (1) the sales tax rate in all other states because tax paid to another state offsets California liability; and (2) the items that are taxable and the items that are exempt in each state to correctly compute the sales tax offset. In sum, unless taxpayers can develop expertise in use tax law, their ability to comply will be limited, and their potential exposure to penalties will be large. Exposing taxpayers to liability without adequate education is simply unfair.

Proposal 1.2(g) proposes to address the deficiency set forth above by suggesting a table for reporting to minimize the taxpayer burden of maintaining receipts. The Board should only establish such a table with an extensive public hearing and taxpayer input to ensure that the numbers in the table fairly will reflect actual taxpayer liability for use tax. Without such public input, the potential for excessive tax liability resulting from use of the table is great.

Due Process Concerns – Sections 1.8 and 3.6: Section 1.8 proposes to seek legislation that would prohibit the issuance or renewal of any state-issued license if any state tax is delinquent or unpaid. This proposal is unworkable, unfair, and leads to serious due process concerns. This proposal will result in the following scenario. Taxpayer A, a hair stylist, owes back taxes to the Franchise Tax Board. Taxpayer A's cosmetology license is up for renewal; however, due to the taxes owed, the hairstylist is unable to renew the license. Taxpayer A thus loses his or her job, and his or her ability to pay the taxes owed is likewise reduced. Section 1.8 would accomplish the opposite of the Board's goal, which is to increase collection of taxes owed. Moreover, whether the state can withdraw an individual's ability to make a

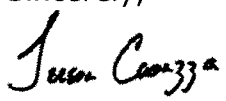
living due to state tax obligations without so much as a hearing raises due process concerns under the United States Constitution.

Similar problems are associated with Section 3.6, which proposes to use auto liens and levies to collect taxes. Does the Board intend to take away an individual's transportation to and from work to collect a portion of taxes owed by placing a levy on the individual's vehicle?

Conclusion: Before embarking on its Tax Gap Implementation Plan, the Board should hold public hearings and an interested parties process to ensure that it has taken into full consideration the impact on taxpayers of every aspect of this Plan. We have serious concerns that certain aspects of the Plan: (1) would result in tax base expansion, rather than increased collection; (2) would be inconsistent with prior Board policy; (3) would violate the Commerce Clause and due process protections; and (4) would be unfair to taxpayers who have not received notice of potential use tax liability and recordkeeping requirements.

For the foregoing reasons, we respectfully request that the Board decline to adopt Sections 1.4(a), 1.4(d), 1.1(a)-(d), 1.2(a)-(e), 1.2(g), 1.8 and 3.6 of the Plan, while opening the Plan up to an interested parties process with public hearings and taxpayer input.

Sincerely,



Teresa Casazza
Acting President

Cc: Honorable Michelle Steel
Honorable Judy Chu
Honorable Bill Leonard
Honorable John Chiang

JOHAN KLEHS & COMPANY
STRATEGY • GOVERNMENT RELATIONS • ADVOCACY

June 11, 2007

The Honorable Betty Yee, Chair
Board of Equalization
450 N Street, MIC: 73
Sacramento, CA 95814

Dear Chair Yee:

Thank you for meeting with the law firm of Linebarger, Goggan, Blair & Sampson. The firm provides professional collection solutions for various public agencies at the federal, state, and local levels of government throughout the United States. The firm would like to assist the Board of Equalization(BOE) in closing its tax gap.

The BOE faces a significant challenge of closing the "Tax Gap". The difference between taxes owed and paid, is estimated to be about $2.0 billion. The largest portion of the tax gap is use tax liabilities. The tax gap associated with use tax liabilities amounts to $1.2 billion. The total amount of existing sales and use tax liabilities in active collections includes 59,257 accounts totaling almost $726 million. These accounts are comprised of 1,504 out-of-state accounts totaling $40.3 million and 57,753 in-state accounts totaling $685.6 million.

California has always been a national leader in tax administration. However, California has generally not utilized the opportunities of private collection vendors. The federal government and other states have used private collection vendors with a high degree of success. Each public agency's program is tailored according to the needs of the individual revenue agency.

Linebarger Goggan would like to assist the BOE by insuring that its collection methods are performing as efficiently as possible. Utilizing a private collection vendor would provide the BOE with a new means for taxpayers to satisfy their tax obligations. Private collection vendors could insure that California does not fall behind. Adding private collection vendors to California's efforts to close the tax gap would not require many additional resources. The U.S. Treasury model is an excellent starting point for using private collection vendors to close the tax gap.

We have enclosed a summary of "Best Practices" using the U.S. Treasury model for your consideration. This list of best practices is identical to the list the firm has sent to the Franchise Tax Board as it considers developing its own criteria for utilizing private collection vendors to close its tax gap.

1415 L STREET, #620 • SACRAMENTO, CA 95814 P.O.BOX 1026 • SAN LEANDRO, CA 94577
TEL: (916) 551-1881 • FAX: (916) 444-7114 • EMAIL: JOHANKLEHS@COMCAST.NET

We look forward to serving you. Please feel free to contact us if we can be of any service in the future.

Sincerely,

JOHAN KLEHS

Enclosure as Stated

Cc: Mr. Ramon Hirsig; Executive Director
Board of Equalization

Linebarger, Goggan, Blair & Sampson LLP

Best Practices for the Board of Equalization(BOE) to consider in utilizing Private Collection Vendors to close the Tax Gap

June 13, 2007

The Linebarger, Goggan, Blair & Sampson law firm has a unique approach to best practices which has consistently kept the firm as a market leader delivering substantive results for public agencies.

I. Innovation and Quality Control

31 years of experience has taught the firm that long-term success requires the ability to anticipate the future. The firm aggressively seeks out innovative ideas from within the organization and the industry at large and integrates the best concepts into the firm's operational processes.

Utilizing private collection for public agencies is highly regulated area. Linebarger Goggan represents many of the largest government and private sector clients in the country. Quality control is paramount throughout all aspects of the firm's operations. As a result, the firm has developed a quality control program for all critical business processes.

This corporate stance toward innovation and quality control offer significant value for our clients.

A. Security and Confidentiality

Linebarger Goggan systems, physical facilities, recruitment and training programs and collections processes were designed with a conscious recognition of the need for the highest levels of security and confidentiality.

B. Physical Security

The Linebarger Goggan facility in San Antonio holds virtually all of the firm's critical network devices and data. Controlling physical access to these systems eliminates the possibility of unauthorized intrusion or damage. To limit physical access to only authorized personnel, Linebarger Goggan has implemented two independent systems: video surveillance and access control.

C. Controlled Destruction of System Outputs

Linebarger Goggan has established a procedure for identifying confidential information and a process for securely destroying it. Electronic media (discs and tapes) are destroyed in a manner that makes recovery impracticable (i.e., burning, shredding, degaussing) and in accordance with IRS protocols. In the event that a computer system is no longer usable, the information contained on the hard drive is destroyed by either magnetically removing the information or destroying the physical hard drive.

D. Monitoring Compliance with Information Security Policies

Linebarger Goggan utilizes the capabilities associated with the Computer Associates Security Command Center and Vulnerability Manager to monitor compliance with regard to information security policies. Additionally, Linebarger Goggan has established an annual review of its NIACAP certification by a third party to maintain compliance.

II. Technology

A. Full Complement of In-house Technology Staff

Recognizing that technology is critical to any successful collection program, the firm maintains an in-house staff of 120 computer engineers, network architects, systems analysts and programmers to develop and maintain an IT environment unsurpassed in the industry. This commitment to maintaining highly skilled workforce means that the client is assured of a Linebarger Goggan collection program that will meet all client requirements.

B. Mailing Facility

The firm has invested in a state-of-the-art mailing operation that is fully integrated with its information technology center. This facility prints the letters for the firm's contract with the federal government, which operates under very strict security and confidentiality requirements; cameras and other monitoring equipment provide uninterrupted security control. Demand letters are printed, stuffed, sealed, and delivered directly to the Post Office. This facility can generate over 17,000 letters per hour in a secure environment.

C. NIACAP Certification

The National Information Assurance Certification and Accreditation Process(NIACAP) involved an extensive review of the firm's information systems security, including disaster recovery as outlined in the firm's business continuity program, intrusion detection, physical plant security, virus protection and a host of related issues. The policies and standards developed to support the firm's NIACAP certification are designed to protect Linebarger Goggan information resources from unauthorized access, inadvertent disclosure of sensitive information to unauthorized individuals, sabotage, natural disaster, etc.

D. Skip Tracing

To obtain the most accurate information in the shortest time period, the firm networked its multiple skip-tracing vendor relationships and its internal research department. The automated search uses a tiered or cascade series of databases to find the taxpayer. Linebarger will send the account to several national skip-tracing databases. Files are submitted successively to the vendors based upon their performance relative to their peers, with the highest performing vendor receiving accounts first.

E. Quality Customer Service

Quality customer service in the collection industry can be measured by the number of legitimate complaints against an agency. To minimize complaints, Linebarger Goggan focuses on its staff and the management structure required supporting them. Well-trained employees are critical to meeting this benchmark, as they are the primary point of contact with the individuals owing delinquent receivables to our clients.

1. Our hiring process pre-screens for best possible candidates:

2. Training stresses all applicable state and federal laws and is then customized to specific client programs and collection criteria.

3. Staff is monitored on a regular basis and receives annual performance evaluations to ensure compliance with all state and federal regulations and client requirements.

4. The firm has a zero tolerance for taxpayer complaints.

   We offer a generous benefits program to retain these employees and reduce staff turnover to ensure continuity in the handling of a client's program.

6. Experienced collection floor managers provide immediate assistance to collectors working with a difficult situation.

7. Licensed attorney oversight of all collection operations to ensure not just contract compliance, but full regulatory compliance as well.

F. Highest Ethical Standards

The firm has made an uncompromising commitment to adhere to the highest ethical standards in the collection industry.

The firm retains an outside Ethics Advisor, who is a former chair of the State Bar of Texas, the professional organization responsible for licensing and oversight of all attorneys' professional behavior.

Our in-house general counsel developed and implemented the firm's current code of ethics. The General Counsel monitors firm compliance with its code of ethics.

G. Project Management

Linebarger Goggan uses a project team approach to organize and manage its human and technical resources. The team includes the managers of each organizational unit engaged in the particular contract: Project Manager (and alternate), Collections Manager, Training Manager, Information Technology Representative, etc. Team members have:

1 Relevant public sector experience. Many of the firm's employees have served either in public office or worked in the public sector.

2. Experience with comparable debt portfolios

3. Clearly delineated functional responsibilities, and

4. Established communication procedures for working with clients to maintain full accountability.

H. Action Teams

The Project Manager may call upon short-term "action teams" comprised of firm technical and managerial personnel with the depth of experience and exceptional skill-sets to address specific issues or opportunities that may arise during a contract. These teams will typically meet via teleconference to assist the project manager with additional analysis, alternate options and strategies and resources for implementing new initiatives. Action team recommendations will be presented to the Project Management Team and incorporated into its work flow as appropriate and with the client's approval.

III. Best Value Equals Best Overall Performance- Getting the most for the public agency client out of the contract!

A. A True Best Value Contract

How can a public agency structure a contract to get the highest best value and overall performance from the vendor? A true "best value" contract equates to several qualitative measures that may include price, but is not limited to price alone. Those measures include:

1. Best overall recovery performance on a contract
2. Best customer service (least number of legitimate complaints)
3. Value-added services
4. Innovative practices

B. The Low Bid Process May Not Be Appropriate for Collection Services

For the very reasons listed above, a low bid (price-driven) contract cannot deliver best value, performance or customer satisfaction for any client.

Collection contracts are not for durable goods; they are for services. The delivery of those services is highly dependent upon the abilities of personnel employed and the application of a highly technical infrastructure.

2. A collection agency operating on a low bid cannot afford to maintain a consistent effort to collect on all accounts without undermining its core business operations. In fact, one or two collection firms have declared bankruptcy in Arizona as a result of winning low bids. The only way a collection vendor can service a low bid contract and stay in business is to produce a minimal effort to collect the easy debts. The more difficult accounts that require more resources (advanced skip tracing, specialized mailings, etc.) are ignored and become part of a growing backlog of older debt that is harder to collect.

3. Some low bid vendors may apply heavy-handed tactics to increase revenue (both for the vendor and the agency) in the short term thereby increasing the possibility of violating state and federal regulations.

C. Alternate Fee Solution

1. Establish a single flat fee structure for all vendors, thus removing price as an evaluation criteria. (This structure should differentiate debts i.e. first placements, second placements, accounts requiring legal services). This allows the revenue agency to assess all proposals on a more equal basis for actual indicators of likely results for the agency (experience/knowledge of work to be performed and actual performance results). It also provides an opportunity to evaluate the merits of any proposed value-added services.

2. Allow vendors to compete under the same contract for a year and then reevaluate their performance, perhaps reducing the field to the top three competitors in order to provide the best overall service to the state agency.

D. Adopting U.S. Treasury Financial Management Service (FMS) Criteria

The U.S. Treasury FMS collections contract serves as the federal government's central debt collection agency, managing over 150 different agency's non-tax delinquent debt portfolio. Thus, the revenue agency may want to consider adopting some or all of the following key factors in its collection program:

1 Place several collection vendors in competition with each other.

2. Use a system of primary and secondary vendors. For example, in addition to using several primary vendors in competition with each other, the revenue agency could use a single vendor for secondary placements to complete a comprehensive collection program. A vendor for secondary placements can monitor the effectiveness of the primary vendor's collection efforts.

3. Rank vendors three times a year (every four months), with the highest ranking vendor receiving a cash bonus and a higher percentage of referrals for the next four month period.

4. Rank calculations based on administrative resolutions as well as net dollars recovered.

5. Use ranking criteria that includes administrative resolutions ensuring that vendors will dissect the entire portfolio for both valid and invalid debt. Procedures to confirm invalid debt must be completed before vendor gets "credit" in the ranking criteria and the benefit to FMS is that the invalid debt is removed from the records.

6. Agencies have different "Blanket Settlement Agreement" (BSA) percentages for disputed debt amounts, some are at 100% (no negotiation or write off), some 95%, 92%, etc. so continuity is maintained after referral to central agency.

7. "Batch tracks" (ranking info) are given to all vendors weekly so they can determine their ranking in relation to the other vendors.

E. Adopting the Inclusion of a Monetary Bonus

A revenue agency might want to consider several factors in calculating monetary bonuses for its vendors. The factors could include:

1. The contractors' performance can be evaluated every four months. The evaluation can be based on a Net Back Recovery % (NBR%) and the Administrative Resolution %. The NBR% can be weighted at 70% and the AR% at 30%. This formula can be used to calculate the individual contractor scores for the performance evaluation period.

2. The individual scores can be totaled and the total divided by the number of contractors. This number can calculate the average performance score for the evaluation period.

3. After the average performance score is determined, a standard deviation can be used to identify the top performers. (Note: The standard deviation to be used can be determined based on the number of task orders issued.)

4. Only the top performers would receive the monetary bonus. The dollars can be distributed proportionally among the top performers.

5. The revenue agency could reserve the right to change the basis of the bonus pool, the weights and/or the method, and will provide the contractor advance notice of any change.

F. Adopting the Inclusion of an Account Referral Bonus

1 The contractors' performance can be evaluated every four months. The evaluation can be based on the Net Back Recovery % (NBR%) only.

2. Account referrals can be based upon the approximate dollar value of accounts available for distribution during the following performance period.

3. As with the calculation of the monetary bonus, the individual net back recovery percentage scores for each of the contractors can be totaled and the total divided by the number of contractors. This will calculate the average performance score for the evaluation period.

4. After the average performance score is determined, a standard deviation can be used to divide the contractors into three groups: above average, average and below average. Among the average group, contractors may receive an average percentage of referrals. The above average group may receive more that the average percentage of referrals based on how much greater their standard deviation is from the average standard deviation. The below average group can receive less than the average percentage of referrals by proportionally dividing the loss created by rewarding the above average collection vendor. (Note that the standard deviation to be used will be determined based on the number of task orders issued).

5. The revenue agency reserves the right to change the basis of the additional account referral bonus, the weights and/or the method, and will provide advance notice to contractors of any change.

For Further Information Contact:

Ms. Daisy Power
Linebarger, Goggan, Blair & Sampson LLP
663 West 5th Street
Suite 2600
Los Angeles, CA 90071
(213)614-9665, Office
(213)624-6152, FAX
E mail: DaisyP@publicans.com

Johan Klehs
Johan Klehs & Company
1415 L Street, #620
Sacramento, CA 95814
(916)551-1881, Office
(916)444-7114, FAX
E mail: johanklehs@comcast.net