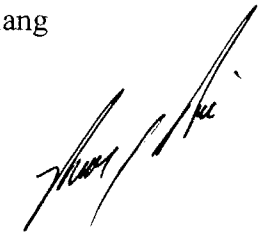
State of California | Board of Equalization

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.