

Department of Revenue

A.R.S. § 42-102

Director: Gale Garriott

JLBC Analyst: Bob Hull

	FY 2005 Actual	FY 2006 Estimate	FY 2007 Approved
OPERATING BUDGET			
<i>Full Time Equivalent Positions</i>	1,148.0	1,148.0	1,148.0 ^{1/}
Personal Services	32,576,300	34,557,400	40,179,400
Employee Related Expenditures	9,907,400	11,620,300	14,863,600
Professional and Outside Services	1,939,800	1,876,300	2,442,300
Travel - In State	246,300	320,500	446,400
Travel - Out of State	110,500	220,400	517,100
Other Operating Expenditures	10,225,900	10,065,400	11,401,400
Equipment	1,297,500	801,000	801,000
OPERATING SUBTOTAL	56,303,700	59,461,300	70,651,200
SPECIAL LINE ITEMS			
Revenue Generating Program	6,788,900	6,989,400	0
Unclaimed Property Administration	1,459,200	1,677,500 ^{2/}	1,691,300
Unclaimed Property Contract Auditors	0	0	1,770,000 ^{3/}
BRITS Operational Support	0	0	1,200,000 ^{4/}
Kerr Settlement Administration	0	975,000 ^{5/6/}	0
Small Towns Revenue Sharing	0	0	850,000 ^{7/}
Ch. 378 Health Insurance Premium Tax Credit	0	0	75,000 ^{8/9/}
AGENCY TOTAL	64,551,800	69,103,200	76,237,500^{10/11/12/}
FUND SOURCES			
General Fund	62,286,100	66,551,600	71,856,100
<u>Other Appropriated Funds</u>			
Estate and Unclaimed Property Fund	1,459,200	1,677,500	3,461,300
Liability Setoff Fund	361,000	398,000	416,800
Tobacco Tax and Health Care Fund	445,500	476,100	503,300
SUBTOTAL - Other Appropriated Funds	2,265,700	2,551,600	4,381,400
SUBTOTAL - Appropriated Funds	64,551,800	69,103,200	76,237,500
Other Non-Appropriated Funds	858,700	784,700	784,700
TOTAL - ALL SOURCES	65,410,500	69,887,900	77,022,200

^{1/} Includes 18 FTE Positions funded from Special Line Items in FY 2007.

^{2/} Laws 2006, Chapter 316 appropriated \$135,000 for supplemental funding for unclaimed property printing and advertising costs.

^{3/} An amount equal to 12.5% of the dollar value of the properties recovered by unclaimed property contract auditors is appropriated from the Estate and Unclaimed Property Fund to pay unclaimed property contract auditor fees in accordance with A.R.S. § 44-313, requiring that administrative expenses be appropriated. This amount is currently estimated at \$1,770,000 in FY 2007. (General Appropriation Act footnote)

^{4/} Laws 2006, Chapter 350 appropriation of \$1,200,000.

^{5/} Laws 2006, Chapter 316 appropriated \$975,000 for administration of the *Kerr v. State of Arizona* lawsuit.

^{6/} This appropriation is a continuing appropriation and is exempt from the provisions of A.R.S. § 35-190, relating to lapsing of appropriations, through June 30, 2007. (Laws 2006, Chapter 316 footnote)

^{7/} Laws 2006, Chapter 351 appropriation of \$850,000.

^{8/} Laws 2006, Chapter 378 appropriation of \$75,000.

^{9/} This appropriation exempt from the provisions of A.R.S. § 35-190, relating to lapsing of appropriations. (Laws 2006, Chapter 378 footnote)

^{10/} General Appropriation Act funds are appropriated as an Operating Lump Sum with Special Line Items by Agency.

^{11/} The Department of Revenue shall pay not more than \$368,100 from all funds in FY 2007 for their Risk Management payment to the Department of Administration. (General Appropriation Act footnote)

^{12/} The department shall provide the department's General Fund revenue enforcement goals for FY 2007 to the Joint Legislative Budget Committee for review by July 31, 2006. The department shall provide quarterly progress reports to the Joint Legislative Budget Committee as to the effectiveness of the department's overall Enforcement and Collections Program. The reports shall include a comparison of projected and actual General Fund revenue enforcement collections for FY 2007. The reports are due within 30 days after the end of each calendar quarter. (General Appropriation Act footnote)

AGENCY DESCRIPTION — The Department of Revenue (DOR) administers and enforces the collection of personal and corporate income, sales, withholding, luxury and estate taxes. The department administers state property tax laws through the 15 county assessors. The department does not collect transportation related fees and taxes, nor the insurance premium tax.

PERFORMANCE MEASURES	FY 2003	FY 2004	FY 2005	FY 2007
	Actual	Actual	Actual	Approved
<ul style="list-style-type: none"> Average calendar days to refund income tax Comments: Average calendar days to refund income tax decreased to 6.3 days in FY 2005 due to an increase in electronic filing. DOR estimates 12 days in FY 2007, due to including returns that go to the error resolution section which are not counted now. 	13.5	8.3	6.3	12
<ul style="list-style-type: none"> % of written taxpayer inquiries answered within 30 calendar days of receipt 	55	58	84	90
<ul style="list-style-type: none"> % of delinquent accounts collected 	10.8	10.0	10.0	11.0
<ul style="list-style-type: none"> Customer satisfaction rating for taxpayer information section (Scale 1-5). 	4.6	4.6	4.4	4.6

Operating Budget

The budget provides \$70,651,200 for the operating budget in FY 2007. This amount consists of:

	FY 2007
General Fund	\$69,731,100
Liability Setoff Fund	416,800
Tobacco Tax and Health Care Fund	503,300

These amounts include an increase of \$4,200,500 for statewide adjustments. This amount consists of:

General Fund	4,154,500
Liability Setoff Fund	18,800
Tobacco Tax and Health Care Fund	27,200

(Please see the Statewide Adjustments section at the end of this Appropriations Report for details.)

Revenue Generating Program

The budget moves \$6,989,400 and 103 FTE Positions from the General Fund in FY 2007 from the Revenue Generating Program special line to the operating budget.

The Revenue Generating Program added 103 revenue enforcement FTE Positions, mainly audit and collection personnel, beginning in FY 2003 intended to increase the department's collections. Since then, a footnote had required DOR to report to the JLBC quarterly as to the effectiveness of the Revenue Generating Program and the department's overall Enforcement and Collections Program. However, while DOR had reported on their overall Enforcement and Collections Program, they had not reported on the Revenue Generating Program per se.

The budget provides a revised footnote requiring continuation of the quarterly report on the effectiveness of

DOR's overall Enforcement and Collections Program, but eliminating of the requirement that DOR report on the effectiveness of the Revenue Generating Program, which was not being done. The revised footnote also requires that DOR provide their General Fund revenue enforcement goals for FY 2007 for Joint Legislative Budget Committee review by July 31, 2006, in order to measure their quarterly progress.

Special Line Items

Revenue Generating Program

The budget moves \$6,989,400 and 103 FTE Positions from the General Fund in FY 2007 from the Revenue Generating Program special line to the operating budget. *(Please see Operating Budget for additional information.)*

Unclaimed Property Administration

The budget provides \$1,691,300 and 18 FTE Positions from the Estate and Unclaimed Property Fund for Unclaimed Property Administration in FY 2007. The amount includes an increase of \$65,800 from the General Fund for statewide adjustments plus the following changes:

Document Imaging System

The budget provides an increase of \$83,000 from the Estate and Unclaimed Property Fund in FY 2007 for an electronic document imaging and management system, including \$72,500 one-time equipment costs and \$10,500 annual software licensing and maintenance costs. This should improve taxpayer response and claim processing compared to the current paper file system.

Monies in this line item are used for the administrative costs of handling, publicizing and selling of unclaimed or abandoned property. Abandoned property can include bank accounts, safe deposit boxes, stock certificates, utility deposits, life insurance policies and unclaimed victim

restitution monies. Property is typically considered "abandoned" after 5 years.

Unclaimed Property Administration (i.e., non-contract auditor costs) is moved to a new Special Line Item from the operating budget to clearly show the 2 unclaimed property amounts. Prior year amounts have been adjusted for comparability.

FY 2006 Supplemental

The budget eliminates \$(135,000) in one-time FY 2006 supplemental funding (Laws 2006, Chapter 316) from the Estate and Unclaimed Property Fund. The supplemental funding was for unclaimed property printing and advertising costs. The State Government Budget Reconciliation Bill (Laws 2006, Chapter 350) revises A.R.S. § 44-309 to eliminate the requirement for the newspaper listing of names of individuals with unclaimed property. Instead, it requires newspaper notices at least semiannually directing the public to the department's internet Web site or a toll-free telephone number.

Unclaimed Property Contract Auditors

The budget provides \$1,770,000 from the Estate and Unclaimed Property Fund in FY 2007 to pay unclaimed property contract auditor fees. This will allow DOR to comply with A.R.S. § 44-313, which requires that DOR's administrative expenses for unclaimed property be appropriated. DOR had previously paid unclaimed property contract auditor fees on a non-appropriated basis. Contract audits generated a total \$14,200,000, including \$1,770,000 paid to the auditors in FY 2005.

Monies in this line item are used to pay contract auditors, who mainly audit large financial and insurance companies headquartered out of state. The actual appropriation is 12.5% of the dollar value of the properties recovered by unclaimed property contract auditors. The amount displayed is the amount that DOR paid unclaimed property contract auditors in FY 2005. A new footnote specifies that 12.5% of the dollar value of the properties recovered by unclaimed property contract auditors is the amount appropriated.

Business Reengineering/Integrated Tax System (BRITS) Operational Support

The State Government Budget Reconciliation Bill (Laws 2006, Chapter 350) provides \$1,200,000 from the General Fund in FY 2007 to DOR for operational support of BRITS. The \$1,200,000 includes \$800,000 for disk storage and equipment costs and \$400,000 for server and printer replacement costs. *(Please see Additional Legislation for additional information.)*

Kerr Settlement Administration

The Supplemental Appropriations Budget Reconciliation Bill (Laws 2006, Chapter 316) appropriates \$975,000 from the General Fund in FY 2006 to the Department of Revenue for supplemental funding for administration of

the Kerr v. State of Arizona lawsuit. The department is required to present an expenditure plan for review by the Joint Legislative Budget Committee that includes an estimate and scope of the entire administrative requirement associated with disbursing payments and costs for this case, before expending any of the \$975,000. The \$975,000 appropriation is a continuing appropriation and is exempt from the provisions of A.R.S. § 35-190, relating to lapsing of appropriations, through June 30, 2007. *(Please see Additional Legislation for additional information.)*

Small Towns Revenue Sharing

The General Revenues Budget Reconciliation Bill (Laws 2006, Chapter 351) provides \$850,000 from the General Fund in FY 2007 to DOR for distribution to towns with a population of 1,500 or less.

Ch. 378 Health Insurance Premium Tax Credit

The Health Insurance Premium Tax Credit Bill (Laws 2006, Chapter 378) provides \$75,000 from the General Fund in FY 2007 to DOR for the department's administration of health insurance premium tax credits. Chapter 378 also appropriates \$30,000 in each of the fiscal years 2008 through 2011 to DOR for administration of health insurance premium tax credits. Each of the above appropriations is exempt from the provisions of A.R.S. § 35-190, relating to lapsing of appropriations.

Additional Legislation

Ladewig Settlement Payments

The Case Settlements Budget Reconciliation Bill (Laws 2006, Chapter 347) allocates \$94,800,000 in FY 2007 to the department for payments and costs associated with the case of Ladewig v. State of Arizona. The \$94,800,000 includes up to \$1,000,000 to be used for department administrative costs and review of payments. The department is required to present an expenditure plan for review by the Joint Legislative Budget Committee that includes an estimate and scope of the entire administrative requirement associated with disbursing payments and costs for this case, before expending any of the \$1,000,000. Chapter 347 reverts any unused amounts of the total \$94,800,000 in FY 2007 for Ladewig payments and costs, including up to \$1,000,000 for administration costs, to the General Fund. Chapter 347 also reverts to the General Fund any unused amounts of the total \$58,300,000 allocated in FY 2006 for Ladewig payments and costs, including up to \$1,800,000 for administration costs.

Based on the 2001 Arizona Supreme Court decision in the Ladewig v. State of Arizona case, the state is required to refund individual income taxes paid on non-Arizona dividends earned for the years 1986 through 1989. Payments and related costs associated with this case were capped not to exceed \$350,000,000 over 5 years.

The Department of Revenue estimates the total cost of the Ladewig Settlement at \$302,500,000, as shown in the following table. The numbers are not yet final.

Summary of Ladewig FY 2003 - FY 2005 Expenditures and FY 2006 & FY 2007 Estimates			
(\$ in millions)			
	Expenditures ^{1/}	Estimates	
	FY 2003 - FY 2005	FY 2006	FY 2007
DOR Admin	\$ 14.5	\$ 1.8 ^{2/}	\$ 1.0
Attorneys	10.2 ^{3/}	4.9	5.0
Taxpayers	124.7 ^{4/}	51.6	88.8
Total	\$149.4	\$58.3 ^{5/}	\$94.8 ^{5/}

1/ In addition, DOR reports operating budget expenditures of \$134,900 in FY 2002 for Ladewig administration.
2/ JLBC favorably reviewed \$1,424,700 to fully fund DOR's estimated administrative costs in FY 2006 at the June 28, 2005 JLBC meeting. \$334,200 was unallocated in DOR's plan.
3/ \$2,000,000 was reimbursed in FY 2004 to DOR by Department of Administration Risk Management.
4/ Refunds to taxpayers began in FY 2005.
5/ Any unused amounts revert to the General Fund.

DOR estimates that the FY 2005 refunds included overpayments of \$6,300,000 to 3,200 of the 306,000 claimants due to clerical and computer matching errors. The court ruled that DOR could not directly collect the first installment overpayments from overpaid taxpayers, but that DOR could offset the amount of the overpayment against any second and/or third installments.

Chapter 347 transfers any unclaimed Ladewig refunds for FY 2007 to the General Fund. Laws 2005, Chapter 333, transferred any unclaimed Ladewig refunds for FY 2005 and FY 2006 to the General Fund. Unclaimed taxpayer payments totaling \$21,300,000 in FY 2005 were transferred to the General Fund.

Kerr Settlement Payments

The Case Settlements Budget Reconciliation Bill (Laws 2006, Chapter 347) allocates \$15,000,000 in FY 2007 to the department for payments associated with the case of Kerr v. State of Arizona. The department is required to present an expenditure plan for review by the Joint Legislative Budget Committee that includes an estimate and scope of the entire administrative requirement associated with disbursing payments and costs for this case, before expending any of the \$15,000,000. Any unused amounts of the \$15,000,000 revert to the General Fund. Chapter 347 also transfers any unclaimed Kerr refunds for FY 2007 to the General Fund.

The Supplemental Appropriations Budget Reconciliation Bill (Laws 2006, Chapter 316) appropriates \$975,000 from the General Fund in FY 2006 to the Department of Revenue for supplemental funding for administration of the Kerr v. State of Arizona lawsuit. The \$975,000 is a continuing appropriation and is exempt from the provisions of A.R.S. § 35-190, relating to lapsing of

appropriations, through June 30, 2007. (Please see *Special Line Items* for additional information.)

In the 1989 case of Kerr v. ADOR federal employees challenged the state's taxing their retirement system contributions, while not taxing Arizona's employees' contributions to the State Retirement System. In 1997, after the State Board of Tax Appeals ruled in favor of the taxpayer, Governor Symington ordered DOR to provide refunds to federal employees who had filed timely claims for refund for the years 1985-1990 (within the 4-year statute of limitations). As a result, DOR paid \$13,700,000 in 1997 – 1998, including \$10,700,000 to qualified taxpayers and \$3,000,000 to plaintiff's lawyers.

Subsequent court rulings extended the deadline for filing timely refund claims for tax cases like Kerr, which allowed additional federal employees to file for relief. The \$15,000,000 in payments is to settle the resulting extension of the Kerr lawsuit. The court has scheduled a final settlement approval hearing for August 4, 2006.

Business Reengineering/Integrated Tax System (BRITS) Contract Extensions or Modifications

The Budget Procedures Budget Reconciliation Bill (Laws 2006, Chapter 346) requires legislative authorization prior to executing any future BRITS contract extensions or modifications that increase the contractor's share of gain-sharing proceeds from state revenues. The State Government Budget Reconciliation Bill (Laws 2006, Chapter 350) authorizes DOR in FY 2007 to execute extensions or modifications of the current BRITS contract provided that DOR submits for review by the Joint Legislative Budget Committee any contract extensions or modifications that change the dollar value of the contract.

The enactment followed DOR signing a \$6,600,000 contract extension in February 2006 for the current contractor to operate and maintain the BRITS data center (servers and network hardware) for 4 years from October 1, 2003 through September 30, 2007. By this action, DOR belatedly addressed the cost of a 4-year data center agreement with the contractor which was executed in December 2003. Operating the BRITS data center had been an additional cost option in the original contract, which DOR chose on its own to implement. The contract extension allowed DOR to use additional General Fund resources on this project without a legislative appropriation.

BRITS is the computer system being implemented by DOR to integrate their separate tax systems, improve enforcement, and ultimately increase revenues to the state. The system was implemented in FY 2003. The original contract called for BRITS to be completed in FY 2007. However, DOR had problems with the transaction privilege tax conversion to BRITS in January 2004, which delayed the BRITS conversions of corporate income tax from September 2004 to July 2006, and of individual income tax from September 2006 to an undetermined date.

The cost of BRITS is being financed by the contractor who, in turn, is paid from the increased revenues generated by BRITS. Payments are made to the contractor based on 85% of tax enforcement revenues above an established baseline amount. These payments are not dependent on the enforcement revenue being directly related to the BRITS project. Enforcement revenue represents collections received through the tax audit and collection processes.

The overall cost of the original BRITS contract was approximately \$133,700,000, including \$122,700,000 for the base contract and \$11,000,000 for estimated interest. DOR currently estimates a total cost of \$136,700,000, including \$122,700,000 for the base contract, \$7,000,000 for estimated interest, \$6,600,000 for the BRITS data center contract extension, and \$422,300 for a contract modification for corporate income tax. The decrease from \$11,000,000 to \$7,000,000 for estimated interest is due to the contractor having to finance less BRITS costs, since BRITS revenues now exceed projections.

An Auditor General performance audit issued in October 2005 found that BRITS had not generated as much revenue as anticipated, and that interest costs for the BRITS project may be higher than estimated. This changed, however, when DOR paid the contractor a total of \$41,000,000 in October and November 2005. The payments represented collections from May 2005 through September 2005. BRITS payments to the contractor totaled \$99,400,000 through April 2006, representing 74% of the estimated original \$133,700,000 cost of the project. The \$99,400,000 paid to the contractor was \$26,200,000 above the projected payment at that point in the contract. The state/county/city had received \$17,500,000, \$4,600,000 more than projected.

BRITS' role in generating the excess May 2005 through September 2005 revenues is unclear. DOR implemented a Voluntary Compliance Initiative (VCI) in February 2005 to provide taxpayers that had previously participated in "abusive tax shelters" the opportunity to voluntarily come forward and pay taxes owed plus interest. Abusive tax shelters involve the use of inflated deductions and artificial losses in order to reduce tax liability. Increased tax enforcement revenues during April and May 2005 included payments made under the VCI, and contributed to the higher level of collections.

The Auditor General concluded that DOR needs to better manage the BRITS project. For instance, DOR did not hire an outside oversight advisor to provide expertise in monitoring the project, although the BRITS contract indicated that they would. Also, DOR did not initially involve enough of its information technology staff with the project, and has had 4 different project managers. The Auditor General recommended that DOR consider hiring an experienced outside advisor, and examine possible funding sources such as allocating monies from its current operating budget or seek a separate appropriation. DOR

reports that they hired a consultant to do an initial assessment by June 30, 2006 and quarterly follow-up audits in FY 2007. DOR is paying the consultant from the operating budget.