Department of Revenue

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DESCRIPTION	FY 2005 ACTUAL	FY 2006 ESTIMATE	FY 2007 JLBC
OPERATING BUDGET			
Full Time Equivalent Positions	1,148.0	1,148.0	1,148.0
Personal Services	32,576,300	33,713,100	33,713,100
Employee Related Expenditures	9,907,400	11,460,000	11,460,000
Professional and Outside Services	1,939,800	1,876,300	1,876,300
Travel - In State	246,300	320,500	320,500
Travel - Out of State	110,500	220,400	220,400
Other Operating Expenditures	10,225,900	10,065,400	10,065,400
Equipment	1,297,500	801,000	801,000
OPERATING SUBTOTAL	**56,303,700**	**58,456,700**	**58,456,700**
SPECIAL LINE ITEMS			
Revenue Generating Program	6,788,900	6,989,400	6,989,400
Unclaimed Property Administration	1,459,200	1,526,000	1,609,000
Unclaimed Property Contract Auditors	0	0	1,770,000
AGENCY TOTAL	**64,551,800**	**66,972,100**	**68,825,100**

FUND SOURCES			
General Fund	62,286,100	64,582,800	64,582,800
Other Appropriated Funds			
Estate and Unclaimed Property Fund	1,459,200	1,526,000	3,379,000
Liability Setoff Fund	361,000	393,500	393,500
Tobacco Tax and Health Care Fund	445,500	469,800	469,800
SUBTOTAL - Other Appropriated Funds	2,265,700	2,389,300	4,242,300
SUBTOTAL - Appropriated Funds	**64,551,800**	**66,972,100**	**68,825,100**
Other Non-Appropriated Funds	858,700	784,700	784,700
TOTAL - ALL SOURCES	65,410,500	67,756,800	69,609,800

CHANGE IN FUNDING SUMMARY

	FY 2006 to FY 2007 JLBC	
	$ Change	% Change
General Fund	0	0.0%
Other Appropriated Funds	1,853,000	77.6%
Total Appropriated Funds	1,853,000	2.8%
Non Appropriated Funds	0	0.0%
Total - All Sources	1,853,000	2.7%

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 Actual	FY 2004 Actual	FY 2005 Actual	FY 2007 JLBC
• Average calendar days to refund income tax	13.5	8.3	6.3	12

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.

• % of written taxpayer inquiries answered within 30 calendar days of receipt	55	58	84	90

Comments: The percent of written taxpayer inquiries answered within 30 calendar days of receipt increased 26 percentage points in FY 2005, since the department raised the priority of answering correspondence in FY 2005.

• % of delinquent accounts collected	10.8	10.0	10.0	11.0

Comments: Delinquent accounts collected has remained relatively constant in recent years, but should improve with the Business Re-Engineering/Integrated Tax System (BRITS).

• Customer satisfaction rating for taxpayer information section (Scale 1-5).	4.6	4.6	4.4	4.6

RECOMMENDED CHANGES FROM FY 2006

Operating Budget

The JLBC recommends $58,456,700 for the operating budget in FY 2007. This amount consists of:

	FY 2007
General Fund	$57,593,400
Liability Setoff Fund	393,500
Tobacco Tax and Health Care Fund	469,800

These amounts are unchanged from FY 2006.

Special Line Items

Revenue Generating Program
The JLBC recommends $6,989,400 and 103 FTE Positions from the General Fund for the Revenue Generating Program in FY 2007. This amount is unchanged from FY 2006.

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 has 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 has reported on their overall Enforcement and Collections Program, they have not reported on the Revenue Generating Program per se.

The JLBC recommends revising the footnote to require continuation of the quarterly report on the effectiveness of DOR's overall Enforcement and Collections Program, but elimination of the requirement that DOR report on the effectiveness of the Revenue Generating Program, which was not being done. The revised footnote would also require 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. *(Please see Standard Footnotes for more details.)*

Unclaimed Property Administration
The JLBC recommends $1,609,000 from the Estate and Unclaimed Property Fund in FY 2007 for Unclaimed Property Administration. This amount includes the following adjustments:

Document Imaging System OF 83,000
The JLBC recommends 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 would 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.

The JLBC recommends moving unclaimed property administration (i.e., non-contract auditor costs) to a new special line item to clearly show the 2 unclaimed property amounts. Prior year amounts have been adjusted for comparability.

Unclaimed Property Contract Auditors
The JLBC recommends $1,770,000 from the Estate and Unclaimed Property Fund in FY 2007 for unclaimed property contract auditors. This amount includes the following adjustments:

Unclaimed Property
Contract Auditors OF 1,770,000

The JLBC recommends an increase of $1,770,000 from the Estate and Unclaimed Property Fund in FY 2007 to pay unclaimed property contract auditor fees. This would allow DOR to comply with A.R.S. § 44-313, which requires that DOR's administrative expenses for unclaimed property be appropriated. Currently, DOR pays unclaimed property contract auditor fees on a non-appropriated basis. Contract audits generated a total $14.2 million, including $1.77 million 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. The JLBC recommends a new footnote which specifies that 12.5% of the dollar value of the properties recovered by unclaimed property contract auditors is the amount appropriated. *(Please see New Footnotes for more details.)*

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JLBC RECOMMENDED FORMAT — Operating Lump Sum with Special Line Items by Agency

JLBC RECOMMENDED FOOTNOTES

Standard Footnotes

The Department of Revenue shall pay no more than $368,100 from all funds in FY 2007 for their risk management payment to the Department of Administration.

THE DEPARTMENT SHALL PROVIDE THEIR GENERAL FUND REVENUE ENFORCEMENT GOALS FOR FY 2007 TO THE JOINT LEGISLATIVE BUDGET COMMITTEE FOR REVIEW BY JULY 31, 2006. ~~Included in the total appropriation of $66,972,100 for FY 2006 is $6,989,400 from the state General Fund and 103 FTE Positions for the Revenue Generating Program. This program is expected to generate $53,249,000 for the state General Fund in FY 2007.~~ The department shall provide quarterly progress reports to the Joint Legislative Budget Committee as to the effectiveness of the ~~Revenue Generating Program and 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 2006~~ FY 2007. The reports are due within 30 days after the end of each calendar quarter. *(DOR does not separately track enforcement revenue for the Revenue Generating Program.)*

New Footnotes

An amount equal to 12.5% of the dollar value of the properties recovered by unclaimed property contract auditors is appropriated to pay unclaimed property contract auditor fees. This amount is currently estimated at $1,770,000 in FY 2007. *(This would allow DOR to comply with A.R.S. § 44-313, which requires that DOR's administrative expenses be appropriated.)*

JLBC RECOMMENDED STATUTORY CHANGES

The JLBC recommends, as session law, allocate $99.2 million from the General Fund for the Ladewig v. State of Arizona settlement and allow $2.6 million to be used for administrative costs in FY 2007 subsequent to Joint Legislative Budget Committee review. The department shall revert any unclaimed Ladewig refunds for FY 2007 to the General Fund. The $99.2 million should decrease when DOR revises their estimate of FY 2007 taxpayer payments, in light of the court's November 18, 2005 ruling on the FY 2005 taxpayer overpayments. *(Please see Other Issues for Legislative Consideration for details.)*

The JLBC recommends a statutory change that would require legislative authorization prior to executing any future Business Reengineering/Integrated Tax System (BRITS) contract extension or modification that would increase the dollar value of the contract. *(Please see Other Issues for Legislative Consideration for further details.)*

OTHER ISSUES FOR LEGISLATIVE CONSIDERATION

Ladewig Settlement

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 million over 5 years.

The Department of Revenue estimates the total cost of the Ladewig Settlement at $306.9 million, 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/	$ 2.6
Attorneys	10.2 3/	4.9	4.9
Taxpayers	124.7 4/	51.6	91.7
Total	**$149.4**	**$58.3** 5/	**$99.2** 6/

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 million 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 of the $58.3 million are set aside for future Ladewig payments.
6/ The FY 2007 allocation by the Legislature will be made prior to this fiscal year once final numbers are determined.

DOR estimates that the FY 2005 refunds included overpayments of $6.3 million to 3,200 of the 306,000 claimants due to clerical and computer matching errors. The court allowed the state to hold off mailing FY 2006 refunds to the 3,200 overpaid claimants, until the overpayment issue is resolved. On November 18, 2005, the court ruled that DOR cannot directly collect the first installment overpayments from overpaid taxpayers. However, DOR may offset the amount of the overpayment against any second and/or third installments. The court further ruled that the second installment is due to these taxpayers by March 1, 2006, and that the final installment remains July 21, 2006. DOR is required to notify the affected taxpayers. The Joint Legislative Budget Committee has asked DOR to update their estimate of the total cost of the Ladewig settlement in light of this ruling.

Unclaimed taxpayer payments totaling $21.3 million in FY 2005 were transferred to the General Fund, in accordance with Laws 2005, Chapter 333. Chapter 333 requires that any unclaimed Ladewig taxpayer payments for FY 2005 and FY 2006 be deposited in the General Fund.

The JLBC recommends allocating another $99.2 million from the General Fund in FY 2007 for the Ladewig v. State of Arizona settlement. The $99.2 million includes up to $2.6 million to be used for department administrative costs upon review by the Joint Legislative Budget Committee. The $99.2 million should decrease when DOR revises their estimate of FY 2007 taxpayer payments, in light of the court's November 18, 2005 ruling on the FY 2005 taxpayer overpayments.

Business Reengineering/Integrated Tax System (BRITS) Cost

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 cost of BRITS is being financed by the contractor who, in turn, is paid from the increased revenues generated by BRITS. The overall cost of the original BRITS contract is approximately $133.7 million, including an estimated $11 million interest. The $133.7 million does not include the $6.4 million cost increase that DOR is seeking for the contractor to continue to operate a data center (BRITS servers and network hardware), as discussed below.

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.

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. The contractor had been paid $44.2 million through September 30, 2005 for increased collections, which was $8.4 million below the projected payment at that point in the contract. The state/county/city had received $7.8 million, $1.5 million less than projected.

The October 2005 BRITS payment of $30.1 million to the contractor was the largest payment made to date. The payment represented collections from May 2005 through September 2005. The October and November BRITS payments to the contractor totaled $41 million, bringing total BRITS payments to $85.1 million, representing 64% of the estimated original $133.7 million cost of the project. The $85.1 million paid to the contractor is $29.6 million above the projected payment at this point in the contract. The state/county/city have received $15 million, $5.2 million more than projected.

BRITS' role in generating the excess May through September revenues is particularly 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.

The Auditor General reported that DOR is seeking to increase the cost of the BRITS contract by $6.4 million for the contractor to continue to operate a data center (BRITS servers and network hardware). By this action, DOR is belatedly addressing the cost of a 4-year data center agreement with the contractor which was executed in December 2003. The contract extension would allow DOR to use additional General Fund resources on this project without a legislative appropriation.

The JLBC recommends a statutory change which would require legislative authorization prior to executing any future BRITS contract extension or modification that would increase the dollar value of the contract. This would increase legislative oversight of cost increases for the BRITS project. *(See JLBC Recommended Statutory Changes.)*

Kerr Lawsuit

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 $13.7 million in 1997 – 1998, including $10.7 million to qualified taxpayers and $3 million 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. DOR is currently in negotiations to settle the resulting extension of the Kerr lawsuit. The court has scheduled a preliminary settlement approval hearing for February 6, 2006.

SUMMARY OF FUNDS	**FY 2005 Actual**	**FY 2006 Estimate**

Client County Equipment Capitalization Fund (RVA2457/A.R.S. § 42-11057) **Non-Appropriated**

Source of Revenue: Monies received over $0.60 per parcel pursuant to an intergovernmental agreement between the department and the county assessor for data processing services. The first $0.60 per parcel is deposited to the General Fund.

Purpose of Fund: To upgrade data processing property tax equipment in the counties, which contract with the department to provide data processing services to their county assessors. Any unencumbered fiscal year-end balance over $300,000 shall be transferred to the General Fund. The department shall file an annual report by October 1 to the Information Technology Authorization Committee accounting for all receipts and disbursements from the fund.

Funds Expended	735,600	649,200
Year-End Fund Balance	147,800	248,800

Escheated Estates Fund (RVA3745/A.R.S. § 12-885) **Non-Appropriated**

Source of Revenue: The fund consists of monies from the sale of escheated estates. Property escheats or reverts to the state, after 5 years when there is no will to transmit the property and there are no legal heirs to inherit it.

Purpose of Fund: To deposit proceeds from the sale of escheated property and hold them in the fund for 12 months, from which payment of claims may be made, before being transferred to the Permanent State School Fund.

Funds Expended	0	0
Year-End Fund Balance	405,200	405,200

Estate and Unclaimed Property Fund (RVA1520/A.R.S. § 44-301) **Partially-Appropriated**

Source of Revenue: The fund consists of monies from the sale of abandoned property, including 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. Notwithstanding the title of this fund, it no longer includes the proceeds of escheated estates. Those funds are deposited to the department's Escheated Estates Fund.

Purpose of Fund: The appropriated portion of the fund covers the department's administrative costs including the handling, publicizing and selling of abandoned property. The department retains not less than $100,000 in the non-appropriated portion of the fund to pay allowed claims, while the state attempts to locate abandoned property owners. Once monies are determined to be "unreturnable" they are disbursed as follows: Monies associated with unclaimed utility deposits are transferred to the Utility Assistance Fund. Monies from unclaimed shares and dividends of Arizona corporations and unclaimed property in a self-storage unit are transferred to the Permanent State School Fund. Unclaimed victim restitution monies are transferred to the Arizona Criminal Justice Commission's Victim Compensation and Assistance Fund. The remaining monies are transferred to the following funds in the following percentages: Housing Trust Fund (55%), State General Fund (25%), and Racing Fund (20%). Racing's 20% share is distributed to 8 different Racing funds which are capped at specific levels of revenue, with any excess being deposited to the General Fund. Racing deposited $5,807,000 in FY 2005 to the General Fund. Transfers totaled $65,333,000 in FY 2005, including $30,715,200 to the General Fund, $23,942,700 to the Housing Trust Fund, $1,664,500 to the Utility Assistance Fund, $8,706,400 to the Racing Fund, $4,600 to the Permanent State School Fund, and $299,600 to the Victim Compensation and Assistance Fund. The $30,715,200 transferred to the General Fund in FY 2005 includes a regular deposit of $9,423,100 and $21,292,100 of unclaimed Ladewig taxpayer payments.

Funds Expended	1,459,200	1,526,000
Non-Appropriated Funds Expended	0	0
Year-End Fund Balance	2,072,500	2,586,500

SUMMARY OF FUNDS	FY 2005 Actual	FY 2006 Estimate

Liability Setoff Fund (RVA2179/A.R.S. § 42-1122) **Appropriated**

Source of Revenue: Fees collected from agencies or taxpayers utilizing the setoff procedure. The Department of Revenue withholds taxpayer refunds to satisfy debts owed by the taxpayers to certain state agencies, such as delinquent child support payments owed to the Department of Economic Security.
Purpose of Fund: To cover the Department of Revenue's costs of administering the Liability Setoff program.

Funds Expended	361,000	393,500
Year-End Fund Balance	943,600	1,155,100

Revenue Publications Revolving Fund (RVA2166/A.R.S. § 42-1004) **Non-Appropriated**

Source of Revenue: Receipts from the sale of department tax-related publications.
Purpose of Fund: To offset costs of publishing and distributing tax-related publications.

Funds Expended	123,100	135,500
Year-End Fund Balance	31,700	40,700

Special Collections Fund (RVA2168/A.R.S. § 42-1004) **Non-Appropriated**

Source of Revenue: This fund consists of all monies received pursuant to contingent fee contracts to collect delinquent state taxes, penalties and interest due under A.R.S. Title 43 (taxation of income) and Title 42, Chapter 8, Article 1 (transaction privilege taxes).
Purpose of Fund: To pay all fees and court costs provided for in contingent fee collection contracts authorized by A. R. S. § 42-104.B.3. The remainder of the collected amounts are distributed to the state or political subdivisions according to the distribution proportions for the tax collected. No revenue was collected from contracted collections in FY 2005.

Funds Expended	0	0
Year-End Fund Balance	0	0

Tobacco Tax and Health Care Fund (RVA1306/A.R.S. § 36-771) **Appropriated**

Source of Revenue: The fund consists of tobacco taxes retained by the department to administer the tobacco tax program.
Purpose of Fund: To monitor and enforce tobacco tax laws.

Funds Expended	445,500	469,800
Year-End Fund Balance	5,400	31,500

Waste Tire Fund (RVA2356/A.R.S. § 44-1305) **Non-Appropriated**

Source of Revenue: Collections from a fee on new tire purchases and penalties for violations.
Purpose of Fund: Up to 3.5% of the monies in the fund are transferred quarterly to the Department of Environmental Quality to monitor and enforce the requirements of A.R.S. Title 44, Chapter 9, Article 8, Waste Tire Disposal. The remainder is distributed quarterly to counties to establish and implement waste tire programs. Monies in the fund are exempt from lapsing under A.R.S. § 35-190. Transfers totaled $8,164,100 in FY 2005, including $285,700 to the Department of Environmental Quality and $7,878,400 to counties.

Funds Expended	0	0
Year-End Fund Balance	7,700	8,500