

Director: Gale Garriott

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	FY 2007 Actual	FY 2008 Estimate	FY 2009 Approved
OPERATING BUDGET			
<i>Full Time Equivalent Positions</i>	1,148.0	1,164.0	1,164.0 ^{1/}
Personal Services	38,514,500	42,098,500	42,098,500
Employee Related Expenditures	14,331,900	15,236,800	15,252,100
Professional and Outside Services	4,755,900	2,645,000	2,645,000
Travel - In State	406,600	411,000	411,000
Travel - Out of State	361,800	400,600	400,600
Other Operating Expenditures	12,115,200	13,674,900	12,033,100
Equipment	821,100	390,000	390,000
OPERATING SUBTOTAL	71,307,000	74,856,800	73,230,300
SPECIAL LINE ITEMS			
BRITS Operational Support	1,200,000	2,223,700	2,223,700
Health Insurance Premium Tax Credit	75,000	30,000	30,000 ^{2/}
Legal Arizona Workers Act	0	70,000	0
Litigation Expenses	113,500	0	0
Small Towns Revenue Sharing	850,000	850,000	0
Unclaimed Property Administration	1,659,400	1,669,200	1,649,300
Unclaimed Property Contract Auditors	1,452,800	1,770,000	1,770,000 ^{3/}
Lump Sum Reduction	0	(2,488,900)	(495,900)
AGENCY TOTAL	76,657,700	78,980,800	78,407,400^{4/5/}
FUND SOURCES			
General Fund	72,638,900	74,498,500	73,918,600
<u>Other Appropriated Funds</u>			
Estate and Unclaimed Property Fund	3,112,200	3,424,000	3,404,000
Liability Setoff Fund	290,200	427,800	422,000
Risk Management Revolving Fund	113,500	0	0
Tobacco Tax and Health Care Fund	502,900	630,500	662,800
SUBTOTAL - Other Appropriated Funds	4,018,800	4,482,300	4,488,800
SUBTOTAL - Appropriated Funds	76,657,700	78,980,800	78,407,400
Other Non-Appropriated Funds	23,039,200	23,008,200	23,008,200
TOTAL - ALL SOURCES	99,696,900	101,989,000	101,415,600

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.

^{1/} Includes 34 FTE Positions funded from Special Line Items in FY 2009.

^{2/} Laws 2006, Chapter 378 appropriated \$30,000 for administering health insurance premium tax credits.

^{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 2009. (General Appropriation Act footnote)

^{4/} General Appropriation Act funds are appropriated as an Operating Lump Sum with Special Line Items by Agency.

^{5/} The department shall provide the department's General Fund revenue enforcement goals for FY 2009 to the Joint Legislative Budget Committee for review by July 31, 2008. The department shall provide an annual progress report to the Joint Legislative Budget Committee as to the effectiveness of the department's overall Enforcement and Collections Program for FY 2009 by July 31, 2009. The reports shall include a comparison of projected and actual General Fund revenue enforcement collections for FY 2009. (General Appropriation Act footnote)

PERFORMANCE MEASURES	FY 2005	FY 2006	FY 2007	FY 2009
	Actual	Actual	Actual	Approved
• Average calendar days to refund income tax Comments: Average calendar days to refund income tax decreased to 5.5 days in FY 2006 due to an increase in electronic filing. DOR estimates 12 days in FY 2008 due to including returns that go to the error resolution section which are not counted now.	6.3	5.5	6.9	12
• % of written taxpayer inquiries answered within 30 calendar days of receipt	84	65	59	65
• Customer satisfaction rating for taxpayer information section (Scale 1-5)	4.4	4.7	4.85	4.7

This agency's FY 2008 and FY 2009 budget was originally appropriated in Laws 2007, Chapter 255. For details on this agency's original FY 2008 and FY 2009 budgets, please see the *FY 2008 Appropriations Report*. The following narrative provides a comprehensive listing of all FY 2009 changes, whether as part of Chapter 255 or this year's budget.

Operating Budget

The budget provides \$73,230,300 and 1,130 FTE Positions for the operating budget in FY 2009. These amounts consist of:

General Fund	\$72,142,400
Liability Setoff Fund	425,100
Tobacco Tax and Health Care Fund	662,800

These amounts fund the following adjustments:

Continue FY 2008 Statewide Adjustments

The budget continues an increase of \$2,558,900 in FY 2009 for FY 2008 statewide adjustments. This amount consists of:

General Fund	2,531,600
Liability Setoff Fund	11,300
Tobacco Tax and Health Care Fund	16,000

(Please see the FY 2008 Statewide Adjustments narrative at the end of this Appropriations Report for details.)

New Statewide Adjustments

The budget provides an increase of \$15,300 from the General Fund in FY 2009 for new statewide adjustments. *(Please see the New Statewide Adjustments section at the end of this Appropriations Report for details.)*

Lease Purchase Adjustment

The budget provides a decrease of \$(1,681,900) in FY 2009 for a lease purchase adjustment. This amount consists of:

General Fund	(1,668,300)
Liability Setoff Fund	(5,800)
Tobacco Tax and Health Care Fund	(7,800)

This funding includes a decrease of \$(930,500) for the Phoenix DOR building. This reduction will provide sufficient funding to make the FY 2009 lease purchase payment of \$1,081,600 from the General Fund and \$22,100 from Other Funds. *(Please see the Unclaimed Property Administration Special Line Item for more information.)*

Tobacco Tax Stamps

The budget provides an increase of \$40,100 from the Tobacco Tax and Health Care Fund in FY 2009 for estimated increases in both the quantity and cost of tobacco tax stamps.

Business Reengineering/Integrated Tax System (BRITS) Operational Support

The budget continues \$2,223,700 and 16 FTE Positions from the General Fund for operational support of BRITS in FY 2009. These amounts are unchanged from FY 2008.

Monies in this line item are used for annual server and printer replacement costs, increased BRITS data storage requirements, and information technology personnel to operate and maintain the BRITS system.

Health Insurance Premium Tax Credit

The budget provides \$30,000 from the General Fund for the Health Insurance Premium Tax Credit in FY 2009 as authorized in Laws 2006, Chapter 378. This amount funds the following adjustments:

Continue One-Time Costs

The budget provides a decrease of \$(45,000) from the General Fund in FY 2009 for one-time costs associated with administering health insurance premium tax credits. Chapter 378 appropriated \$75,000 from the General Fund in FY 2007, and \$30,000 in each of the fiscal years 2008

through 2011, for DOR to administer health insurance premium tax credits.

Monies in this line item are used to administer health insurance premium tax credits. As a result of the appropriation in Chapter 378, this funding does not appear in the FY 2008 General Appropriation Act.

Legal Arizona Workers Act

The budget provides no funding from the General Fund for the Legal Arizona Workers Act (Laws 2007, Chapter 279) in FY 2009. This amount funds the following adjustments:

Eliminate One-Time Funding

The budget provides a decrease of \$(70,000) from the General Fund in FY 2009 to eliminate one-time funding associated with the Legal Arizona Workers Act.

Litigation Expenses

The budget provides no funding from the General Fund for Litigation Expenses in FY 2009. This amount is unchanged from FY 2008.

The FY 2007 Supplemental Bill (Laws 2007, Chapter 256) provided \$1,000,000 from the Risk Management Fund in FY 2007 for supplemental funding for litigation expenses. The appropriation is exempt from lapsing.

Small Towns Revenue Sharing

The budget provides no funding from the General Fund for Small Towns Revenue Sharing in FY 2009. This amount funds the following adjustments:

Eliminate One-Time Funding

The budget provides a decrease of \$(850,000) from the General Fund in FY 2009 to eliminate one-time funding associated with the Small Towns Revenue Sharing program.

The Revenue Budget Reconciliation Bill (Laws 2008, Chapter 290) establishes as permanent law a minimum annual distribution of Urban Revenue Sharing funds to incorporated cities and towns equal to the amount that would be received by a city or town with a population of 1,500 or less. The distribution of Urban Revenue Sharing to other cities and towns shall be reduced by the increased distribution amounts required to meet this minimum distribution to small cities and towns. Towns included in the Small Town Revenue Sharing program are; Jerome, Winkleman, Duncan, Hayden, Patagonis, and Fredonia.

Unclaimed Property Administration

The budget provides \$1,649,300 and 18 FTE Positions from the Estate and Unclaimed Property Fund for Unclaimed

Property Administration in FY 2009. These amounts fund the following adjustments:

Continue FY 2008 Statewide Adjustments

The budget provides an increase of \$40,200 from the Estate and Unclaimed Property Fund in FY 2009 for FY 2008 statewide adjustments.

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. *(Please see the Unclaimed Property narrative in Additional Legislation for more information.)*

New Statewide Adjustments

The budget provides an increase of \$500 from the Estate and Unclaimed Property Fund in FY 2009 for new statewide adjustments.

Lease Purchase Adjustment

The budget provides a decrease of \$(20,400) from the Estate and Unclaimed Property Fund in FY 2009 for a lease purchase adjustment. This reduction will provide sufficient funding to make the FY 2009 lease purchase payment. *(Please see the operating budget section for more information.)*

Unclaimed Property Contract Auditors

The budget provides \$1,770,000 from the Estate and Unclaimed Property Fund to pay unclaimed property contract auditor fees in FY 2009. This amount is unchanged from FY 2008.

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 standard footnote specifies that 12.5% of the dollar value of the properties recovered by unclaimed property contract auditors is the amount appropriated.

Lump Sum Reduction

The budget provides a decrease of \$(495,900) in FY 2009 from the department's budget for a lump sum reduction. This amount consists of:

General Fund	(477,500)
Liability Setoff Fund	(3,100)
Estate and Unclaimed Property Fund	(15,300)

These amounts fund the following adjustments:

Additional Hiring Freeze Reduction

The budget provides an additional decrease of \$(300) in FY 2009 for the hiring freeze originally enacted as part of the FY 2008 budget revisions. This amount consists of:

General Fund	(200)
Estate and Unclaimed Property Fund	(100)

This amount represents the agency’s share of a statewide hiring freeze reduction. *(Please see the Statewide Hiring Freeze Reduction section at the end of this Appropriations Report for details.)*

Reduce Lump Sum Reduction

The budget provides an increase of \$1,993,300 from the General Fund in FY 2009 from the agency’s budget to reduce the size of a lump sum reduction. The agency is responsible for identifying savings sufficient to meet this reduction.

Fund Transfers

The budget provides a transfer of \$2,132,800 to the General Fund in FY 2008 and \$850,000 in FY 2009. These amounts comprise transfers from the funds listed below:

	<u>FY 2008</u>	<u>FY 2009</u>
Estate and Unclaimed Property Fund	\$1,132,800	\$ 0
Liability Setoff Fund	1,000,000	850,000

These transfers are not part of the agency’s appropriation and are not reflected in the table above.

Additional Legislation

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

The General Revenue Budget Reconciliation Bill (Laws 2008, Chapter 290), as session law, continues to require that before executing any BRITS contract extensions or modifications that increase the contractor’s share of gain-sharing proceeds from state revenues during FY 2009, DOR shall submit the proposed changes for Joint Legislative Budget Committee review, retroactive to June 30, 2008. Contract extensions have allowed DOR to use additional General Fund resources on this project without a legislative appropriation. DOR shall also submit for Joint Legislative Budget Committee review the use of revenue proceeds for \$1.6 million in data center charges.

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 September 2006, and of individual income tax from September 2006 to December 2007.

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 \$157,700,000, including \$122,700,000 for the base contract, \$7,000,000 for estimated interest, and \$28,000,000 for the BRITS contract extensions. 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. DOR has postponed the evaluation and development of their document imaging and customer relationship management needs until after the implementation of individual income tax.

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. DOR reported that, through June 2008, BRITS revenues totaled \$411,500,000, which was \$136,200,000 (or 49.3%) above the baseline estimated for this time in the project.

The Joint Legislative Budget Committee had asked that an outside panel be convened to evaluate the amount of enforcement revenue which has been credited to the BRITS project using the baseline methodology. As input to the outside panel, the JLBC Staff subsequently developed a summary of the issue and asked DOR to review the summary. JLBC Staff found that BRITS has had a positive impact on increasing enforcement revenue, but it is difficult to determine how much of an effect it had compared to other factors not related to BRITS. DOR generally agreed with the JLBC Staff findings, but commented that “under any sound calculation method, BRITS will clearly generate enough revenues to pay for the project over the ten-year contract period.”

The outside panel felt that the JLBC Staff analysis was a fair assessment. The panel believed that the methodology had to balance some level of precision with ease of administration, and that the BRITS project would continue to produce benefits to Arizona.

Additional Information

Kerr Settlement Payments

DOR was allocated \$15,000,000 in FY 2007 for payments and costs associated with the case of Kerr v. State of Arizona. The settlement was for an expanded group of

federal employees who had challenged the state's taxing their retirement system contributions, while not taxing Arizona's employees' contributions to the State Retirement System for the years 1985-1990. The settlement requires that DOR complete the taxpayer refunds by August 4, 2007. DOR began paying Kerr taxpayer refunds in October 2006, and had paid \$13,702,600 through June 2008 for taxpayer refunds and plaintiff's lawyers. Any unused amounts of the \$15,000,000 appropriation revert to the General Fund.

Ladewig Settlement Payments

DOR was allocated \$94,800,100 in FY 2007 for payments and costs associated with the case of Ladewig v. State of Arizona. FY 2007 was the final year for paying refunds to taxpayers. Of this amount, \$13,456,068 was unused and reverted to the General Fund.

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 \$289,123,200, as shown in *Table 1*.

Any unclaimed Ladewig refunds are transferred to the General Fund. Unclaimed taxpayer payments totaling \$21,300,000 in FY 2005, \$12,600,000 in FY 2006, and \$4,700,000 in FY 2007 were transferred to the General Fund.

Table 1

Summary of Ladewig FY 2003 - FY 2006 Expenditures and FY 2007 Actual (\$ in millions)

	<u>Expenditures^{1/}</u> <u>FY 2003 - FY 2006</u>	<u>Actual</u> <u>FY 2007</u>	<u>Total</u>
DOR Administration	\$ 15.3	\$.5 ^{2/}	\$ 15.8
Attorney Fees	15.4 ^{3/}	4.8	20.2
Taxpayer Payments	<u>177.2^{4/}</u>	<u>75.9</u>	<u>253.1</u>
Total	\$207.9	\$81.2^{5/}	\$289.1

^{1/} In addition, DOR reports operating budget expenditures of \$134,900 in FY 2002 for Ladewig administration.

^{2/} JLBC favorably reviewed \$974,600 to fully fund DOR's estimated administrative costs in FY 2007 at the June 14, 2006 JLBC meeting. \$25,400 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. Includes unclaimed taxpayer payments totaling \$21,292,100 in FY 2005 and \$12,568,900 in FY 2006, which were transferred to the General Fund.

^{5/} Any unused amounts revert to the General Fund.