

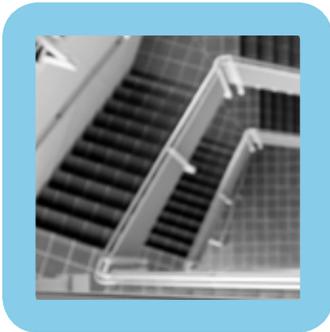


State of California
Franchise Tax Board



Operations Report

Fiscal Year 2005-2006



**OPERATIONS REPORT
FISCAL YEAR ENDING JUNE 30, 2006**

FY 2005-2006 BOARD MEMBERS

Hon. Steve Westly Chair, Controller
John Chiang Member, Board of Equalization
Michael C. Genest. Member, Director of Finance

CURRENT BOARD MEMBERS

John Chiang Chair, Controller
Judy Chu, Ph.D. Member, State Board of Equalization
Michael C. Genest Member, Director of Finance

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Introduction

This report presents fiscal year (FY) 2005-2006 operations of the Franchise Tax Board (FTB). Significant changes took place during the year. We saw the retirement of our executive officer and the appointment of his replacement; we implemented and resolved tax amnesty; we received legislative funding for tax gap endeavors; and we implemented enterprise-wide policies for external outreach.

Gerald Goldberg, the Executive Officer for the past 25 years, retired. Our three-member board appointed his successor, Selvi Stanislaus, on January 11, 2006. She is the department's fourth executive officer and is the first woman to hold this position.

The resolution of tax amnesty was a key priority for our department. The deadline to apply for amnesty was March 31, 2005, but we continued to work cases during FY 2005-2006.

We received funding for specific Tax Gap endeavors, allowing us to enhance our methods of detecting preparers who file fraudulent returns. We were also able to hire additional audit and collection staff.

We addressed enterprise-wide policies and practices affecting how we operate externally, including: educational efforts, customer service, and self-compliance opportunities. As part of the effort to improve customer service and transparency, we assigned a task force to identify, select, develop, translate, and produce appropriate publications and forms for non-English speaking taxpayers. During FY 2005-2006, eight publications were translated into Chinese, Korean, Spanish, and Vietnamese.



Mission Statement

Our mission is to collect the proper amount of tax revenue and operate programs entrusted to us, at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency, and fairness.

Revenue Collection, Efficiency, Integrity, and Fairness

As our primary goal, we administer California's personal income and corporation tax laws. Over the years, responsibility to administer certain nontax programs has been added, such as the Homeowner and Renter Assistance (HRA) Program, Political Reform Act Audit, and certain nontax collection programs such as Vehicle Registration Collections and Court-Ordered Debt Collections.

To administer these programs, we assist taxpayers in many ways. We offer around-the-clock tax help through our toll-free telephone assistance line, and we provide a wealth of information on our website. We also provide public service at our six field offices located throughout the state, during normal business hours. In addition, we provide filing assistance to various groups through our volunteer programs, which include: volunteer income tax assistance (VITA), tax counseling for the elderly (TCE), military tax preparation assistance (VITA-Military), and HRA.



Franchise Tax Board Programs

We administer these programs and their components:

Tax Programs:

- Personal Income Tax
- Corporation Tax
- Non-Admitted Insurance Tax Collection

Nontax Collection Programs:

- Child Support Collections
- Vehicle Registration Collections
- Court Ordered Debt Collections
- Industrial Health and Safety Collections

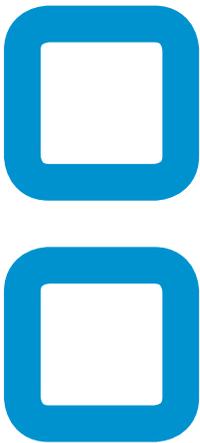
Other Programs:

- Homeowner and Renter Assistance
- Political Reform Audit
- Contract Work
- Child Support Automation Project
- Technology



Expenditures

Our expenditures for FY 2005-2006 totaled \$649.9 million, a 10.2 percent increase over the prior fiscal year.



Expenditures by Program A Two-Year Comparison (\$ in thousands)

Fiscal Year	2005-2006	2004-2005
Personal Income Tax	\$270,432	\$261,424
Corporation Tax	152,866	146,597
Non-Admitted Tax	104	94
Total Tax Programs	423,402	408,115
Nontax Collection Programs	15,448	24,077
Other Nontax Programs	211,054	157,394
Total Nontax Programs	226,502	181,471
Total Expenditures by Program	<u>\$649,904</u>	<u>\$589,586</u>

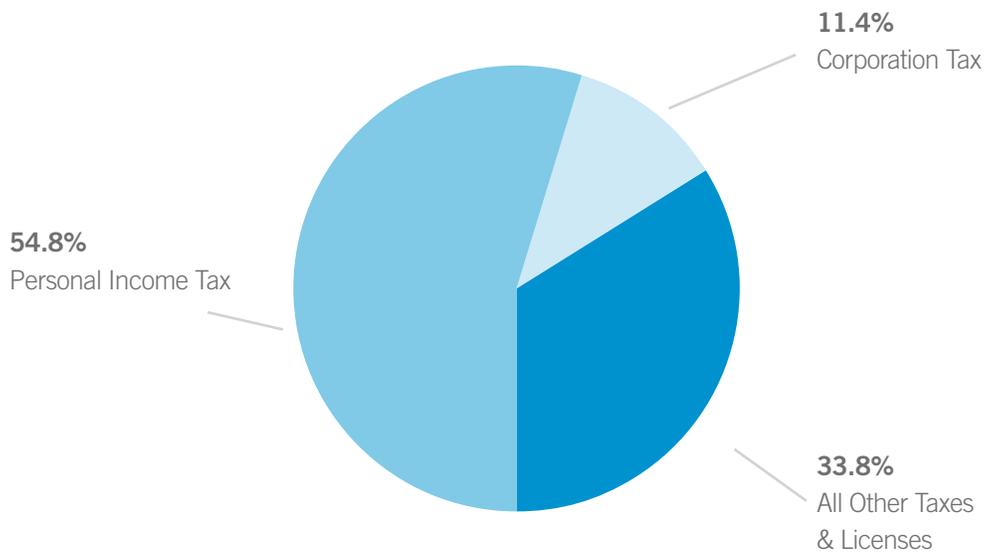


California's General Fund

The General Fund is the state's primary funding source for government services. The General Fund received \$91.2 billion from all major tax and license revenue sources. As illustrated below, personal income tax and corporation tax were principal contributors.

Major Tax and License Revenue

FISCAL YEAR ENDED JUNE 30, 2006



Major Tax and License Revenue 1/ (\$ in millions)

Fiscal Year	2005-2006	2004-2005
Personal Income Tax 2/	\$49,947	\$42,476
Corporation Tax	10,436	12,497
Other Major Taxes & Licenses	30,832	28,622
Total	<u>\$91,215</u>	<u>\$83,595</u>

1/ Source: Statistics extracted from State Controller's Annual Financial Report 2005-2006

2/ Including withholdings by EDD: \$31,378 million for FY 2005-2006 and \$29,045 million for FY 2004-2005

Tax Programs

Our tax programs consist of personal income tax, corporation tax, and non-admitted insurance tax. Related tax program activities include taxpayer assistance, tax return processing (self-assessment activities), filing enforcement, auditing, and tax collections. Tax program activities also include the collection and disbursement of voluntary contributions to charitable organizations designated on the personal income tax returns.

SELF-ASSESSMENT ACTIVITIES

General

Self-assessment activities include the development and delivery of several products and services to aid taxpayers in the tax return filing process. While our core focus is processing tax forms, payments, and refunds, we also design, produce, and distribute tax forms and publications. Furthermore, we provide customer service to taxpayers and practitioners. Our call center provides automated and personal telephone filing assistance, whereas our district offices provide full service assistance for walk-in requests. We also respond to questions regarding notices.

We receive millions of tax returns and phone calls each year, but the preferred method of doing business both internally and externally is through e-transmissions. Over the last decade, we've implemented new online services that allow California taxpayers to transact business instantaneously in a self-service manner. Taxpayers can file returns through tax practitioners, commercial tax software, or directly to us using CalFile and ReadyReturn.

In addition, taxpayers can request direct deposit of their refunds with either paper returns or e-filed returns. Other online services allow taxpayers to make an electronic payment from a checking account or by credit card. Taxpayers may also review their accounts, including refund status.

Taxpayer Assistance

We concentrate our efforts on assisting taxpayers and tax practitioners so that they can file complete and accurate returns and pay taxes due in a timely manner. To accomplish this, we respond to telephone inquiries, written correspondence, Internet correspondence, and field office walk-in requests. During the 2005-2006 FY, we received six million calls through our automated interactive voice response system. Additionally, our line agents and public counter staff responded to a total of 2.2 million calls, paper and electronic correspondence, and field office public counter requests combined. Phone requests comprised the majority of our correspondence received.

In addition to these services, we develop and deliver paper and electronic forms to taxpayers, their representatives, and external stakeholders. For FY 2005-2006, we distributed 7.2 million tax return booklets, forms, and other tax products. Our customers downloaded 9.7 million forms and publications.

Return Processing

Part of processing and validating tax returns involves the cashiering of payments we receive. We cashier paper payments and manage electronic payments. We issue refunds in the case of overpayments, and Return Information Notices in the case of underpayments when additional liability or errors are found on the return.

In FY 2005-2006, we processed over 16 million personal income tax returns with reported tax of \$43.9 billion. Of those returns, approximately 10.2 million resulted in \$8.2 billion in refunds, inclusive of withholdings, prepayments, and refundable credits. Of the 16 million returns, taxpayers and tax practitioners electronically filed 8.8 million returns, together with 3.8 million electronically scanned returns.

While we processed far more personal income tax returns, 1.1 million business entity returns were processed too. This total volume consisted of 703,249 corporation tax returns, 216,731 partnership returns, and 217,155 limited liability company tax returns. The total amount of business entity tax reported was \$10.4 billion.

Business e-file

As stated previously, our preferred method for doing business is electronically. To that end, we implemented the first phase of Business Entities e-file in January 2006, allowing corporations to electronically file Form 100 and other accompanying forms and schedules. By June 30, 2006 we processed 5,020 e-filed corporation returns.

ReadyReturn

We first piloted ReadyReturn during FY 2004-2005. The program offers to ease the filing burden for taxpayers who file the simplest returns. Invitations to participate were mailed to a select group of taxpayers. Essentially, we completed their California returns by using data the state already had on file. If the taxpayer participated, they had the

option to accept the return as is, or to make any changes as necessary, then sign and file the return.

During FY 2005-2006, the second year of the pilot, 50,000 taxpayers received completed returns and over 10,000 opted to participate. Of the participants, 5,000 filed electronically.



Filing Enforcement Activities

Filing enforcement activities identify individuals and corporations that are required to file a return, but have not yet done so. Our filing enforcement activities include the use of over 350 million income records for FY 2005-2006 from various sources to identify and appropriately tax individuals and corporations that do not comply with filing requirements.

Delinquent nonfilers who fail to respond to request-to-file or demand-to-file letters are issued tax assessments based on the income records available to us. Assessments become part of the tax collection inventory if nonfilers fail to file their delinquent return and pay their tax liabilities, or fail to prove their right of exemption under the law before the protest period expires.

During FY 2005-2006, the filing enforcement activities generated cash revenue of over \$492 million from individuals and over \$30 million from corporations.

Withholding Services and Compliance Activities

Withholding services and compliance activities include management of tax payments withheld from: sellers of California real estate, entertainers, independent contractors, nonresident partners, and beneficiaries. Other Activities include the nonresident professional athlete, the non-admitted insurance tax, and bulk sales certificate programs. Approximately \$2.2 billion was deposited in the General Fund in fiscal year 2005-2006 from these activities.

Tax Audit Activities

The Audit Program conducts professional audits of income tax returns filed by corporate, partnership, and personal income taxpayers. In addition, the program administers both a federal/state and special automated audit program.

The primary responsibilities of the program are to:

- Conduct examinations of taxpayer income tax returns.
- Determine the propriety of self-assessed tax liabilities.
- Issue notices of proposed changes to taxpayers.
- Resolve taxpayer disputes.

The Audit Program continues to address several high profile and significant issues.

ABUSIVE TAX SHELTERS

We aggressively pursue investors in, and promoters of, abusive tax transactions and shelters that have been utilized to understate significant amounts of tax liability. These transactions by nature are complex and are typically reported on a tax return in a way to avoid or hinder detection.

TAX GAP

The tax gap is the difference between what taxpayers should pay and what they actually pay. It has grown over the years to an estimated \$6.5 billion in California. The gap puts an additional burden on those paying their fair share and creates an unnecessary strain on the state's General Fund.

The Audit Program is pursuing a number of initiatives aimed at addressing California's increasingly large tax gap, such as:

- Detecting preparers filing fraudulent returns.
- Adding audit staff to manage new workloads.
- Initiating discovery audit activities.

PROTECTIVE CLAIMS

In connection with the Tax Amnesty Program (February 1, 2005 – May 31, 2005), we received protective claim payments from taxpayers who anticipated they might have a tax liability related to ongoing or anticipated audits, protests, appeals, or settlements. Protective claim payments received by March 31, 2005, totaled \$3.6 billion.



**Tax Audit Activities
Assessments 1/
(\$ in thousands)**

Fiscal Year	2005-2006	2004-2005
Personal Income Tax (PIT):		
Tax Audit — PIT	\$238,821	\$274,000
Federal Audit Report — PIT	388,893	159,946
Corporation Tax (CT):		
Tax Audit — CT	1,366,381	1,053,053
Federal Audit Report — CT2/	(24,718)	155,529
Total Audit Workload Summary	<u>\$1,969,377</u>	<u>\$1,642,528</u>

Audit Revenue Impact to General Fund

While it is important to measure our performance by assessments as stated above, we also measure program benefits that directly impact the General Fund. They are derived from assessments and are measured in terms of cash, denied claims, and credits and adjustments.

**Total Revenue Benefits
(\$ in thousands)**

Fiscal Year	2005-2006
Personal Income Tax (PIT)	
Cash - PIT	\$192,559
Denied Claims For Refund - PIT	11,125
Credits - PIT3/	34,661
Corporation Tax	
Cash - Corp	247,363
Denied Claims for Refund - Corp	708,439
Credits - Corp	200,999
Total	<u>\$1,395,146</u>

1/ The assessment amounts include claim denials.

2/ Federal Audit Report – CT negative revenue amount for FY 2005-2006 is due to interest and penalty adjustments related to a single settlement case.

3/ Credits and adjustments are payments on prior years which are brought forward and applied to a current year liability.

Tax Collection Activities

Tax collection activities involve collections of accounts receivable that are established by our self-assessment, audit, settlement, and filing enforcement activities. An automated billing system combined with central and field office collection staff administers collections. The automated system initiates the billing process and accounts for tax revenues collected from voluntary compliance.

The collection staff conducts manual collection efforts to ensure that noncompliant taxpayers contribute their fair share to the General Fund.

In FY 2005-2006, we closed \$2.32 billion accounts receivable. Of that, \$1.76 billion was collected through automated and manual collection activities.

Collection Analysis (\$ in thousands)

Inventory - dollars	Personal Income Tax	Corporation Tax	TOTAL
Beginning Inventory (7/1/05)	\$3,559,384	\$707,829	\$4,267,213
Added During 2005-2006	4,751,716	781,327	5,533,043
Abated During 2005-2006	(1,992,911)	(228,213)	(2,221,124)
Available for Collection	6,318,189	1,260,943	7,579,132
Less:			
Collected	1,248,805	513,240	1,762,045
Discharged	370,565	140,240	510,805
Total Accounts Closed	1,619,370	653,480	2,272,850
Ending Inventory (6/30/06)	<u>\$4,698,819</u>	<u>\$607,463</u>	<u>\$5,306,282</u>

Collection Analysis

Inventory Volumes	Personal Income Tax	Corporation Tax	TOTAL
Total Number of Accounts (7/1/05)	1,034,403	222,634	1,257,037
Total Number of Accounts (6/30/06)	997,987	153,637	1,151,624
Change in Collection Accounts	<u>(36,416)</u>	<u>(68,997)</u>	<u>(105,413)</u>



Nontax Collection Programs

As authorized by governing legislation, we pursue debts owed to certain state and local governments. The nontax collection programs are:

Vehicle Registration Collections - Delinquent motor vehicle registration fees and penalties assessed by the Department of Motor Vehicles.

Court-Ordered Debt Collections - Criminal fines, penalties, forfeitures, restitution orders, and vehicle code violations imposed by superior, municipal, and justice courts.

Industrial Health and Safety Collections - Fees, wages, penalties, and interest imposed by the Department of Industrial Relations.

Costs incurred by us in the above stated collection activities are reimbursed from Vehicle Registration Collections and Court-Ordered Debt Collections.

Nontax Collection Programs (\$ in thousands)

Program	Year Initiated	# Cases Closed	Revenue	Costs
Vehicle Registration Collections	1993	1,044,642	\$134,731	\$5,704
Court-Ordered Debt Collections	1994	1,100,084	\$55,153	\$6,037
Industrial Health and Safety Collections	1994	1,675	\$1,604	\$248

OTHER PROGRAMS

Homeowner and Renter Assistance

The HRA program provides partial reimbursement of property taxes or rent paid by eligible senior citizens, disabled, and blind individuals as provided by the Senior Citizens Property Tax Assistance Law. The principal program activities include: design and distribute claim forms and instructions, provide advisory services to claimants, and process claims.

Political Reform Audit

The Political Act of 1974 requires complete public disclosure of receipts and expenditures by political candidates and lobbyists. As a result, the Act authorizes us to conduct, on behalf of the Fair Political Practices Commission, randomly selected field audits of reports, statements, and issues to ensure accuracy and completeness. We also investigate and report information to the Commission regarding the delinquent nonfiling of such reports and statements.

Contract Work

We provide high quality processing services to other governmental entities, utilizing sophisticated data processing equipment and skilled personnel. We also assist governmental agencies to determine eligibility for various services by providing income verification, tax liability, and filing status. Our contractual service costs are reimbursed by the respective governmental entities.



Child Support Automation Program

State Assembly Bill 150, Chapter 479 of the Statutes of 1999, effective September 27, 1999, states that the Department of Child Support Services (DCSS) is the state agency responsible for operating California's child support enforcement program. AB 150 also mandated the creation of a single statewide child support system, the California Child Support Automation System (CCSAS). FTB, as an agent for DCSS, is responsible to produce, develop, implement, and maintain the operation of CCSAS.

In FY 2005-06, the CCSAS project and the local child support agencies worked together to complete final preparation tasks for Version 1.3, to include statewide allocation of payments. Policy, training, and procedures were put in place to support business operations. Extensive testing of CCSAS and all sub-systems was conducted. The CCSAS project was ready for another major milestone to place CCSAS Version 1.3 into production by July 2006.

**Expenditure Analysis Comparison
Comparison of Costs
(\$ in thousands)**

EXPENDITURES

Fiscal Year	2005-2006	2004-2005
Salaries and Wages	\$270,002	\$270,199
Staff Benefits	95,289	98,142
Total Personal Services	365,291	368,341
Operating Expenses & Equipment	284,613	221,245
Total Expenditures	649,904	589,586
Less Reimbursements	(141,754)	(111,152)
Net Expenditures	<u>\$508,150</u>	<u>\$478,434</u>

For the two years shown, the total expenditures increased \$60.3 million. The major component of the increase of \$53.3 million was spent on the Child Support Automation System. The department also received additional funding to increase compliance with tax laws. This included Tax Amnesty, Tax Gap Enforcement and Abusive Tax Shelters.

Expenditure Analysis
Program/Process Costs
(\$ in thousands)

Tax Programs

Conduct Tax Amnesty	\$6,465
Provide Assistance	44,281
Provide Tax Forms	17,961
Provide Analyses & Recommendations /1	11,268
Process Tax Returns	53,348
Process Payments	21,219
Conduct Tax Auditing	133,338
Conduct Tax Collection	101,011
Conduct Filing Enforcement	16,999
Conduct Investigations /2	10,576
Conduct Withholding Services /3	6,935
Total Tax Program	\$423,401

Other Programs

Homeowner and Renter Assistance	5,786
Political Reform Audit	1,473
Implement Child Support Automation System	199,333
Department of Motor Vehicles Collections	5,704
Court-Ordered Debt Collections	6,037
Contract Work Program	8,170
Total Other Programs	226,503

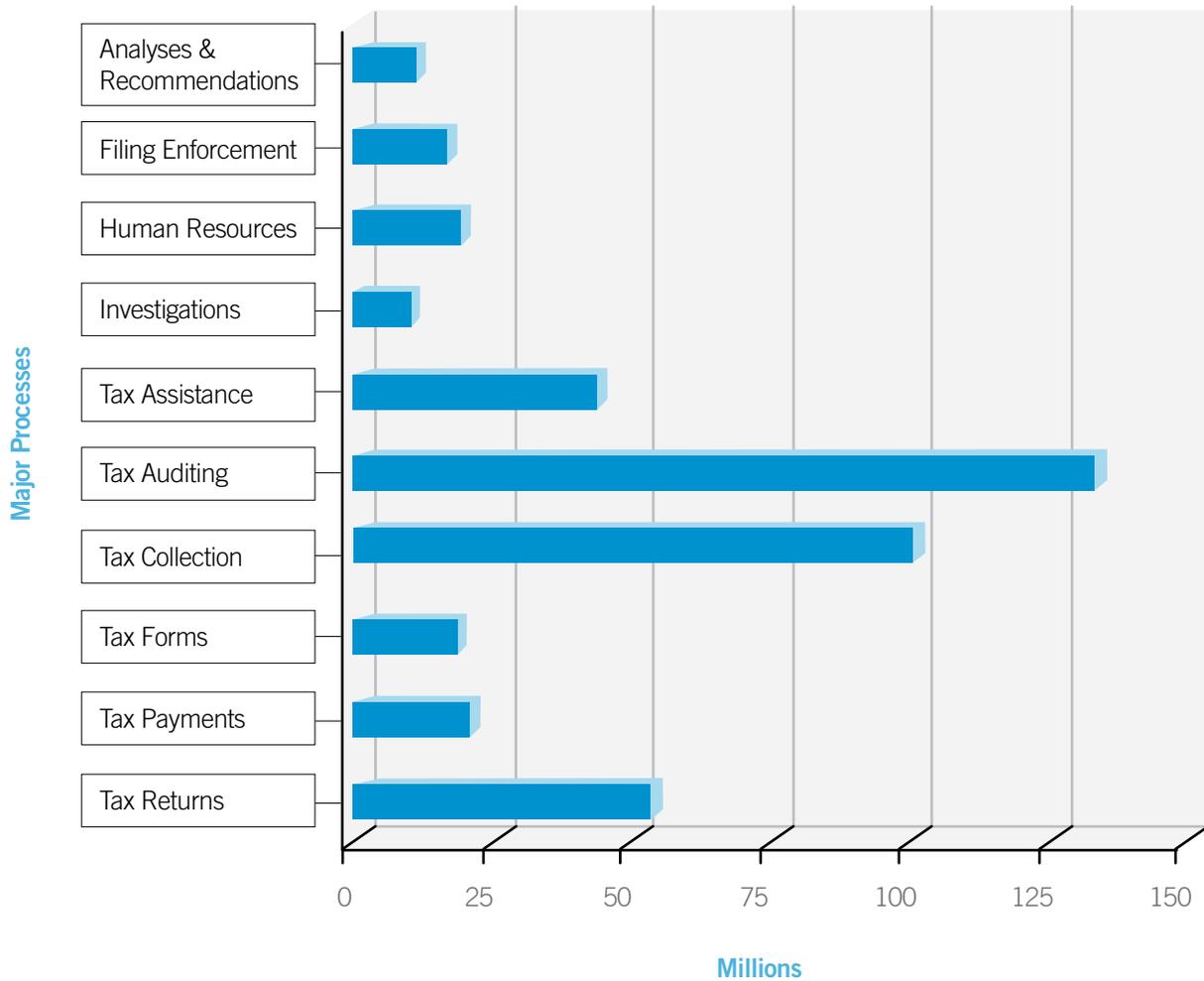
Total Program Costs	\$649,904
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1/ Providing research and legislative services that cover both tax and nontax policy, as well as California economic conditions (includes issuing regulations, rulings and notices).

2/ Investigating cases that appear to involve the willful failure to file a tax return, the filing of fraudulent returns, and other criminal violations of the tax laws.

3/ Educating withholding agents and collecting withholding on payments to taxpayers.

Costs of Ten Major Processes





Technology

Our primary focus of technology is to create better business outcomes. Technology staff is a combination of both information technology (IT) and business experts working together to create applications and websites, manage call centers, and print notices.

For FY 2005-2006, the IT staff supported 1 mainframe, 440 servers, 7000 personal computers, 760 printers, and our call centers. As technology advances, we will shift our focus and seize the opportunity to change the way we do business. In the last decade, new services were implemented to allow California taxpayers to transact business online in a self-service manner, e-file their returns, and request their refunds to be directly deposited into their bank accounts. We received less than one percent of PIT returns electronically in 1994; whereas, in 2006, approximately 60 percent of returns were e-filed and 12 percent of payments were e-payments.

We must continue becoming an electronic tax administration agency. We need to make e-transmissions, e-payments, e-correspondence, and e-communication our preferred methods of doing business.

