

**FRANCHISE TAX BOARD
Fiscal Year 2006/07**

Budget Change Proposal

BCP No. 2

Outside Counsel and Case Expert Contracts

Date: July 25, 2005

A. Nature of Request

The Franchise Tax Board (FTB) requests an augmentation of \$840,000 and 2.8 PY (3 positions) to contract with out-of-state counsel, case experts and consultants, and to perform necessary in-house legal services for out-of-state legal cases. The Attorney General's Office (AGO) has informed the FTB it no longer has the necessary resources to represent the FTB in out-of-state cases nor to contract with case experts and consultants on litigation conducted within California. This augmentation would serve to protect state revenue in out-of-state bankruptcy claims as well as to ensure the strength of the State's representation in litigation within the state.

B. Background/History

Out-of-State Counsel:

The AGO is responsible for representing the FTB in litigation, pursuant to Government Code Section 11042 et.seq., including out-of-state bankruptcy cases. California attorneys are generally only licensed to practice in California and therefore, the AGO has represented the State's interest in out-of-state litigation cases through contracts with outside counsel licensed to practice in other states.

On September 3, 2004, the AGO notified the FTB that they will no longer fund contracts with out-of-state counsel, nor represent FTB in out-of-state cases, and has provided authorization for FTB to contract directly for these services, pursuant to Government Code Section 11040. In order to represent the State's interests, the FTB will now have to contract directly for these services as well as perform necessary in-house legal services that the AGO would otherwise be performing.

Case Experts and Consultants:

As necessary, when representing the FTB in litigation, the AGO has contracted with case experts and consultants to best defend the State's interest. On June 15, 2005, the AGO notified their agency clients that the AGO would no longer fund the cost of these contracts but would require agency clients to assume responsibility for these costs and pay the invoices directly when due.

FTB's Legal Department currently has four cases in which expert witness services are anticipated for an estimated \$120,000 beginning in the current fiscal year. There is also the potential for the need exceeding this amount should the disputes

become more contentious as one case alone involves nearly \$110 million in tax revenue. These four cases total approximately \$120 million in revenue.

The Legal Department is requesting a permanent augmentation of \$100,000 to provide continued funding of expert witness costs offering essential elements in the defense of tax assessments.

C. State Level Consideration

The State of California's recovery from its fiscal crisis relies heavily on an improved economy and an increase in tax revenue. Failure by the State to effectively allocate funds required to defend tax assessments will have an adverse effect on the State's tax revenue stream.

D. Justification

This request is consistent with the FTB Strategic Plan. Specifically, this proposal conforms to Goal 2: Promote a Fair and Effective Tax Administration, Strategy 1: Provide fair and impartial treatment for every taxpayer, and Strategy 2: Identify and implement approaches to resolve tax gap issues, such as abusive tax shelters. This proposal will assist the effectiveness of Strategy 1 by ensuring that out-of-state taxpayers who owe California tax are treated equally and in the same manner as in-state taxpayers. Strategy 2 will be addressed by ensuring that taxpayers do not use out-of-state bankruptcies to avoid paying California tax.

Out-of-State Counsel:

Out-of-state corporate bankruptcy cases have been rapidly rising as corporations are allowed to file for bankruptcy in any state where business is conducted or where the business incorporated. Delaware and New York are showing a trend of becoming the more popular states in which businesses file for bankruptcies.

As the result of the AGO's decision, the FTB will assume responsibility for out-of-state bankruptcy litigations utilizing outside counsel who are licensed to practice in other states. Contracting with outside counsel will enable the state to defend against objections or other adverse court actions filed by taxpayers opposing FTB bankruptcy claims. There is currently a total of approximately \$50 million in bankruptcy claims filed out-of-state, of which approximately \$27 million are in active litigation. We are currently working on minimal contractual agreements with outside counsel, however, as there are millions of dollars in revenue at stake, a minimal defense will not protect the state in these actions.

In addition, current staffing levels cannot maintain the required in-house legal services that were previously performed by AGO staff. Bankruptcies and litigation are specialties within the law and require special skills that are not common in current staffing. To assume these legal services, the Legal Department is requesting 1.9 PYs (2.0 positions) at the Tax Counsel III level and 0.9 PY (1.0 position) for paralegal work. See Attachment 1 for a schedule of work to be performed.

The AGO has not provided the FTB with a complete itemization of its costs for the previous out-of-state legal services it has performed on behalf of the FTB. The request for funding in this proposal is two fold. It is partially based upon the projected number of future out-of-state bankruptcy cases requiring outside counsel services as well as the hiring of additional qualified staff to manage, in-house, the additional workload for the out-of-state legal cases.

Due to the large revenue at stake, the FTB must be in a position to best represent the State's interest with regard to out-of-state bankruptcies which primarily involve corporations with access to highly skilled counsel at large firms.

Without funding to replace the AGO services to defend the State in bankruptcies filed out-of-state, we stand to risk a minimum average loss of \$12.5 million annually (based on prior years averages). Therefore, the FTB is requesting \$400,000 to secure outside counsel to represent the State as well as 2.8 PY (3 positions) to perform necessary in-house legal services.

Case Experts and Consultants:

On June 15, 2005, the AGO notified the FTB that financial responsibility for case experts and other case costs would become that of the separate agency clients that the AGO represents in litigation. Proceeding with litigation without having the expertise to strategically refute testimony given on behalf of the plaintiff would diminish the State's ability to effectively defend the State in court.

In a recent year, the AGO expended over \$92,000 for expert witnesses to defend the State in litigation filed against the FTB. In FY 2004/05, expenditures declined primarily due to delays or resolution of litigation cases. However, current casework indicates expert witness annual needs will exceed \$100,000 in the near future as issues and litigation methods have become more complex. Because exact funding need cannot be established from year to year due to the unpredictability of court processes, we are requesting a permanent funding level of \$100,000 for these services.

E. Analysis of All Feasible Alternatives

Alternative # 1 - Approve the augmentation of \$840,000 and 2.8 PYs (3 positions) to fund outside counsel (Exhibit 1) and in-house staffing for out-of-state bankruptcy cases, and in-state expert witnesses no longer supported by the AGO.

This alternative will put the FTB in the best position to effectively pursue out-of-state cases as well as in-state litigation and therefore fully protect the State's economic interests.

Alternative # 2 - Approve augmentation of \$500,000 for contracted legal services for out-of-state bankruptcy cases and in-state expert witnesses no longer supported by the AGO.

Under this alternative, there is no requirement to fund new positions. This alternative would have a lower measure of success, as out-of-state counsel would still be retained to pursue state tax revenue, but FTB would not be able to provide effective legal services and oversight. The FTB would have to concede management of out-of-state cases to the contracted outside counsel. The department is unable to absorb additional workload associated with providing assistance on California tax law to the outside counsel and therefore, this alternative could put General Fund revenue at risk.

Alternative # 3 - Provide no additional funding.

The FTB does not possess the necessary resources to handle out-of-state cases, and the Attorney General will no longer do so. The negative impact on General Fund revenue could be very significant. The lack of authorized funding to contract with expert witnesses to solidify the State's position in high-dollar tax litigations will diminish the State's ability to defend itself effectively.

E. Time Table

The proposal would be implemented July 1, 2006.

F. Recommendation

The FTB recommends alternative #1 be adopted. Approval of this alternative, at a cost of \$840,000 will ensure the State's interests are effectively represented and will protect a minimum annual state income tax revenue of \$12.5 million for bankruptcy cases and an undeterminable amount for case experts.

BCP # 2	DATE	07/25/2005	Title of Proposed Change:		
			Outside Counsel and Case Expert Contracts		
PROGRAM	ELEMENT	COMPONENT			
Tax Programs	All Tax Programs				
		Personnel Years			Current Year
		CY	BY	BY + 1	
Total Salaries & Wages a/		.0	3.0	3.0	\$ 0
Salary Savings		.0	-2	-2	\$ 0
Net Total Salaries and Wages		.0	2.8	2.8	\$ 0
Staff Benefits b/					\$ 0
Total Personal Services					\$ 0
Operating Expenses and Equipment					
General Expenses /1					\$ 0
Printing					0
Communications /2					0
Postage					0
Travel-In-State /3					0
Travel Out-of-State					0
Training					0
Facilities Operations /4					0
Utilities					0
Cons & Prof Svs - Interdept'l					0
Cons & Prof Svs - External /5					0
Consolidated Data Center					0
California Health and Human Services Agency Data Center					()
Stephen P. Teale Data Center					()
Data Processing /6					0
Equipment					0
Other Items of Exp (Specify Below)					0
Total Operating Expense & Equipment					\$ 0

a/ Itemized detail on Page II-3 by classification as in Salaries and Wages Supplement.

b/ Detail provided on following pages.

- /1 General Expense for Branch @ \$225, and for Depart'l \$433 per position. Plus minor equipment @ \$1784 per position. PCs @ \$1350 per position. Dues & M'ships @ \$445 for 2 positions.
 2 Desks @ \$642 each, 2 Bookcases @ \$343 each, 2 File Cabinets @ \$456 each, 2 Desk Chairs @ \$539 each
 4 Visitor Chairs @ \$235 each
- /2 Departmental \$762 per position. \$200 per position for ID display phones, 2 positions.
- /3 In State Travel - frequent day trips to Southern California for Appeals, 2 positions.
- /4 Departmental \$330 per position.
- /5 \$400,000 Outside Legal Counsel. \$100,000 Expert Witnesses. Online Research Svc @ \$600 each for 3 positions
- /6 Data Processing/Software @ \$500 per position, 3 positions.

Current Year

TOTAL OPERATING EXPENSES AND EQUIPMENT

\$ 0

SPECIAL ITEMS OF EXPENSE d/

\$ 0

PROGRAM ADMINISTRATION

\$ 0

Distributed Admin

\$ 0

TOTAL STATE OPERATIONS EXPENDITURES

\$ 0

Source of Funds

Appropriation No.

	Org	-	Ref	-	Fund	
General Fund	<u>1730</u>		<u>001</u>		<u>0001</u>	\$ 0
	_____		_____		_____	0
	_____		_____		_____	0
	_____		_____		_____	0
	_____		_____		_____	0
	_____		_____		_____	0
	_____		_____		_____	0
Reimbursements	<u>1730</u>		<u>501</u>		<u>0995</u>	0
Totals						<u>\$ 0</u>

LOCAL ASSISTANCE

\$(0)

Source of Funds

Appropriation No.

	Org	-	Ref	-	Fund	
General Fund	<u>1730</u>		<u>001</u>		<u>0001</u>	\$ 0
	_____		_____		_____	0
	_____		_____		_____	0
	_____		_____		_____	0
	_____		_____		_____	0
Reimbursements	_____		_____		_____	0
Totals						<u>\$ 0</u>

d/ Special Items of expense must be titled. Please refer to the Uniform Codes Manual for a list of the standardized Special Items of expense objects which may be used.

**DETAIL OF STAFF BENEFITS
AND PERSONAL SERVICES**

Positions		<u>CY</u>	<u>BY</u>	<u>Positions</u>		<u>Salary Range</u>		<u>CY</u>
					<u>BY + 1</u>			
Legal Division								
Tax Counsel IV, Ftb	PERM	0.0	1.0			\$ 7,625	\$ 9,415	\$ 0
Tax Counsel III Spec	PERM	0.0	1.0			\$ 6,902	\$ 8,517	\$ 0
Legal Analyst	PERM	0.0	1.0			\$ 3,589	\$ 4,363	\$ 0
Total Legal Division		<u>.0</u>	<u>3.0</u>		<u>.0</u>			<u>\$ 0</u>
Adjust for Part Year Positions		<u>.0</u>	<u>.0</u>					
Net Positions/ PYs before salary savings		<u>.0</u>	<u>3.0</u>		<u>.0</u>			
Total Salaries and Wages								
	Positions	<u>.0</u>	<u>3.0</u>		<u>.0</u>			<u>\$ 0</u>
	Part Yr Adj	<u>.0</u>	<u>.0</u>		<u>.0</u>			
	P.Y.s	<u>.0</u>	<u>3.0</u>		<u>.0</u>			

**Schedule of Staff Benefits Costs
FOR FISCAL YEAR 2006/07**

Staff Benefits	<u>2005/06</u>
OASDI /1	\$ 0
Dental /2	0
Health /3	0
Retirement /4	0
Vision /5	0
Medicare /6	0
Worker's Comp /7	0
Industrial Disability /8	0
Non Industrial Disability /9	0
Unemployment Insurance /10	0
Total Staff Benefits	<u>\$ 0</u>

- 1/ For permanent and overtime, 6.2% of net salary.
- 2/ For permanent, \$543 per net personnel year.
- 3/ For permanent, \$6,558 per net personnel year.
- 4/ For permanent, 17.022% of net salary.
- 5/ For permanent, \$85 per net personnel year.
- 6/ 1.45% of net salary for permanent.
- 7/ 1.1% of net salary for permanent.
- 8/ 0.1% of net salary for permanent.
- 9/ 0.17% of net salary for permanent.
- 10/ 22.57% of net salary for temporary help.

<u>Budget Year</u>	<u>Budget Yr +1</u>
\$ 243,000	\$ 243,000
-\$ 12,000	-\$ 12,000
\$ 231,000	\$ 231,000
\$ 80,000	\$ 80,000
\$ 311,000	\$ 311,000

\$ 17,000	\$ 8,000
0	0
3,000	3,000
0	0
4,000	4,000
0	0
0	0
1,000	1,000
0	0
0	0
502,000	502,000
0	0
()	()
()	()
2,000	0
0	0
0	0
\$ 529,000	\$ 518,000

<u>Budget Year</u>	<u>Budget Yr +1</u>
<u>\$ 529,000</u>	<u>\$ 518,000</u>
<u>\$ 0</u>	<u>\$ 0</u>
\$ 0	\$ 0
\$ 0	\$ 0
<u>\$ 840,000</u>	<u>\$ 829,000</u>
\$ 840,000	\$ 829,000
0	0
0	0
0	0
0	0
0	0
0	0
0	0
<u>\$ 840,000</u>	<u>\$ 829,000</u>
\$(0)	\$(0)
\$ 0	\$ 0
0	0
0	0
0	0
0	0
0	0
<u>\$ 0</u>	<u>\$ 0</u>

<u>Amount</u>	
<u>BY</u>	<u>BY + 1</u>
\$ 102,000	
\$ 93,000	
\$ 48,000	
<u>\$ 243,000</u>	<u>\$ 0</u>

<u><u>\$ 243,000</u></u>	<u><u>\$ 0</u></u>
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<u>2006/07</u>	<u>2007/08</u>
\$ 15,000	\$ 0
2,000	0
18,000	0
39,000	0
0	0
3,000	0
3,000	0
0	0
0	0
0	0
<u>\$ 80,000</u>	<u>\$ 0</u>

**STATE OF CALIFORNIA
BUDGET CHANGE PROPOSAL - COVER SHEET
FOR FISCAL YEAR 2006/07
DF-46 (REV 03/03)**

**Department of Finance
915 L Street
Sacramento, CA 95814
IMS Mail Code: A-15**

BCP # 2	PRIORITY NO	ORG CODE 1730-001-0001	DEPARTMENT Franchise Tax Board
PROGRAM 10 Tax Programs	ELEMENT 00 All Tax Programs	COMPONENT	

TITLE OF PROPOSED CHANGE:

Outside Counsel and Case Expert Contracts

SUMMARY OF PROPOSED CHANGE:

The Franchise Tax Board (FTB) requests an augmentation of \$840,000 and 2.8 PY (3 Positions) to contract with outside counsel, case experts and consultants, and to perform necessary in-house legal services for out-of-state legal cases. The Attorney General's Office (AGO) has informed the FTB it no longer has the resources to represent the FTB in out-of-state cases nor to contract with case experts and consultants on litigation conducted within California. This augmentation would serve to protect State revenue in out-of-state bankruptcy claims as well as to ensure the strength of the State's representation by FTB in litigation within the state.

REQUIRES LEGISLATION <input type="checkbox"/> YES <input checked="" type="checkbox"/> NO	CODE SECTION(S) TO BE AMENDED/ADDED	BUDGET IMPACT-PROVIDE LIST AND MARK IF APPLICABLE <input checked="" type="checkbox"/> ONE-TIME COST <input checked="" type="checkbox"/> FULL-YEAR COSTS <input type="checkbox"/> FACILITIES/CAPITAL COSTS <input type="checkbox"/> FUTURE SAVINGS <input checked="" type="checkbox"/> REVENUE
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PREPARED BY:	DATE	REVIEWED BY:	DATE
Pending Board Approval			
PROGRAM APPROVAL:			
DEPARTMENT DIRECTOR:	DATE	AGENCY SECRETARY:	DATE

IF PROPOSAL AFFECTS ANOTHER DEPARTMENT, DOES OTHER DEPARTMENT CONCUR WITH PROPOSAL? N/A

YES NO

ATTACH COMMENTS OF AFFECTED DEPARTMENT SIGNED AND DATED BY THE DEPARTMENT DIRECTOR OR DESIGNEE.

FOR INFORMATION TECHNOLOGY REQUESTS, SPECIFY THE DATE SPECIAL PROJECT REPORT (SPR) OR FEASIBILITY STUDY REPORT (FSR) WAS APPROVED BY THE DEPARTMENT OF FINANCE.

DATE PROJECT # FSR OR SPR

**DOF ANALYST USE
(ADDITIONAL REVIEW)**

CAPITAL OUTLAY TIRU FSCU OSAE CALSTARS