

Privileged and Confidential

Executive Summary – Tax Department Transition

### **Department Overview**

Tax is responsible for administering most major tax types for the state, collecting \$1.5B from over 500,000 filers. Tax has undergone enormous transformation from 2011, starting with formation of a policy and outreach division, which has helped us keep to pace with thorny tax issues in the modern economy and to strengthen relationships with our many stakeholders. In 2012, we switched course from a problematic IT project to VTax, a COTS system with a proven vendor, FAST. In one month we will complete implementation of the last major tax, personal income tax, on time and on budget, with self-funding through the Tax modernization fund. We have overhauled all our business processes in parallel, and have a Strategic Improvement team that is institutionalizing change with ROI, with a particular focus on improving our audit, assessment and appeal processes. The challenge for Tax is to continue to leverage modernization and explore taking on more revenue collection functions from other agencies.

### **Key Decision Dates**

#### **Early January**

*Department Budget:* As the initial VTax contract draws to close, the Department needs to start shifting expenses that have been carried as project costs in our modernization fund over to our operational budget (for example, maintenance and support). So after years of no or low growth, we have proposed a 5-10% increase. The Department has been losing an average 3% positions for the past decade, which we have absorbed through efficiencies. All of our staff is focused on revenue collection; absent some major simplification of our tax laws, further cuts in our staff will result in less revenue for the state.

*Miscellaneous Tax Bill:* The annual bill containing all major substantive tax proposals, as well as technical administrative improvements, is generally presented to legislature simultaneous with the Governor's budget.

*Studies:* Tax is involved in many studies, although most driven by other agencies.

*VTax Project Scope Department of Revenue:* In early January, decisions will need to be made about the scope of the fourth and final phase of VTax. DOL has asked us to take on the employer health assessment, which FAST has indicated could be done for no cost. Possibilities for a 5<sup>th</sup> phase should be explored early before our implementation coordinators return to their business units and FAST starts downsizing its onsite project staff (currently over 20 members). Tax would like to move Current Use, and any collection activities from agency MOUs, into VTax. In 2012, Tax had been slated to become the Department of Revenue (an initiative of the prior Administration) – extending VTax would allow us to do just that. FAST has modules for DOL unemployment insurance and benefits and DMV motor vehicle registration and licensing; other possibilities would include DHVA provider taxes in and child support.

#### **Mid Year**

*VTax Vendor Support Level and Hosting:* We recommend that Tax contract with FAST for the highest level of fixed price support in order to maintain our system on the most recent version without costly

upgrades. We also recommend that we contract to have the system hosted by FAST in the cloud rather than on DII servers, since they can offer 24/7 service and modern security.

### **Major and Evolving Issues**

Aside from the budget and department of revenue considerations, Tax is tackling a number of operational and policy issues.

On the operational side, we recommend a study to look at restructuring our administrative appeals process, with the possibility of an independent hearing officer and *de novo* review of facts. We suggest continued de-escalation of the internal appeal process, especially through our planned mediation pilots. Tax will be dealing with refund fraud through a new service provided by FAST and in conjunction with IRS Security Summit initiatives. Tax needs to keep monitoring tax preparation software products for return errors, after issues with Intuit's Turbo Tax and other products ultimately led to \$2.5M settlements for lost revenue in the 2015 tax year. Tax needs to continue enhancing its systems security, and we are also addressing building security with a new entrance and visitor protocols.

On the policy side, aside from a number of studies by other agencies that we are supporting, the major tax debate is on dealing with new economy models. Cloud services replacing taxable software products is just one example. There is a battle nationally with remote sellers who don't have the requisite nexus to collect sales tax, centered on possible Supreme Court action or deliberation in Congress over a Main Street fairness bill. Last session the Vermont legislature passed some measures of questionable constitutionality that should be re-examined, but in the meantime, we have been approached by a major remote vendor to enter into an MOU for collection going forward. Short term lodging rentals present similar collection issues for rooms tax; the Department recently entered into an MOU for AirBnB to collect on behalf of their hosts (currently estimated at \$1.3M) and has approached another big player. In the meantime, we have had little success getting individual hosts using other platforms to collect sales tax, and may need to beef up enforcement.

Besides new economy issues, Tax recommends that we go forward with a study of the corporate income tax. Our neighboring states have moved to market based sourcing to allocate services for income tax purposes, which should favor in-state companies. The study should also address volatility that we are seeing with M&A activity, as well as various issues being explored nationally concerning pass through entities. After our success in reforming the estate tax, advocates would like a push to increase the exemption to the federal level. And finally, every year there are various proposals to address our complex Education Finance system; everything from the income component to various issues in the property valuation, exemption and collection process.

### **Interagency and External Groups**

The nature of tax policy is that it cuts across just about every other substantive policy area in government. So we have extensive dealings with other agencies, starting with our annual call for any tax proposals (targeted funding, credits, incentives), since such measures generally should be in the Miscellaneous Tax Bill to avoid offense to Ways & Means. We work regularly with Ag on sales tax exemptions and Current Use, with ACCD on VEGI and other incentives, ANR on Lake Champlain clean up funding, and AOE on Education Finance issues.

Externally, we formed two active advisory boards in 2011 – one focused on practitioners, one focused on business and other taxpayer groups. We deal extensively with municipal organizations, including VLCT, and professional organizations, such as the CPAs, Bar Association, Retailers, Fuel Dealers. Nationally, we work closely with the IRS and the national/regional associations of tax administrators.