

CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

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GAVIN NEWSOM
Governor

AMY TONG
Secretary, Government Operations Agency

NICOLAS MADUROS
Director

December 1, 2023

Honorable Nancy Skinner, Chair
Joint Legislative Budget Committee
1020 N Street, Room 553
Sacramento, CA 95814

Attention: Mr. Hans Hemann

Re: Supplemental Report Requirement Item 0860-001-0001 from the 2002, 2006, 2010 & 2011 Budget Acts Annual Report on Sales and Use Tax Audit and Collection Activities, Statewide Compliance & Outreach Program, and Audit Selection Improvements for Fiscal Year 2022-23

Dear Chairwoman Skinner:

The Supplemental Report requirement from the 2002 Budget Act (Item 0860-001-0001) requires an Annual Report on Sales and Use Tax Audit and Collection Activities. The 2006 Budget Act requires the report to include the outcomes of certain audit selection improvements. The 2010 Budget Act expands the 2002 and 2006 requirements to incorporate reporting the average and marginal benefit-to-cost ratios for the audit and collection activities. In addition, the 2011 Budget Act requires a report on the performance of the Statewide Compliance & Outreach Program. The combined report is to be provided to the Chair of the Fiscal Committee in each house of the Legislature and the Chair of the Joint Legislative Budget Committee by December 1, 2023.

The Annual Report on Sales and Use Tax Audit and Collection Activities, Statewide Compliance & Outreach Program, and Audit Selection Improvements for Fiscal Year 2022-23 is attached. If you have any questions, please contact me at 1-916-309-8300.

Sincerely,

A handwritten signature in black ink, appearing to read "Nicolas Maduros".

Nicolas Maduros
Director

NM:ck

Enc: Annual Report on Sales and Use Tax Audit and Collection Activities, Statewide Compliance & Outreach Program and Audit Selection Improvements for FY 2022-23

cc: Mr. Hans Hemann, Joint Legislative Budget Committee, (Hans.Hemmann@sen.ca.gov)
Legislative Analyst Office (LAO.Secretary@lao.ca.gov)
Ms. Sue Parker, Chief Clerk of the Assembly, (Agency.Reports@asm.ca.gov)
Ms. Erika Contreras, Secretary of the Senate, (Senate.AgencyReports@sen.ca.gov)
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Ms. Teresa Calvert, Department of Finance, (Teresa.Calvert@dof.ca.gov)
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CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

**Report Based on Supplemental Report Requirement
from the 2002, 2006, 2010, & 2011 Budget Acts (Item 0860-001-0001)**

**SALES AND USE TAX AUDIT AND COLLECTION ACTIVITIES,
STATEWIDE COMPLIANCE & OUTREACH PROGRAM,
AND AUDIT SELECTION IMPROVEMENTS FOR FY 2022-23**

December 1, 2023

Sales and Use Tax Audit & Collection Activities, Statewide Compliance & Outreach Program and Audit Selection Improvements

BACKGROUND

The Supplemental Report of the 2002 Budget Act requested an annual report on Sales and Use Tax Audit and Collection Activities. In addition, the Supplemental Reports from the 2006 and 2011 Budget Acts required updates on Audit Selection Improvements and the Statewide Compliance and Outreach Program which are also included in this report.

The 2002 Budget Act requests the following information: (a) description of the methodological approach used to conduct its audit and compliance activities; (b) the number of hours and costs associated with direct audit and compliance activities, as well as supporting (overhead) activities; (c) the revenues associated with its audit and compliance activities; and (d) the data regarding the revenue and cost impacts associated with any increase or decrease in resources devoted to the audit and compliance activities. Items (b), (c), and (d) are to include prior-year actual data, current-year estimated data, and budget-year projected data.

The 2006 Budget Act requests a description of, and the outcomes associated with, the following audit selection enhancements: (a) utilizing new Clementine software; (b) putting U.S. Customs data into the audit selection database; (c) extending the time allowed for audit selection; (d) sharing information with local field offices on claimed deductions; (e) making greater use of data from the Franchise Tax Board's (FTB's) Integrated Nonfiler Compliance (INC) database; and (f) utilizing North American Industry Classification System (NAICS) to identify under-reporters. Several of these audit selection enhancements were incorporated into routine audit selection methods. The 2006 Budget Act also requests we identify other audit selection improvements to assist in closing the Tax Gap.

The 2010 Budget Act expands the above 2002 and 2006 Supplemental Report Language requirements to incorporate reporting on the average and marginal benefit-to-cost ratios of all its audit and compliance activities.

The 2011 Budget Act requires a report on the performance of the Statewide Compliance and Outreach Program. The report shall include, but not be limited to, a schedule of authorized positions, vacant positions, expenditures, and revenues attributable to the program.

This combined report is due to the Chair of the Joint Legislative Budget Committee (JLBC) and Chairs of the Fiscal Committees of the Legislature by December 1st of each year with copies provided to the Department of Finance. This report was designed in consultation with the Legislative Analyst's Office (LAO) and the California Department of Tax and Fee Administration's (CDTFA) Business Tax and Fee Division (BTFD) and Field Operations Division (FOD).

SALES AND USE TAX PROGRAM OVERVIEWS

BTFD and FOD are responsible for planning, organizing, and directing the CDTFA's sales and use tax programs which includes: 1) registration of taxpayers, 2) processing tax returns, 3) auditing accounts and 4) collecting taxes receivable. Total California sales and use tax revenue reached

Sales and Use Tax Audit & Collection Activities, Statewide Compliance & Outreach Program and Audit Selection Improvements

\$79.88 billion in fiscal year 2022-23 with 1,038,753 registered master consolidated and single location accounts filing 2.5 million returns annually. The CDTFA encourages voluntary tax law compliance and offers sales and use tax assistance through its Sacramento Headquarters and 19 field offices located across the state. The staff in the department's New York, Chicago, Houston, and Western States - Sacramento Out-of-State field offices perform audits of taxpayers located outside California who are registered to do business in this state.

Audit Program (Exhibit I)

FOD maintains the Audit Program to ensure businesses report neither more nor less tax than required by law. The audit program also educates taxpayers on the proper application of sales and use tax allowing them to report more accurately in the future. The audit program operates on a three-year cycle and is designed to include the largest taxpayers and other accounts which will maximize the productivity of the audit staff. In fiscal year 2022-23, the sales and use tax audit program disclosed deficiencies (less refunded amounts) over \$797.7 million with a direct benefit-to-cost ratio of 5.9 to 1.

Compliance Program (Exhibit II)

The CDTFA's Compliance Program includes a number of programs which are discussed below. In fiscal year 2022-23, these programs generated nearly \$1.1 billion in revenue with a direct revenue benefit-to-cost ratio of 8.7 to 1.

All functions of the CDTFA are directed toward the collection of all amounts due under the revenue and taxation laws the CDTFA administers. The compliance programs examine sales and use tax returns to investigate discrepancies, create billings, make adjustments to amounts reported, process refunds, or take other actions as warranted by examination. In addition, the CDTFA works closely with state and federal agencies to identify use tax due via the desk-review process.

Statewide Compliance and Outreach Program (SCOP)¹

The revenue from SCOP is reported as a part of both the Audit and Compliance Programs. The goal of this program is to provide outreach, educate business owners on their sales and use tax responsibilities, and increase tax compliance. In fiscal year 2022-23, SCOP performed 66,328 permit checks and registered 76 businesses which were found operating without seller's permits. In addition, 104 sub-locations were added to existing permits, and 319 leads were referred to audit. These permit checks also resulted in 9,834 taxpayer registration updates. SCOP had 161 authorized positions of which 7 were vacant. In fiscal year 2022-23, SCOP generated \$95.3 million in revenue and incurred \$14.1 million in costs.

COLLECTION WORKPLAN METHODOLOGY

Collection risk scores are automatically calculated when a new collection case is created in Centralized Revenue Opportunity System (CROS). A combination of these collection risk scores are used to calculate an overall collection risk score. Collections with higher risk scores are prioritized to receive more attention than those with lower risk scores. CROS offers enhanced

¹ The SCOP revenue is the sum of the SCOP audit revenues under Field Operations (Exhibit I) and the SCOP amended returns under Compliance Program (Exhibit II).

Sales and Use Tax Audit & Collection Activities, Statewide Compliance & Outreach Program and Audit Selection Improvements

collection strategies (including automated collection actions programmed based on collection policies) and improves the assignment and prioritization of collection cases. CROS allows the CDTFA greater flexibility in assigning work and adjusting workloads for greater efficiency. In addition, accounts which have been written off and under 30 years old are resurrected once new assets are located.

AUDIT SELECTION METHODOLOGY

BTFD and FOD perform audit selection annually. The audit selection methodology is designed to maximize the marginal productivity of the audit program by identifying the most productive accounts for audit. The selection process is a cooperative effort between team members in CDTFA's Headquarters and field offices. This selection process continues to evolve as new technologies and information become available.

AUDIT SELECTION IMPROVEMENTS

As audit selection improvements are incorporated into the normal audit selection process, they are no longer included within this report.

Return Analytics Project

CDTFA continues to utilize external agency data to perform return analytics while incorporating machine learning techniques. Requested enhancements have been incorporated into the data and the data is received more frequently throughout the tax year to facilitate timely identification and evaluation of accounts with potential underreporting issues. The project has successfully implemented a letter campaign to encourage the filing of amended returns and identify accounts for field audit review. Business rules have been developed and incorporated into the system to create letter campaign cases. The results of these cases will be used to refine audit selection based on return analytics. The goal of the project is for better analysis and improved identification of potential tax underreporting.

FIELD OPERATIONS DIVISION - AUDIT PROGRAM

Exhibit I

SALES & USE TAXES

AUDIT PROGRAM ^{(b)(1)}

WORKLOAD	2022- 2023				2023- 2024 ^(b)				2024- 2025			
	ACTUAL - Audit Element of Galley				ESTIMATED - Audit Element of Galley ^(b)				ESTIMATED - Prorated Costs Based on Change in Hours			
	HOURS		TOTAL	REVENUE / ACTUAL PYs	HOURS		TOTAL	REVENUE / AUTHORIZED PYs	HOURS		TOTAL	REVENUE / AUTHORIZED PYs
DIRECT	SUPPORT / OVERHEAD	DIRECT			SUPPORT / OVERHEAD	DIRECT			SUPPORT / OVERHEAD			
FIELD OPERATIONS												
ROUTINE AUDITS (SELECTED)	636,941		636,941	\$ 903,430,294	858,700		858,700	\$ 689,487,000	858,700		858,700	\$ 758,023,000
DISCOVERY (Field Billing Order)	10,581		10,581	\$ 60,159,862	10,600		10,600	\$ 45,913,000	10,600		10,600	\$ 50,477,000
REFUNDS (SELECTED)	47,965		47,965	\$ (40,132,160)	48,000		48,000	\$ (69,234,000)	48,000		48,000	\$ (71,340,000)
AUDIT ACTIVITIES ⁽¹⁾	695,487		695,487	\$ 923,457,996	917,300		917,300	\$ 666,166,000	917,300		917,300	\$ 737,160,000
REFUND CLAIMS ⁽²⁾	33,791		33,791	\$ (125,707,610)	33,800		33,800	\$ (216,866,000)	33,800		33,800	\$ (223,460,000)
FIELD SUPPORT		525,252	525,252			588,600	588,600			588,600	588,600	
STATEWIDE AUDIT ACTIVITY	729,278	525,252	1,254,530	\$ 797,750,386	951,100	588,600	1,539,700	\$ 449,300,000	951,100	588,600	1,539,700	\$ 513,700,000
UTAS and HQ AUDIT ACTIVITY ⁹	138	-	138	\$ 7,873								
TOTAL AUDIT ACTIVITY	729,416	525,252	1,254,668	\$ 797,758,259								
PYs				728.10				886.50				886.50
FIELD PERSONNEL SERVICES			\$ 112,556,402			\$ 131,151,000		\$ 131,151,000			\$ 131,151,000	
FIELD OPERATING EXPENSE			\$ 18,118,227			\$ 15,585,000		\$ 15,585,000			\$ 15,585,000	
SUT HQ SUPPORT HOURS		295,441				344,700			344,700			
PYs				156.30				182.35				182.35
HQ PERSONNEL SERVICES			\$ 26,231,847			\$ 28,627,000		\$ 28,627,000			\$ 28,627,000	
HQ OPERATING EXPENSE			\$ 317,602			\$ 3,273,000		\$ 3,273,000			\$ 3,273,000	
TOTAL HOURS	729,416	820,693			951,100	933,300			951,100	933,300		
DIRECT PYs				884.40				1,068.85				1,068.85
DIRECT AUDIT COST			\$ 157,224,078			\$ 178,636,000		\$ 178,636,000			\$ 178,636,000	
INDIRECT SUPPORT UNITS:												
LEGAL			\$ 24,510,530			\$ 23,247,000		\$ 23,247,000			\$ 23,247,000	
TAXPAYER RECORDS			\$ 1,000,915			\$ 1,239,000		\$ 1,239,000			\$ 1,239,000	
TECHNOLOGY SERVICES			\$ 2,774,090			\$ 3,059,000		\$ 3,059,000			\$ 3,059,000	
CROS - Centralized Revenue Opportunity System			\$ -			\$ 992,000		\$ 992,000			\$ 992,000	
CDTFA OVERHEAD			\$ 15,467,369			\$ 22,454,000		\$ 22,454,000			\$ 22,454,000	
INDIRECT COSTS			\$ 43,752,904			\$ 50,991,000		\$ 50,991,000			\$ 50,991,000	
TOTAL AUDIT COST & DIRECT PYs			\$ 200,976,982	884.40		\$ 229,627,000	1,068.85		\$ 229,627,000	1,068.85		
AUDIT COST BENEFIT ⁽³⁾			Total	4.6		Total	2.9		Total	3.2		
			Direct	5.9		Direct	3.7		Direct	4.1		
NET REVENUE				\$ 797,758,259			\$ 449,300,000			\$ 513,700,000		
CANCELLATIONS ⁽⁴⁾				\$ 226,156,310			\$ 171,204,000			\$ 188,222,000		

Footnotes

- Audit Activities include the accounts selected for audit and investigations handled by the audit staff.
- Refund Claims are claims for refund assignments referred to the field audit staff to work. These assignments were not selected for audit.
- The Total Audit Cost Benefit is Audit Activities divided by the Total Audit Cost. The Refund Claims amount and Cancellations are not considered. The Direct Audit Cost Benefit is the Audit Activities divided by the Direct Audit Cost. The Refund Claims amount and Cancellations are not considered.
- Cancellations are an estimate of the reduction to the audit billings which will occur during the appeals process.
- Audit revenue fluctuations from year to year are primarily due to the result of large audits over \$5 million.
 - In 2022-23, there were 14 large audits for \$386.8 million and four large refunds for (\$64.5) million.
 - In 2023-24, based upon the current audits in process, it is estimated there will be 11 large audits for \$102.0 million and six refunds for (\$88.6) million.
 - In 2024-25, the audit revenue is based upon historical averages.
- The methodology used to calculate costs and PYs is updated to provide a more accurate representation of the Audit Program overall.
- Loaned employees' time is recorded accurately within the report when the timesheets are completed correctly.
- The Estimates for the PYs and Costs are projections and represent what is set aside for the Department, should the entire budget be expended, which includes all anticipated positions and filled vacancies. The Department makes such calculated projections so the budgeted amounts can be allocated throughout the fiscal year. Revenue estimates are based on historical averages and take potential hours increase into consideration.
- UTAS was disbanded and incorporated in to Field Operations audit activities above.

This report is subject to discussions with the Legislative Analyst's Office

FIELD OPERATIONS DIVISION and BUSINESS TAX AND FEE DIVISION - COMPLIANCE

Exhibit II

SALES & USE TAXES

COMPLIANCE PROGRAMS ⁽⁵⁾⁽⁶⁾	2022-2023				2023-2024 ⁽⁷⁾				2024-2025			
	ACTUAL - Compliance Element of Galley				ESTIMATED - Compliance Element of Galley				ESTIMATED - Prorated Costs Based on Change in Hours			
	HOURS		TOTAL	REVENUE / ACTUAL PYs	HOURS		TOTAL	REVENUE / AUTHORIZED PYs	HOURS		TOTAL	REVENUE / AUTHORIZED PYs
	DIRECT	SUPPORT / OVERHEAD			DIRECT	SUPPORT / OVERHEAD			DIRECT	SUPPORT / OVERHEAD		
COLLECTIONS												
DIRECT HOURS	649,453		649,453	\$ 837,372,136	866,600		866,600	\$ 1,117,351,000	866,600		866,600	\$ 1,117,351,000
SUPPORT HOURS		424,592	424,592			566,600	566,600			566,600	566,600	
TOTAL ⁽¹⁾	649,453	424,592	1,074,045	\$ 837,372,136	866,600	566,600	1,433,200	\$ 1,117,351,000	866,600	566,600	1,433,200	\$ 1,117,351,000
OTHER COMPLIANCE PROGRAMS												
DIRECT HOURS	351,290		351,290	\$ 284,859,825	431,777		431,777	\$ 333,449,800	431,777		431,777	\$ 333,450,000
SUPPORT HOURS		62,982	62,982			59,839	59,839			59,839	59,839	
TOTAL	351,290	62,982	414,272	284,859,825	431,777	59,839	491,616	\$ 333,449,800	431,777	59,839	491,616	\$ 333,450,000
ALL COMPLIANCE PROGRAMS TOTAL	1,000,743	487,574	1,488,317	\$ 1,122,231,962	1,298,377	626,439	1,924,816	\$ 1,450,800,800	1,298,377	626,439	1,924,816	\$ 1,450,801,000
PYs ⁽²⁾				703.71				908.29				908.29
FIELD PERSONNEL SERVICES		\$ 91,453,405				\$ 114,685,000				\$ 114,685,000		
FIELD OPERATING EXPENSE		\$ 18,771,740				\$ 19,614,000				\$ 19,614,000		
SUT HQ SUPPORT HOURS		60,042				24,000				24,000		
PYs		Includes Field Operation's Support		120.57				39.99				39.99
HQ PERSONNEL SERVICES		\$ 17,301,386				\$ 6,934,000				\$ 6,934,000		
HQ OPERATING EXPENSE		\$ 1,008,888				\$ 1,083,000				\$ 1,083,000		
TOTAL HOURS	1,000,743	547,616		824.27	1,298,377	650,439		948.28	1,298,377	650,439		948.28
DIRECT PYs				824.27				948.28				948.28
DIRECT COST		\$ 128,535,419				\$ 142,316,000				\$ 142,316,000		
INDIRECT SUPPORT UNITS:												
CASHIERS		\$ 83,218				\$ 167,000				\$ 167,000		
CUSTOMER SERVICE CENTER		\$ 1,055,676				\$ 1,419,000				\$ 1,419,000		
DATA ENTRY		\$ 158,510				\$ 204,000				\$ 204,000		
LEGAL		\$ 3,689,928				\$ 4,645,000				\$ 4,645,000		
MAILROOM		\$ 186,249				\$ 267,000				\$ 267,000		
TAXPAYER RECORDS		\$ 28,532				\$ 31,000				\$ 31,000		
TECHNOLOGY SERVICES		\$ 8,781,461				\$ 8,924,000				\$ 8,924,000		
CROS-Centralized Revenue Opportunity System		\$ 1,822,071				\$ 2,671,000				\$ 2,671,000		
SPECIAL PROCEDURES		\$ 1,585				\$ -				\$ -		
CDTFA OVERHEAD		\$ 10,944,302				\$ 16,739,000				\$ 16,739,000		
INDIRECT COSTS		\$ 26,751,532				\$ 35,067,000				\$ 35,067,000		
TOTAL COST & DIRECT PYs		\$ 155,286,951		824.27		\$ 177,383,000		948.28		\$ 177,383,000		948.28
COMPLIANCE COST BENEFIT ⁽³⁾		Total Cost		7.2		Total Cost		8.2		Total Cost		8.2
		Direct Cost		8.7		Direct Cost		10.2		Direct Cost		10.2
NET REVENUE				\$ 1,122,231,962				\$ 1,450,800,800				\$ 1,450,801,000
CANCELLATIONS ⁽⁴⁾				\$ 15,406,266				\$ 10,807,000				\$ 10,807,000

Footnotes

- Total Hours and Revenue for Collections only.
- PY's and Costs represent all Compliance activities.
- Total Cost Benefit is the Total Compliance Revenue divided by the Total Compliance Cost. Cancellations are not considered.
The Direct Compliance Cost Benefit is the Total Compliance Revenue divided by the Direct Compliance Cost. Cancellations are not considered.
- Cancellations are reductions to the net revenue during the fiscal year. These include adjustments, cancellations, redeterminations, scheduled write-offs, and refunds. Applies to Other Compliance Programs only, not Collections.
- To adhere to reporting requirements, Compliance Programs are summarized on the FY 2022-23 Supplemental Report.
- Loaned employees' time is recorded accurately within the report when timesheets are completed correctly.
- The Estimates for PY's and Costs are projections and represent what is set aside for the Department, should the entire budget be expended, which includes all anticipated positions and filled vacancies. The Department makes such calculated projections so the budgeted amounts can be allocated throughout the fiscal year. Revenue estimates take into consideration the potential increase in hours worked. These projections are based upon the entire budgeted amounts being expended.

This report is subject to discussions with the Legislative Analyst's Office