



March 11, 2008

Honorable Denise Moreno Ducheny, Chair  
Joint Legislative Budget Committee  
Attention: Ms. Jody Martin  
Senate Budget and Fiscal Review Committee

Honorable John Laird, Chair  
Assembly Budget Committee

Honorable Tom Torlakson, Chair  
Senate Appropriations Committee

Honorable Mark Leno, Chair  
Assembly Appropriations Committee

### **Report per Government Code Section 13292.5**

Attached is the first annual report prepared pursuant to Government Code (GC) Section 13292.5, which requires the Director of Finance to submit a report on the status of delinquent accounts of seven specified state departments. This report presents information on the number and amount of delinquent debts that were owed as of July 1, 2006, the state's current process for collecting debts, the amounts collected on delinquent accounts in 2006-07, and the age of the remaining outstanding debts as of June 30, 2007. While this is useful information, it should be noted that total collections of accounts receivable are much greater than just that collected against delinquent accounts. For example, the Franchise Tax Board (FTB) collected \$1.9 billion of their total accounts receivable in 2006-07.

GC Section 13292.5 defines a delinquent account as any amount owed to an agency that is unpaid for 180 or more days after the obligation was first due. Based on the definition of delinquent debt in Section 13292.5, a large number of the receivables for the taxing departments are considered delinquent. This can be misleading due to the nature of the tax process.

- Approximately 60 percent of the accounts receivable for the FTB are estimates of tax liability because the taxpayer has not filed a return, but FTB has received information indicating that they have a liability. A significant amount of time is required to locate the taxpayer and determine the true liability. Historically, 30 to 40 percent of FTB's estimated assessments are reduced because the taxpayer filed a late tax return showing that their liability was less than FTB estimated. Until this process is complete, the accounts receivable are overstated. Once the correct liability has been determined, additional time may then be necessary to collect the actual amounts owed.
- Taxpayers may be permitted to pay their tax debts through installment agreements. While the taxpayer is making payments, the remaining debt is included in the accounts receivable.

- Collection may be delayed by legal limitations. For example, if a tax debtor also owes child support, the child support obligation has priority over the tax debt. Bankruptcy, criminal investigations, innocent spouse claims, and offers in compromise are other types of cases that can delay collections.
- The tax agencies may have wage garnishments, levies, and liens in place to collect debts, but the collection is not immediate.
- A portion of the accounts receivable are also under collection agreements with private collection agencies.
- The length of time between when income is earned and tax is due may impact the age of the receivable and/or whether it will be collectible. For example, a business may have made money and tax liability was created for a year but payment was not due until the following April. In the following year, the business may no longer be profitable and/or may no longer be in business.

The Department of Finance (Finance) and the other state departments will continue to explore opportunities to increase collections. An April Finance Letter is currently under review which could increase collections by \$8 million, for example. Finance will also be looking at alternative payment arrangements with private vendors to determine the most cost-effective compensation approach. In addition, Finance will convene a work group to review the state's collection processes and procedures and to explore opportunities to increase collections of amounts due the state. Staff from various state departments, including the seven that were surveyed in this report will be invited to participate. In addition to suggesting ways to improve collections, Finance hopes to work with this group to make recommendations for modifications to the reporting requirements of GC 13292.5 to make the report more meaningful for decision makers.

If you have any questions or need additional information regarding this matter, please call Larry Satter at (916) 445-3434.

MICHAEL C. GENEST

Director

By:



VINCENT P. BROWN

Chief Deputy Director

Attachment

cc: On following page

This report is submitted to meet the provisions of Government Code (GC) Section 13292.5, requiring annual reporting by the Department of Finance to the Legislature on the status of delinquent receivables for seven specified departments and the efforts made to collect these accounts in the previous fiscal year. This reporting requirement sunsets on July 1, 2010. The reporting departments are: Franchise Tax Board (FTB), Board of Equalization (BOE), State Lands Commission, Department of General Services (DGS), Department of Motor Vehicles (DMV), Department of Real Estate, and the Department of Corporations. As required by statute, the amounts shown are valid and collectible. That is, the amount is due and payable, there is no dispute about the amount of the claim, and collection has not been deferred by any other provision of law. This report summarizes the accounts receivable and collection data received from the departments for Fiscal Year 2006-07. Attachments 1 and 2 provide all data required in GC Section 13292.5. Since this is the first year of the reporting requirement, prior year data is not available for comparison.

The state's collection procedures are detailed in the State Administrative Manual. Collection steps may include some or all of the following:

- Sending three letters in 30-day intervals to request payment (a required step)
- Offsetting amounts owed to the debtor
- Taking legal action
- Contracting with collection agencies
- Selling accounts receivable

If all reasonable collection procedures do not result in payment, departments may request discharge from accountability (write-off) from the California Victim Compensation and Government Claims Board. Discharging debt relieves the department of pursuing additional collection efforts, but does not relieve the debtor of their obligation to repay the funds. Millions of dollars are collected annually from accounts that have been written off.

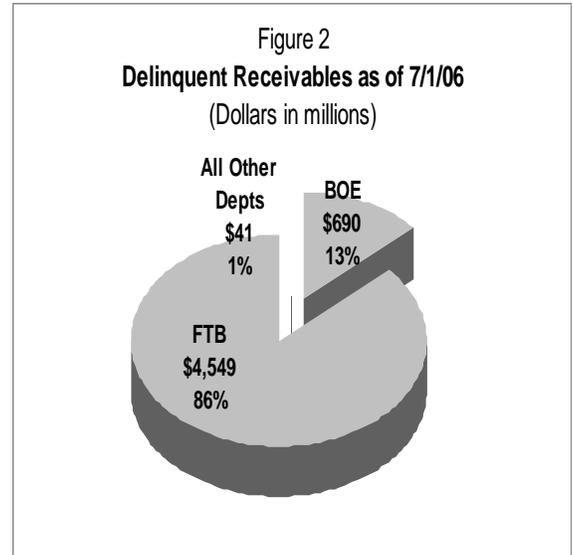
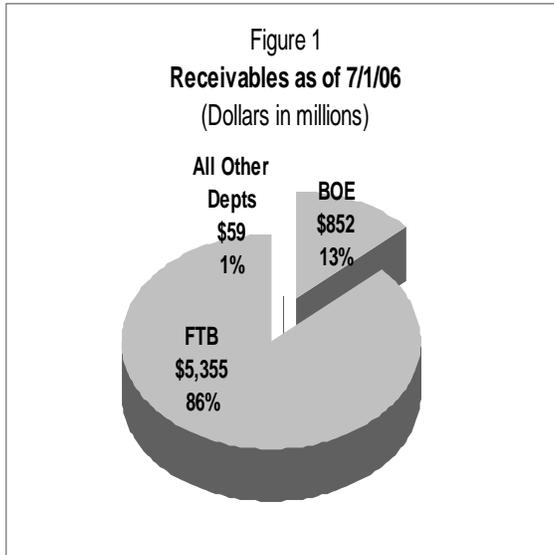
In addition to sending the three letters requesting payment and offsetting tax refunds through FTB, the departments in this study reported using the following collection methods:

- Licensing departments withheld or revoked licenses.
- FTB utilized an extensive computerized tracking system.
- Taxing departments (FTB and BOE) issued liens on property, levied bank accounts and wages.
- DMV used FTB as a collection agency.
- FTB used private collection agencies.

A detailed description of the state's collection procedures is included in Attachment 3.

Receivables and Delinquencies as of July 1, 2006

- The seven departments reported a total of \$6.3 billion in outstanding receivables as of July 1, 2006. Receivables for the taxing departments, FTB and BOE, comprise 99 percent of the total. Figure 1 displays the percentage of total receivables by department. Of the \$6.3 billion, \$5.3 billion were delinquent. These amounts include approximately \$3.1 billion in estimated receivables for filing enforcement assessments. Based on historical trends, a minimum of 30 percent of these estimated receivables will be reduced. Figure 2 displays the percentage of "delinquent" receivables by department.



- GC Section 13292.5 defines a delinquent account as any loan, accounts receivable, fine, assessment, penalty, or other obligation owed to an agency that is unpaid for 180 or more days after the obligation was first due to the state agency.

For FTB, it is not uncommon to have delinquent receivables, as defined by this statute, because of the nature of the receivables. Once a tax assessment is determined, a receivable is established. The debtor then has an opportunity to voluntarily pay, while the receivable remains on the accounting records. If a debtor cannot pay their debt in full, installment agreements may be established. Generally, the average length of an installment agreement is 36 months but not more than 60 months. FTB also turns over some accounts to private collection agencies. In addition, FTB has the ability to garnish wages, levy bank accounts, and issue liens, which may increase the time a receivable remains on the accounting records. Other departments may have similar situations, which require payments over multiple years.

FTB also has a large number of receivables that are not subject to normal collections due to statutory limitations, which also increases the time a receivable remains outstanding. Some examples include: (1) Bankruptcies - If a debtor has filed for bankruptcy, FTB is limited to the collection actions that can be taken. (2) Decedent - FTB must follow probate laws in collecting debts of the decedent. (3) Dual Liability Child Support/Taxes - Debtors may owe both taxes and child

support. Child support obligations must be resolved prior to FTB taking collection action on tax debts. (4) Offer in Compromise - FTB may accept compromises for less than the tax amount owed if the taxpayer does not have the money, assets, or means to pay their tax liability. Approximately 60 percent of FTB's receivables are attributable to taxpayers who have not filed tax returns, but for whom FTB has gotten third-party information that indicates they appear to have a liability. FTB prepares estimates of these taxpayers' liability based on available data sources; however, these estimates are subject to a great deal of uncertainty until FTB can locate the taxpayer and convince them to file a return. A very high proportion of these receivables are eventually reduced or adjusted when the taxpayer actually files a late return. FTB reports that tax returns are often filed more than a year after the filing enforcement activities are brought to bear; therefore the estimated receivable may remain in the accounting records for some time.

As of July 1, 2006, FTB's delinquent receivables totaled \$4.5 billion, representing 86 percent of the total delinquent receivables in this report. The \$4.5 billion includes approximately \$3.1 billion in estimated receivables for enforcement assessments. Based on historical averages, a minimum of 30 percent of these receivables are ultimately reduced because the taxpayer files a return showing they have a lower liability. For purposes of this report, we have applied 30 percent (or \$930 million) to the estimated assessment amount to get a more accurate receivable amount. FTB also discharged \$793 million in receivables in 2006-07 and continues to pursue collection of the remaining \$2.8 billion. Below is a breakdown of FTB's delinquent receivables:

<b>FTB's Delinquent ARs as of July 1, 2006</b>	
(In Millions)	
Installment Agreements	\$268
Collection Agencies	\$543
Liens, Withholding, Levies	\$425
Other <sup>1</sup>	\$2,382
Statutorily Limited:	
Bankruptcies	\$309
Decedent	\$97
Dual Liability Child Support/Taxes	\$481
Offer In Compromise	\$23
Other Statutorily Limited	\$20
Total	\$4,548
Adjustment for estimated receivables	(\$930)
Discharged in 2006-07	(\$793)
Active Collection Inventory	\$2,825

<sup>1</sup> Includes receivables in the first stages of the collection process, and other receivables in various stages of the collection process. Receivables may be satisfied by collections from installment agreements, liens, withholdings, levies, and/or collection agencies. In addition, the collection efforts on the receivable may become statutorily limited.

Collections in 2006-07

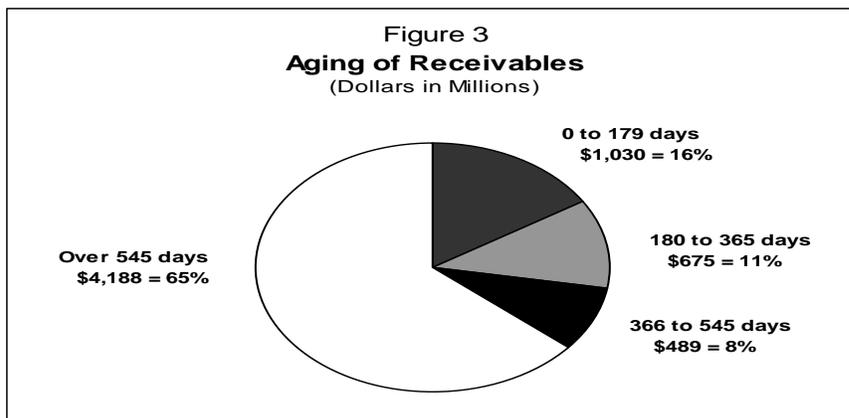
- \$661 million was collected in 2006-07 on delinquent and discharged receivables.
- Private Collection Agencies – An additional \$8 million was recovered by private collection agencies in 2006-07. The collection agency recovery rate is likely reduced as a result of FTB's extensive collection procedures.

Write-offs in 2006-07

- Write-offs or discharged amounts totaled \$865 million in 2006-07 for these seven departments. However, even after the receivables are discharged, departments may still collect revenues on those accounts. For FTB, the discharged accounts remain in FTB's automated collection system. The system will continue to search for new employers or new addresses for the debtor. If the debtor becomes re-employed or re-enters the state, for example, the system alerts FTB, and collection procedures resume. FTB reports that it collects about \$130 million annually on discharged debt.
- Of the \$865 million discharged, \$793 million was for FTB. After collection efforts have been exhausted, debt is discharged when it is no longer cost effective to pursue collection.
- Some of these seven departments reported they were not able to file discharge from accountability due to internal system and resource constraints, which may overstate receivables.
- The discharge of accountability process can be very lengthy and labor intensive, taking several months, which may also temporarily overstate receivables.

Aging of Receivables as of June 30, 2007

- The seven departments reported a total of \$6.4 billion in outstanding receivables as of June 30, 2007. The \$6.4 billion includes approximately \$3.1 billion in estimated receivables for filing enforcement assessments. Based on historical trends, a minimum of 30 percent of these estimated receivables will be reduced. Receivables for the taxing departments, FTB and BOE, comprise 99 percent of the total. Figure 3 displays receivables categorized by the age of the receivable.
- Due to various administrative procedures and the nature of the receivables, the age of the receivables may not be a determining factor when assessing their collectability.



**CONCLUSION**

GC Section 13292.5 did not provide additional resources to prepare the annual reports and only required reporting if sufficient resources were available. Due to these constraints, the data collected was limited to elements identified in the section to ensure data was received from all seven of the state departments. After conducting an analysis on the data received, we determined that estimated receivables were included in the data reported, which inflate receivable totals. We also noted many factors that contribute to the length of time receivables remain outstanding such as establishing installment agreements and statutory limitations that delay or prevent collection efforts. The process to gather data required by this section is further complicated by the state's decentralized accounting systems. From the data gathered, we cannot draw sound conclusions to accurately assess the state's accounts receivables management practices.

An evaluation of the procedures identified in the State Administrative Manual and procedures obtained from state departments determined that accounts receivable practices may not be consistent among departments, partially due to the types of receivables (tax debt vs. non-tax debt).

In the spring of 2008, Finance will be establishing a working group of various state departments, including the seven that were surveyed in this report, in order to further examine the feasibility of improving administrative procedures and collections on delinquent accounts. Finance will also explore changing the data elements collected from the departments for future reporting years.

-A- Department	-B- ARs as of 7/1/06	-C- Delinquent ARs as of 7/1/06	-D- Count of Delinquent ARs as of 7/1/06	-E- Payments Received on Delinquent ARs (Col C)	-F- ARs as of 6/30/07	-G- Count of ARs Discharged	-H- ARs Discharged	-I- Amounts to Collection Agencies	-J- Amts Collected by Collection Agencies
BOE	\$852,172,527	\$689,866,218	102,646	\$81,965,045	\$914,523,410	6,682	\$71,232,920	\$0	\$0
FTB	5,354,583,675	4,549,264,311	752,137	573,000,000	5,403,975,357	143,087	793,000,000	465,000,000	7,873,000
Lands Commission	2,416,651	346,586	205	156,084	2,619,602	0	0	0	0
DGS	2,839,647	2,061,267	852	695,390	5,259,523	8	2,086	0	0
DMV	51,912,408	37,454,307	109,092	4,307,585	52,470,239	11	347,141	0	0
Real Estate	218,814	108,496	266	15,586	1,252,101	0	0	0	0
Corporations	1,962,893	828,219	143	405,723	1,551,075	51	6,058	0	0
<b>Totals</b> <sup>1/</sup>	<b>\$6,266,106,615</b>	<b>\$5,279,929,404</b>	<b>965,341</b>	<b>\$660,545,413</b>	<b>\$6,381,651,307</b>	<b>149,839</b>	<b>\$864,588,205</b>	<b>\$465,000,000</b>	<b>\$7,873,000</b>

## NOTES

- FTB's delinquent receivables total \$4.5 billion, representing 86 percent of the total delinquent receivables. The \$4.5 billion includes \$3.1 billion in estimated receivables for enforcement assessments. Based on historical averages, 30-40 percent of these receivables are ultimately reduced because the taxpayer files a return showing they have a lower liability. For purposes of this report, we have applied 30 percent (or \$930 million) to the estimated assessment amount to get a more accurate receivable amount. FTB also discharged \$793 million in receivables in 2006-07 and continues to pursue collection of the remaining \$2.8 billion.
- After FTB goes through its collection processes and determines that it is not cost beneficial for them to pursue further, the account may be turned over to private collection agencies. Of the \$465 million FTB turned over to private collection agencies, \$8 million was recovered.
- The discharge process can be very lengthy and labor intensive, taking several months, which may temporarily overstate receivables.
- Some departments reported they were not able to discharge receivables due to internal system and/or resource constraints, which may overstate receivables.
- After receivables are discharged, departments may still collect on these accounts. FTB collected \$573 million in 2006-07, which includes \$130 million on discharged receivables.

**Aging of Receivables as of 6/30/07**

	0 to 179 days		180 to 365 days		366 to 545 days		Over 545 days		Totals	
	Count	Amount	Count	Amount	Count	Amount	Count	Amount	Count	Amount
Equalization	N/A	\$143,328,859	43,539	\$56,227,976	26,263	\$57,747,554	127,561	\$657,219,021	197,363	\$914,523,410
FTB	529,139	864,521,628	164,224	611,432,567	143,959	425,693,656	471,285	3,502,327,506	1,308,607	5,403,975,357
Lands Comm	261	2,274,623	27	112,551	15	24,895	163	207,533	466	2,619,602
DGS	997	3,040,509	159	1,021,819	54	103,227	474	1,093,968	1,684	5,259,523
DMV	27,587	15,566,037	20,210	5,659,883	15,841	5,083,999	88,875	26,160,320	152,513	52,470,239
Real Estate	207	1,075,231	56	53,252	80	30,594	237	93,024	580	1,252,101
Corporations	343	747,640	66	109,831	3	497	87	693,107	499	1,551,075
<b>Totals 1/</b>	558,534	\$1,030,554,527	228,281	\$674,617,879	186,215	\$488,684,422	688,682	\$4,187,794,479	1,661,712	\$6,381,651,307

**NOTES**

- As defined in GC 13292.5, delinquent accounts means any loans, accounts receivable, fines, assessments, penalties, or other monetary obligation owed to a state agency that is unpaid for 180 or more days after the obligation was first due to the state agency. However, due to system limitations, some departments age the receivable based on the invoice date.
- Due to the nature of FTB's receivables, it is not uncommon for them to have delinquent ARs. It may take several months for the debtor to pay their liability.
- The discharge process can be very lengthy and labor intensive, taking several months, which may temporarily overstate receivables.
- Some departments reported they were not able to discharge receivables due to internal system and/or resource constraints, which may overstate receivables.

N/A = Not available

1/ Amounts for governmental cost funds only

## Accounts Receivable Management

### Current Collection Procedures for all State Agencies

The State Administrative Manual specifies procedures for the collection of amounts owed the State. These procedures differ depending upon whether the receivable is owed to the State by an employee or non-employee. For non-employees, the collection process is as follows:

- Locate the address of the debtor, if it is not known, through a Government Agency Request for Driver License/Identification Record Information form from the Department of Motor Vehicles.
- Send a sequence of three collections letters at 30-day intervals, with each letter having a stronger tone.
- Prepare an analysis to determine what additional collection efforts should be made, including a cost/benefit analysis of the following collection actions, and initiate one or more of these. Actions taken should be based on which generate the highest net income and which do not compromise future state collections:
  1. Offset procedures—Intercepting amounts owed by other state departments to the debtor. Possible departments are the Franchise Tax Board, Board of Equalization, Employment Development Department, Lottery Commission, and State Controller's Office (SCO).
  2. Court judgments—Filing action in small claims courts for small amounts or consulting department counsel for the possibility of pursuing larger amounts through the courts.
  3. Collection agencies—Contracting with another department that has a collection unit or with an outside collection agency. Prior to assigning the debt to a collection agency, the debtor must be notified in writing at the address of record. Any amounts collected by collection agencies must be remitted to the department. The collection agency is paid in arrears by a set fee per collection, on an hourly basis, or on a percentage basis.
  4. Sale of debt—Selling accounts receivables to private persons or entities. Prior to selling the debt, the debtor must be notified in writing that the debt will be sold to a private entity if the debt is not appealed or paid by a specified date. (No State agency currently uses this option.)

### Discharge of debt

If all reasonable collection procedures do not result in payment, departments may request discharge of the debt. The California Victim Compensation and Government Claims Board may authorize State departments to refrain from collecting aggregate amounts of \$250 or less from a debtor. For amounts over \$250, departments may file an Application For Discharge From Accountability form with the SCO. The application for discharge includes the following:

1. Statement of the nature of the amount due.
2. Name(s) of the person(s) liable.
3. Estimated cost of collection.

4. Any other fact(s) supporting the request, including offset attempts.
5. If the discharge is due to bankruptcy, the supporting documentation must include a copy of the court's final discharge of the debtor and evidence that the specific dept is included in the petition for bankruptcy.
6. Signature, phone number, printed name, and title of person completing the discharge request.
7. Signature, printed name, and title of manager authorizing the request. This person should be at a level at least equivalent to the manager of the accounting office.

The SCO determines if the collection methods were appropriate and whether further efforts would be cost beneficial. State agencies must generally certify that no state credit exists against which the debt may be offset, that collection is improbable, and the cost of recovery does not justify the collection.

If the debt amount is over \$7,500, the SCO forwards the application to the Department of Justice (DOJ). DOJ reviews the discharge application to determine whether the state can legally be paid and how much it would cost to attempt to collect through the legal process. In order to do this, they review such things as the statute of limitations for the type of debt at issue, whether bankruptcies or death are involved, and whether the debtor is out-of-state.

Approved discharge applications are then submitted to the California Victim Compensation and Government Claims Board for the final approval.

#### Franchise Tax Board's Collection Process

The Franchise Tax Board (FTB) collects state tax revenue as well as debts owed to other governmental entities. Its collection process begins with its automated collection system (ARCS). ARCS sends taxpayers any number of bills with requests for payment. The number of letters that are sent is based on a number of factors, including the taxpayer's personal tax history. The letters become more aggressive as the collection action moves through the system.

For debts that aren't paid after bills are sent, the automated system automatically begins to look for assets. Social security numbers are matched with other departments and private agency information and if a match is found, an order to withhold is automatically sent out. If this goes to a bank, a demand is made to withhold 100 percent of the amount owed. If this goes to the debtor's employer, the amount withheld is 25 percent of disposable income and several notices to withhold may be required. Also, state tax liens are used. If the debtor has property in California, a lien is filed in the county in which the property is located for the amount of the debt. If the owner attempts to sell or refinance the property, the title company will deduct the tax debt from the proceeds and send it to FTB, before paying the owner the balance. Also, assets may be seized, income sources levied, or holds placed on liquor licenses.

If these procedures don't liquidate the tax debt, the account moves to the manual collection process. FTB initially attempts to resolve delinquent accounts through phone calls. FTB staff attempt to explain the legal issues to the taxpayer, address the specific circumstances of each account, and determine the taxpayer's willingness to comply. They establish specific dates for taxpayers to file returns, pay taxes, or provide

documents to resolve their accounts. FTB staff then follow-up to prevent delays or tax evasion. If necessary, this may involve visits to the debtor's home and/or business, gathering information from third party sources, issuing warrants for the seizure of assets, or recommending a criminal investigation.

For debts that are still uncollected and FTB determines that it is not cost beneficial for them to pursue further, the account may be turned over to a private collection agency. FTB has three firms that they use for in-state collection and one firm for out-of-state collection.

Revenue and Taxation Code Section 19443 permits the FTB to accept compromises for less than the tax amount owed. Offers in compromise are for taxpayers who do not have, and will not have in the foreseeable future, the money, assets, or means to pay their tax liability. A compromise is conditioned upon the determination that the amount that is offered by the taxpayer is more than FTB can expect to collect within a reasonable period of time and the taxpayer does not have reasonable prospects of acquiring increased income or assets to satisfy a greater amount. The Executive Officer and Chief Counsel are permitted to approve compromises of \$7,500 or less. Amounts in excess of this must be approved by the Franchise Tax Board.

Finally, accounts may be discharged if they are deemed to be uncollectible. It should be noted that even though debts are discharged, they may be collected at a later date. FTB maintains these accounts in its automated collection system and reactivates the account if new asset information is discovered until the 20-year statute of limitations that is specified in Revenue and Taxation Code Section 19255 expires. If a payer is identified, the system automatically initiates due process notices and levies. FTB reports that it collects about \$130 million annually on discharged debt.

#### Board of Equalization's Collection Process

When the Board of Equalization (BOE) determines that amounts are owed, either because the taxpayer has filed a return which indicates a liability or as a result of an audit by BOE, a demand for immediate payment is sent to the taxpayer and the account goes into BOE's collection system. If the taxpayer has not filed a return, but BOE has reason to believe that they owe taxes, BOE will make an estimate of the tax liability and send a notice to the taxpayer. The taxpayer has 30 days to dispute the assessment before it becomes final. Approximately 14 percent of BOE's accounts receivable are based on estimates of liability. The collection process varies depending upon the amount owed and BOE's assessment of the risk of non-collection based upon information such as the prior history of the taxpayer.

- If the amount owed is over \$15,000, it is immediately assigned to a collector who will make phone calls, visit the taxpayer's home/business, etc. as necessary.
- If the debt is less than this amount, up to three additional billing notices will be sent before being considered for manual collection. Each letter has a stronger tone.

When BOE determines that voluntary compliance is not likely, they then take summary action, which can involve garnishing wages, orders for banks to withhold, and liens against property.

Each account is evaluated on a case-by-case basis by the assigned collector to determine if it is cost effective to continue to pursue or should be discharged. Even after accounts have been discharged, BOE may collect revenues on those accounts. This may occur, for example, when liens against property were put in place during the collection process.

The Board of Equalization has an offer in compromise program similar to the Franchise Tax Board's, which is described above. Compromises are only approved if they are in the state's best interests.

#### Department of Finance Role

The Fiscal Systems and Consulting Unit is responsible for providing statewide guidance to departments on the procedures for collection of accounts receivable and the discharge of indebtedness in the State Administrative Manual.

The Office of State Audits and Evaluations (OSAE) prepares the Audit Guide for the Evaluation of Internal Controls and performs risk based evaluations, which includes the required review of departments' accounts receivable collection procedures. This is used by OSAE and internal audit units to determine if departmental controls over the establishment and collection of accounts receivables are adequate to safeguard state assets.

#### Department of Justice Role

In addition to reviewing departmental requests to discharge debts, DOJ works with departments to obtain money judgments for legal violations, or for such things as recovering public funds expended by a department to clean up environmental contamination.

Also, for 2006-07 and 2007-08, DOJ established a collections unit as a pilot project. The collections unit was intended to streamline and standardize the collections process by having specialists knowledgeable in the specialized area of enforcing judgments and other non-tax debt owed to DOJ's client agencies. However, the effort did not prove cost-beneficial and so will not be continued after 2007-08.