

TO: The Joint Fiscal Committee

FROM: Mary Peterson, Commissioner

DATE: November 7, 2014

SUBJECT: Annual Report on the Tax Computer System Modernization Fund

The Tax Computer System Modernization Fund (the "Modernization Fund") was created in 2007 to use part of the enhanced revenue gained through modernization of processes at the Department of Taxes (the "Department") to re-invest in further modernization, including an integrated tax system. Currently, the Modernization Fund is the vehicle by which tax modernization projects pay for themselves – vendors are paid only after the Department uses the new tools to collect from taxpayers who otherwise would escape their tax liabilities. The Tax Commissioner is directed to report on the Fund annually at the November Joint Fiscal Committee meeting.

The first section in this report provides a brief update from our July report on the first phase of our integrated tax system project, VTax, which is on schedule to go live on December 8. The second section provides an update from last year's November report on the sources of revenue and uses of the Modernization Fund.

Update on VTax Project

Our July report described the Department's contract with FAST Enterprises, LLC for an integrated tax system. VTax will provide a modern electronic platform to handle all aspects of taxpayer interaction for all tax types. Among other things, VTax will enable the Department to provide modern customer service, including e-services; to produce enhanced accounting and reports; and to ensure the best practices in essential security. With a single view of the taxpayer, VTax will improve our ability to analyze data and maximize audit initiatives. When fully installed, VTax will allow the Department to retire three legacy systems.

The FAST solution is in full production in over sixteen states. FAST moved over 20 employees to Vermont for VTax implementation upon contract signing in January, and every milestone for phase one, corporate and business taxes, has been met. Since the July report, VTax has been undergoing extensive testing; system testing on various functions, and currently, three passes of end to end testing. The usability of the online portal is being evaluated with the assistance of practitioners and businesses. All staff is now receiving training. Currently we are on track to "go live" with VTax on December 8. In January, the Department will be able to accept and process corporate and business taxes online for the first time, which addresses a major complaint of preparers and taxpayers.

FAST also has completed installation and training of a microsimulation model developed by Chainbridge Software, LLC for sales and use and income tax. The Chainbridge model provides a robust analytical tool allowing JFO to send Tax data queries related to proposed tax changes and quickly receive reports based on aggregate data.

Update on the Modernization Fund

The Modernization Fund was first established in 2007, and the sources of funds and use of funds have been amended three times, as outlined below. However, the basic structure has remained that enhanced revenue from projects have been split 80/20 between the Modernization Fund and the General Fund. Prior to the VTax project, two modernization projects contributed to the Fund, a small data warehouse designed by the Department and a comprehensive data warehouse designed and installed by an experienced tax vendor, Revenue Solutions Inc. ("RSI"). RSI is paid from the Modernization Fund pursuant to its contract that runs through 2016. The main investment objective for the Modernization Fund is VTax, which itself will generate additional revenue necessary to pay FAST under its contract running through 2024.

An independent review of the FAST bid, utilizing a cost-benefit analysis with very conservative assumptions, concluded that over the 10 year life of the VTax project, Vermont will realize \$36M in increased revenue over and above vendor payment. After FY2024, the General Fund will reap the entire benefit of the Department's vastly improved capabilities to collect tax that is owed.

Last session, the Administration requested and received an amendment to the Modernization Fund to accommodate the FAST contract, extending the Modernization Fund to the end of the contract period in FY2024. However, although the structure of the revenues into the Modernization Fund is set, and the uses are defined, there currently has not been an appropriation sufficient to cover our contracts and project costs in out years. This session the Department, through the budget bill, will seek additional appropriation from the Modernization Fund, so that it can continue meet its contractual obligations to vendors and associated costs of the project.

This report outlines the history of the Modernization Fund. Attached is a table summarizing the revenue sources and expenditures to date.

History of the Fund

Creation in 2007: Department Data Warehouse and ETM Project

Source of Funds

The Modernization Fund was initially set up in 2007. The source of funds was primarily an in-house project by the Department to generate non-filer leads from Vermont Department of Labor data.

Use of Funds and Appropriation

A basic 80/20 split of revenue between the Fund and the General Fund was established. An appropriation of \$7.8M was made from the Fund in order to facilitate the Department's purchase of Oracle's Enterprise Tax Management ("ETM") product from CGI for use in administration of the corporate income and several other small taxes. The ETM project went live in 2010, and the Department continues to use this software. However, after extensive discussions with Oracle, and an RFI to survey the market, the Department decided in 2012 to seek other bids on an integrated tax system, ultimately resulting in the VTax contract with FAST.

The General Fund received \$2.74M as a result of the DOL Project. After payments to CGI/Oracle, the Modernization Fund brought forward \$2.76M for the Department to put toward VTax.

Amendment in 2011: RSI Data Warehouse

Source of Funds

A new source of funds was added: tax receipts received from the data warehouse built by RSI. RSI is under a five year contract running from 2011 to 2016. The data warehouse project (which includes non-filer detection, discrepancy analysis, refund fraud review, audit selection and collection scoring) currently is estimated to yield a total of \$16.1M in enhanced revenue. This represents tax amounts that are owed, but would not have been paid without modernizing the Department's collection tools.

An excellent example is refund fraud review. Prior to installation of the RSI warehouse, the Department had to review refund requests manually, utilizing several reports generated by our various legacy systems to find markers of fraud. Now the RSI warehouse compiles one daily list of suspicious requests, based on several sources of data and sophisticated algorithms. Without this tool, the Department could not have kept up with the explosion in fraudulent requests. Using this tool has enabled the Department to stop approximately \$1.5M in fraudulent refunds.

Use of Funds and Appropriation

Under the self funding principle, RSI agreed to be paid out of a sliding percentage of enhanced revenue generated from its warehouse. The Commissioner of the Department of Finance and Management approves the baselines from which the RSI enhanced revenue is measured. The 80/20 split between the Modernization Fund and the General

Fund continues net of the RSI payments. An appropriation of \$7.5M was made from the Modernization Fund in the 2011 Amendment.

RSI is forecasted to receive total payment of \$4.9M through 2016; it has been paid \$4.1M to date. The General Fund is forecast to receive a total of \$2.2M as a result of the RSI project, and \$8.9M from the RSI project will be retained in the Modernization Fund to put toward VTax. The RSI project currently is on time and on track to meet the five year forecast.

Amendment in 2013: VTax Project

Sources of Funds

The source of funds remained the DOL and RSI projects.

Use of Funds and Appropriation

Since the Department decided in 2012 to go back out to bid, the uses of the funds were amended to replace references to ETM with the generic "integrated tax system", and language was added to allow for planning and implementation. An additional \$9.02M was appropriated; together with the \$7.5M from 2011, the Modernization Fund carries a \$16.52M appropriation (these appropriations by their terms carry forward through FY2018).

Amendment in 2014: FAST Contract

Sources of Funds

The source of funds was expanded to include the VTax contract with FAST. As noted above, VTax will bring processing improvements across all tax types, and greatly expand the Department's refund review, data warehouse and compliance opportunities. This work will enable the Department to capture revenues that were previously uncollectable. 80% of the enhanced revenue from VTax, again as measured against baselines approved by the Commissioner of Finance and Management, is retained in the Modernization Fund. The Modernization Fund also was amended to sunset in 2024, at the conclusion of the FAST contract term.

Use of Funds

The 2014 Amendment added to the uses of the Modernization Fund the costs associated with the Chainbridge microsimulation model, included in the FAST contract (these amounts were due upon invoice). The Department has paid \$198,000 on the invoices for Chainbridge (net of JFO payments).

The VTax contract with FAST is divided into two parts, with the first four years representing implementation and the out years consisting of maintenance and support. As with the RSI contract, the implementation phase of the VTax contract with FAST is self-funded through additional tax receipts directly attributable to the project. The contract price with FAST is capped. FAST invoices the Department pursuant to completed milestones but the invoices will only be paid as the Department has available monies from enhanced revenue. The first phase of VTax will be complete by the end of 2014 and the Department anticipates enhanced revenue to start being generated in the second half of FY2015.

The FAST contract provides for a significant discount on the contract price for payments on invoiced amounts from funds not generated by the VTax Project. The Department reduced the contract price by \$395,000 by paying \$3.8M on the initial invoice from FAST for licensing from revenue already in the Modernization Fund due to the DOL and RSI projects.

Major Expenditures FY12, FY 13, and FY14 to Date

Aside from the payments to vendors outlined above, the Department has paid for associated costs related to the projects from the Modernization Fund. Major costs include \$631,261 to DII for hardware, maintenance and support; \$277,045 to replace our servers (CHAMP); \$328,810 for additional IT services necessary to support the continuing operation of ETM until it can be retired; and \$111,255 in VTax procurement costs.

Future of the Fund

Use of Funds and Appropriation

In order to continue to cover the contract price and associated costs for the lifespan of VTax, the Department intends to seek an additional appropriation in the 2015 budget from the Modernization Fund. No change in use of funds or the sources of funds is needed at this time.

Conclusion

The Department has successfully developed a model whereby modernization of its processes has brought in additional revenues for the state without raising taxes. 80% of those revenues are leveraged further on modernization efforts that continue to close the Tax Gap, the difference between the taxes owed and taxes actually paid.

This initiative will be completed with the installation of VTax, a modern integrated tax system. In the decade from 2011-2024, the Department will have thoroughly modernized its compliance processes and tax administration. The Department will have efficient, integrated operations that, among other things, will maximize employee productivity, provide data security, ensure accurate accounting, and furnish robust reports of revenue. Both the Administration and the Legislature will have better tools to analyze the impacts and results of future revenue proposals. Vermonters will be able to more easily pay the taxes they owe, for example, with standardized 24-hour online access to their accounts.

In the meantime, over the entire course of the Department's modernization, the General Fund will be receiving "found money". This money comes without any tax increase – it is amounts that would have escaped collection but for the Department's improved ability to ensure that what is owed is actually paid. After 2024, the Department will fully operationalize its costs with respect to VTax; at that point, all of the additional revenue from the modernization will accrue directly to the General Fund.

TAX COMPUTER SYSTEM MODERNIZATION FUND (MF)¹

Statutory References: Act 65 of 2007 Section 282, Act 63 of 2011 Section C.103, Act 1 of 2013 Section 65 and 66, Act 95 of 2014 Section 62

Sources of Funds: Enhanced revenue from DOL project (2007-2012), RSI data warehouse (2011-2016), FAST integrated tax system (2014-2024)

Use of Funds: Technology investments to allow for modernized compliance and an Integrated Tax System

DOL Project: 2007-January 29, 2012

	Total
Enhanced Revenue	\$13,308,724
Distribution:	
CGI/Oracle ²	\$7,800,000
GF	\$2,746,552
MF	\$2,762,172

RSI Project: 2011-2016 (Live: February 2012)

	Estimate (Cumulative through 2016)	To Date
Enhanced revenue	\$16,100,000	\$10,775,812
Distribution:		
RSI contract payments	\$4,900,000	\$4,158,611
GF	\$2,200,000	\$1,323,440
MF	\$8,900,000	\$5,268,121

MF Expenditures: FY2012-To Date

	Expenditure	To Date
FAST discounted contract payments ³		\$3,805,000
		(\$395,000 discount earned)
Chainbridge (net JFO)		\$198,264
DII hardware, maintenance, and support		\$631,261
VTax procurement services		\$111,255
Other VTax project expenses ⁴		\$45,424
Oracle services ⁵		\$32,030
CHAMP (servers)		\$277,045
Additional IT FTE ⁶		\$328,810
Total		\$5,429,089

¹ To date is as of FY15 Q1.

² \$7,800,000 appropriation in 2007, payments 2008-2011.

³ Payments made to FAST outside of VTax Project benefits-based payments generate a discount to the contract price.

⁴ Additional services paid through the Department's budget.

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⁶ IT FTE will eventually be rolled into the Department's budget.