

TO: The Joint Fiscal Committee

FROM: Mary Peterson, Commissioner, Department of Taxes

DATE: November 10, 2016

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 the modernization of processes at the Department of Taxes (the “Department”) to re-invest in further modernization, including an integrated tax system. Given that the Department is the state agency that collects money, we are in the unique position that modernization efforts give us better collection tools that can directly pay for themselves. Our new integrated tax system allows us to more efficiently reach taxpayers who otherwise would escape their tax liabilities.

The first section in this report provides an update on our integrated tax system, VTax, from our last report in November 2015. We are on schedule in less than one month to successfully launch personal income tax in VTax, which will mean that we have implemented all of the major tax types in less than three years, on time and on budget. The second section outlines considerations for the scope of the final phase of this contract, and possibilities for further phases to extend VTax to other revenue functions, some currently in other agencies. The third 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

As general background, we signed a contract in January 2014 with FAST Enterprises, LLC for an integrated tax system based on their COTS system that is in use in over twenty other states. VTax provides a modern electronic platform to handle all aspects of taxpayer interaction for all tax types. VTax enables the Department: to provide modern customer service, including e-services; to use modern discovery programs to detect tax non-compliance and design optimal outreach and audit initiatives; to produce enhanced accounting and reports; and to ensure the best practices in essential security.

We have an internal project team consisting of “implementation coordinators” from each of our operating divisions who work full time with the twenty-four member on site FAST team. Each of our major phases have involved roughly the same eleven- or twelve-month schedule, starting with design meetings, development, system testing throughout the summer with all of our users, end to end testing and training in the fall, a quiet period for conversion and cutover, and then launch and production support.

Phase 1, Corporate and Business Income Tax, Completed December 2014

Less than one year after the contract signing, we went live with the first phase of VTax, migrating our corporate and business income taxes from the Oracle ETM system. This allowed us to offer online filing of corporate and business income tax for the first time, piggybacking on the IRS Modernized E-File system. We also launched myVTax, an online web portal used by tax preparers and taxpayers to register, file and pay, as well as to communicate securely and keep a record of accounts. For the 2015 tax year we achieved high utilization of our modern platform for these taxes by mandating the online filing of

Corporate Income, Business Income, and Fiduciary Income taxes when prepared by a tax preparer. Tax preparers have collaborated with us on the design of myVTax, which is very flexible in its configuration. We are continuously improving the user experience, and this December will introduce some major new functionality.

Phase 2, Meals & Rooms, Sales & Use, Withholding and Six Other Tax Types, Completed November 12, 2015

Phase 2 was a considerably larger launch, involving conversion of a total of nine taxes from our Advantage Revenue and manual processing systems into VTax. The full list included Meals & Rooms, Sales & Use, Payroll Withholding, Fuel Gross Receipts, Premium Insurance, Captive Insurance, Fiduciary, Bank Franchise and Health Care Claims Taxes. As in Phase 1, all milestones were met on time.

Phase 2 had the most public facing impact, since businesses and practitioners had to be transitioned from our old VTBizFile portal to myVTax to file and pay (as discussed below, personal income tax payers will not use myVTax as frequently). Meals and Rooms and Sales and Use are very high volume, and remitters range from big box retailers to small family restaurants and inns, so our relatively small taxpayer services division was challenged to meet the volume of calls through January and February. The ability to continuously improve myVTax and push out information on our website and through our newsletters helped us smooth out the early high rate of user errors.

Chainbridge Microsimulation Model

FAST also has completed installation and training of a microsimulation model developed by Chainbridge for sales and use and income tax. The Chainbridge model provides a robust analytical tool, and this session JFO will have the ability to directly query proposed tax changes and quickly receive reports aggregating data. The income tax model, originally based on 2011 tax year data, is being updated to 2014 tax year data – and will be updated every other year going forward. The sales tax model is currently based on 2013; it will be updated next year and every five years going forward.

Phase 3, Personal Income Tax

Phase 3 commenced in January, and involves the conversion of individual income tax. Go live is on track for December 7. We are slowly shutting off functions this month in our three major legacy systems – Advantage Revenue, data warehouse, and ETM, and they will be officially mothballed at launch. A very exciting day for us, as the quirks of the two older systems will not be missed. The Department will be in a quiet period on December 1 and 2, as we do the final conversion, and then have a soft launch on the December 5.

There are some significant improvements in myVTax that will be rolled out in this phase, including online filing for Landlord Certificates and Renter Rebate. But for the most part, personal income tax filers will not see a change in their experiences. That is because, for better or worse, for both federal and state filings we have evolved to widespread use of commercial tax preparation services. These packages offer a great deal of convenience for personal income tax filers, and are free for the low income, but as we saw this year in Vermont, poor coding can lead directly to headaches for the filers and loss of revenue for the state. Having personal income tax in VTax gives the Department much more robust real time analytics of filings. Hopefully we will never see errors on the scale of what we experienced, particularly with TurboTax, but we will have surveillance capabilities to catch filings anomalies going forward.

It is worth noting that a critical challenge for the Department since 2010 has been that crucial collection and accounting functions were linked not only to decades old hard coding in Advantage Revenue, but

also the unstable ETM system. With each rollout, we have overhauled business processes, but it is only with the retirement of these three problematic systems that we can complete our business makeover. We have an exciting cross-divisional Strategic Improvement team that is working with our business users to ensure that we capitalize on our new technology. One of their projects is to finalize all the steps that we have been taking around our audit process with the creation of a centralized audit plan; they are also tackling a transparency project designed to leverage our new data with superior internal and external reporting.

Phase 4, Rest of Miscellaneous Taxes, Possible Transfer of DOL Assessment

Phase 4 consists of conversion of the final Miscellaneous taxes. These taxes have very few payers, currently administered largely with manual spreadsheets and any collection activities in the mainframe. We are currently discussing with FAST postponing and compressing the design and development phases that would ordinarily start in January, so that we can focus on production support for Phase 3 in the early months of the personal income tax season.

The Administration is also discussing the possibility of advancing legislation to transfer the employer assessment for health care from the Department of Labor to us. We have discussed including this in Phase 4 with FAST, which likely could be easily accomplished under the current contract.

Another function that the Department would like to consider implementing into VTax is Current Use. Presently, the front-end application for Current Use is handled with a VIC online portal. VTax offers the capacity to handle both the application and the back-end processing. However, in discussions with FAST this would be an additional cost and require another phase of the project.

Maintenance and Support, Hosting

When we entered into the contract with FAST, they committed to fixed price options for maintenance and support for the six years after implementation: at the lowest level, the Department just receives patches for the VTax software; at the second level, FAST actually commits to installing those patches; and at the highest level, FAST will also maintain VTax on the latest version of its software. The cost for the highest level is \$1.8M, which might be a wise annual investment versus the risks inherent in operating an older system that later will require a costly upgrade.

When we contracted, the state also opted for hosting by DII on the state servers. This did cause some complexity in implementation, and DII's level of service does not include commitment to 24-hour operation (which is important since VTax does use a number of overnight batching functions). FAST does offer cloud hosting, that aside from higher level of service also may offer some security enhancement. Both of these matters will need to be decided in mid-2017.

Possible Extension of the Contract

Ironically, the last Administration had pushed for the Department to become a full Department of Revenue and we successfully had the slated name change in 2012 repealed. However, now that we have a modern integrated tax system in place along with the staff that build it, the time is probably right to revisit this concept. FAST has modules that handle unemployment taxes and benefits that are used in other states. FAST also has modules for drivers licensing and motor vehicle registration in place in other states. Provider taxes and child support are examples of other revenue functions currently administered by other agencies.

Note on Budgeting Considerations

In last year's report we noted that the Department has been able to accomplish the rapid and successful implementation of this IT project at a time of low or no budget growth for the Department, and while we lost positions. However, as we transition from project mode back to normal operation of our core revenue collection functions, some of the related costs for our system, such as licensing, maintenance and support costs, need to be operationalized. In future budgets, you may anticipate requests to increase our operation budget to reflect this transfer of ongoing costs from the project. Fortunately, as the project winds down, we will be in the position to finish contract payments to FAST, and when the Modernization Fund is retired, all of the enhanced revenue from our new efficiencies will flow to the General Fund.

Update on the Modernization Fund

The Modernization Fund was first established in 2007, and the sources of funds and use of funds were amended three times throughout 2014, as outlined in our previous reports. In Act 58 of 2015 there was an additional appropriation of \$15.5M to carry through FY 2024. The basic structure has remained where 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"). The RSI contract wrapped up in April, so payments for the warehouse no longer will come from the Modernization Fund (we have paid RSI for some consulting hours to continue use of the warehouse until full transition to VTax).

The main investment objective for the Modernization Fund is VTax, which itself will generate additional revenue necessary to pay FAST under its contract that runs 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 FY 2024, the General Fund will reap the entire benefit of the Department's vastly improved capabilities to collect tax that is owed.

Attached is a table summarizing the revenue sources and expenditures to date. The Department has made payments to RSI, FAST and Chainbridge pursuant to the respective contracts. The Department has paid consultants who have worked on the procurement and evaluation of the project. The Department has paid DII expenses related to the Project out of the Modernization Fund. The Department has also paid one IT employee out of the Fund, though this position will be transitioned to our operating budget.

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). By the end of this year, we will have largely completed our modernization. We have demonstrated efficient, integrated operations that maximize employee productivity, provide data security, enhance our online presence, ensure accurate accounting, and furnish robust reports of revenue. We have vastly improved the taxpayer experience and customer service.

Throughout the course of this transformation, the General Fund is receiving “found money.” This money comes without any tax increase – it includes amounts that would have escaped collection but for the Department’s improved ability to ensure that what is owed is actually paid.

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

I. 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

II. RSI Project: 2011-2016 (ended April 30, 2016)

	Total
Enhanced revenue	\$22,264,379
Distribution:	
RSI contract payments	\$5,624,666
GF	\$3,327,942
MF	\$13,311,771

III. FAST Project: 2015-2016 (phases I & II)

	To Date
Enhanced revenue	\$3,726,291
Distribution:	
FAST benefit payments	\$2,389,998
GF	\$745,258
FAST non-benefit payments (MF)	\$11,338,438
Discount Achieved	\$1,320,000

¹ To date is as of FY15 Q1.

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

IV. MF Misc Expenditures: FY2012-To Date

Expenditure	To Date
FAST Chainbridge (net)	\$281,493
DII Hardware, maintenance, and support	\$1,316,265
VTax procurement services	\$121,330
Other VTax project expenses ³	\$222,213
Oracle services ⁴	\$32,030
CHAMP	\$277,045
Additional IT FTE ⁵	\$445,564
Total	\$2,695,940

³ Additional services paid through the Department's budget.

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⁵ IT FTE will eventually be rolled into the Department's budget.