

MEMORANDA

To: The Joint Fiscal Committee
cc: Jeb Spaulding, Secretary of Administration
From: Mary Peterson, Commissioner, Department of Taxes
Jim Reardon, Commissioner, Department of Finance & Management
Date: July 17, 2014
Subject: Integrated Tax System Report pursuant to Act 95 Section 63 of 2014

Introduction

This joint report by the Department of Taxes ("Tax") and the Department of Finance & Management ("F&M") is required by the 2014 Budget Adjustment Act, Section 63. Tax has entered into a contract with FAST Enterprises, LLC (FAST) to implement an Integrated Tax System (ITS). This report will provide background on the contract and progress to date.

This report specifically addresses the background to the contract, including the selection process and references for FAST from other states. The report explains the contract implementation and payment schedules for the core tax processing modules included in the ITS, as well as for the Chainbridge modeling software included in the contract. The report details the deliverables and milestones in the contract, as well as the methodology for establishing the baselines that will measure the incremental tax receipts directly attributable to the contract that will form the basis for payment to FAST. Finally, this report summarizes the Independent Review (IR) that was completed on the FAST contract.

Background*What Is an Integrated Tax System?*

An ITS is a seamless platform for Tax to administer all taxes. An ITS will handle all tax functions for all tax types, from the development of forms, filing of returns, payments and correspondence, to audit and collection of delinquencies. A modern ITS includes a taxpayer access portal for secure online transactions by taxpayers and practitioners, with similar functionality to modern online banking systems.

An ITS greatly improves efficiency. It incorporates the best business practices and offers ease in training, configuration and support. With fewer interfaces, it is more secure. It offers modern convenience to taxpayers. It is easier for taxpayers to comply and, with a single view of the taxpayer and more digital data, easier for Tax to spot non-compliance.

What is the Computer System Modernization Fund?

As described more fully below, the Computer System Modernization Fund (CSMF) was set up in 2007 as a self-funding mechanism for Tax to modernize through IT projects. Modernization generates revenue over baseline receipts; a percentage of that lift is retained by Tax to repay vendors. These baselines represent

the work Tax would do without the modernization projects and the lift represents revenue Tax would be unable to realize but for the projects. Over the life of the CSMF, the split has been 20% of the enhanced revenue transferred to the General Fund, and 80% retained by Tax to repay vendors. As explained below, use of this model with FAST results in a true “benefits based” contract, in which the product pays for itself and FAST bears the risk of non-payment if there is not sufficient lift demonstrated from implementation over ten years to cover the contract price.

What Systems Does Tax Currently Use?

Tax currently uses three “legacy” systems for processing taxes. A number of smaller taxes are processed and tracked through our 1980s mainframe system. Personal Income Tax (PIT) and Trust Taxes (Sales & Use, Purchase & Use, Meals & Rooms) are processed through the Advantage Revenue (A/R) system that was first put in service in 1999. Corporate and Business Income Tax, together with three smaller taxes and collections for all taxes, are processed through the Enterprise Tax Management (ETM) system that was first put in service in 2010.¹

Currently Tax has limited options for online filing of returns and payments. PIT returns can be filed electronically through IRS partner software vendors, and we accept some Trust Tax returns and payments through portals custom designed by the Vermont Information Consortium (VIC). Notably, we do not have electronic channels for filing corporate and business income taxes, insurance taxes or bank franchise taxes. Aside from taxpayer inconvenience, paper returns hamper efficient processing and audit.

How Did Tax Select FAST?

In 2012, Tax issued an RFI to gather information on ITS solutions. Over the winter and spring of 2012-2013, Tax engaged the firm BerryDunn to prepare a business case confirming the cost-benefit of an ITS, develop requirements, and draft an RFP. The RFP was issued in early summer 2013, and Tax received three proposals. Evaluation of the bids included review by a team comprised of representatives from various internal divisions and the Department of Information and Innovation (DII). Full day demos of all three bids were conducted, and included presentations to a panel of tax practitioners. Based on the results of the evaluations, Tax announced the intent to contract with FAST in September 2013.

Why FAST?

FAST is a closely held Colorado company of about 500 employees that is focused exclusively on government revenue work. Tax dealt directly with two of the owners during the proposal review, demos, and subsequent negotiation. As described more fully below, FAST offered a mature ITS product, with

¹ The Department awarded a contract for implementation of ETM in 2007. ETM was a new product that Oracle adapted from a utility billing platform for use by government revenue agencies. Although ETM was put into service at the Department in 2010, it has never performed optimally. In 2012, Tax announced that it was going to seek proposals for other solutions. Contracts for ETM were awarded by 3 other state revenue agencies around 2007; all but Ohio have halted implementation of ETM.

numerous successful implementations; an excellent team that would be onsite throughout the project; and a stellar demo. The FAST price structure offered a predictable value that reduced risk.

The FAST Product: GenTax

FAST developed GenTax in the late 1990s, and it has been in full production processing all types of taxes for provinces, states and municipalities for over a decade. Sixteen state revenue agencies currently have GenTax in full production; three more states, including Massachusetts, also are in the process of implementing GenTax. During due diligence checks, we confirmed FAST's flawless record of delivering GenTax on-time and on-budget. FAST is given outstanding marks by its current customers. In fact, to paraphrase one state official, the only "negative" she could suggest was that the company indeed is very fast – which is not to reflect badly on them, but only to say that an agency can be challenged to keep up. This was very consistent with our discussions with other FAST states; they had only positive feedback on the FAST implementation methodology, product and staff, with the only caution being not to underestimate the enormity of the transition in a relatively quick period of time.

The VTax Team

Immediately upon contract signing, Chad Curtis, a longtime FAST employee who has worked on five other state and provincial implementation projects, relocated to Vermont with his family. As FAST project manager, Chad has assembled a team of other FAST employees with experience and skills ranging from development, to testing and training. Currently 21 FAST employees are onsite in Vermont. The project director for Tax, Doug Farnham, leads a team including an implementation coordinator drawn from each of our divisions. Since May, the joint VTax teams have been co-located in open workspace configured specifically for the collaborative nature of a project of this undertaking.

The VTax Steering Committee, comprised of the Commissioner, Deputy, the VTax Directors and Divisional Directors, as well as representatives from DII, meets biweekly to review the progress of the project. In addition, an interagency Oversight Committee, comprised of the Commissioner, Deputy, the Deputy Secretary of the Agency of Administration, as well as the Deputies of DII and F&M, meets every other month. Tax also has continued its consultant contract with Jordan Harris, who has extensive experience in advising state government on IT projects. Jordan worked with both Tax and MA on contract negotiations with FAST, and Jordan has a lead role in the MA implementation.

FAST Contract

VTax Schedule

The contract with FAST runs for 10 years through 2024. Four implementation phases run through 2018, followed by two years of warranty support. Vermont then has the option of choosing fixed price levels of maintenance and support for an additional four years. The current implementation is as follows:

Phase 1 (2014): Corporate and Business Income Tax, Chainbridge Microsimulation Model

Phase 2 (2015): Trust Taxes

Phase 3 (2016): Personal Income Taxes

Phase 4 (2017): Remaining Miscellaneous Taxes
2018-2019: Warranty Support
2020-2023: Fixed Price Support at level that Vermont chooses

Milestones and Deliverables for Tax Types

All of the functions are rolled out in the implementation of each tax type. So, for example, in the current implementation, all functions related to corporate income tax, including registration, forms, payments, refunds, correspondence, billing, collection and audit, as well as the online taxpayer access portal, will be put in service. Each phase is roughly one year long, with the aim of going into live production in November, to be ready for taxpayer filings in January.

The milestones and deliverables for each phase include definitions and design, base configuration, development, conversion, testing, training and rollout. We are at the halfway point for Phase I, with all activities to date completed on-time. We fully anticipate being able to accept online filing of corporate and business income tax returns as of January 1, 2015, which addresses a major complaint of taxpayers and preparers.

Payment Structure

The contract is structured with an implementation cost tied to the written acceptance of milestones and deliverables in each of the four phases, then two years of warranty support payments (in the nature of hold backs), and finally, fixed prices for optional maintenance and support for the final four years of the ten year contract. Invoices are issued according to the contract schedule, if the relevant milestones and deliverables have been accepted by Vermont.

The contract is “benefits based”, in that FAST is paid on its invoices only to the extent that there is a measurable lift of increased revenue due to the implementation. As described below, baselines are established for various programs and initiatives enabled by VTax, and then 80% of the revenue attributed to lift over such baselines is deposited in the CSMF (20% goes to the General Fund). Again, FAST invoices Vermont as milestones and deliverables are accepted for each phase; however, the invoices are not due until there are sufficient benefits in the fund. FAST bears the risk of generating sufficient benefits over the course of the ten year project to cover the implementation contract price: if benefits are not generated, FAST does not get paid. In addition, Tax negotiated a discount to the extent that it is able to pay invoices from funds other than benefits.

Total Implementation Cost

The software licensing, implementation services, and warranty support—assuming acceptance of all milestones and deliverables—will generate invoices under the contract totaling \$29.2M through the year 2019. At this price, FAST has committed that Tax will be upgraded to the latest version of GenTax through 2017. Again, this \$29.2M is only paid to the extent that there are demonstrated benefits.

First Payment and Discount

Pursuant to the contract schedule and acceptances, Tax was invoiced \$4.2M for the GenTax license on February 28th. Tax was able to pay this amount from monies accumulated in the CSMF for this purpose, since 2007, as the result of the legislatively approved data warehouse projects. Tax paid \$3.8M on the license invoice, realizing a \$395,000 discount because the payment was not a result of FAST benefits. This payment (together with other project costs, including payment to Chainbridge and purchase of hardware from DII) has depleted the fund, so it is not clear if Tax will be in the position to make other discounted payments to FAST.

Establishing Baselines

A joint baseline committee comprised of both FAST and Tax staff has been set up, including Joe Milack, a FAST representative with 25 years experience in the compliance division for the State of New York, and Victor Gauto, Senior Economist for Tax. This committee identifies initiatives enabled through VTax and establishes baselines for the current results in that area by Tax. The methodology for establishing the baseline and measuring the lift is approved by the Deputy and Commissioner at Tax, and also must be approved by the Commissioner of F&M.

The baseline committee has just proposed the first set of three baselines from implementation of corporate and business income tax. The first baseline measures a reduction of interest paid by Tax when it issues a refund more than 90 days after receipt of a return. In the past, Tax took as long as eighteen months to finish processing a corporate return, after VTax we anticipate staying current in the processing of corporate returns. The methodology is being refined, however early work suggests that the baseline may be as high as \$250,000 in interest paid as a result of delayed refunds. To use an example, if Tax were to completely eliminate payment of interest on these refunds after VTax, the savings of \$250,000 would represent benefits which would be deposited in the CSMF, with 20% transferred to the General Fund and 80% available to pay any invoices due to FAST.

The second proposed baseline would be reduced refunds based on improved examination of current year returns. Currently Tax has limited means to examine the paper filed corporate returns before issuing refunds (particularly since interest is generally accruing). The proposed baseline would measure our current corporate refunding against refunding results after VTax. The third proposed baseline would be improved collection on delinquency with the improved data available with VTax. Again, the proposed baseline would measure our current collection results on delinquent corporate accounts against the improved collection results, if any, after VTax.

Fixed Price Support in Contract Out Years

In the out years, Tax negotiated for fixed price support options, ranging from no support, Level 1 support with access to patches, fixes and upgrades (but no onsite FAST staff), Level 2 support including installation of patches and fixes, and Level 3 support which includes installation of upgrades so that Vermont is always running the latest version of GenTax. Assuming that Tax would chose either Level 2 or Level 3, the total fixed price of support would range from \$3.4M – 8.4M over the last four years of the contract. (At \$8.4M, or

\$2.1M per year, Tax would be running a constantly refreshed software system, and avoid costly upgrades.) These amounts are not paid through benefits, and would be operationalized in the Tax budget.

Chainbridge Microsimulation Model

FAST subcontracted with Chainbridge to provide a microsimulation model for use by both the Administration and JFO in the modeling of sales tax and personal income tax changes. The sales tax module includes national macro data and state micro data, including DOL survey information. The personal income tax module matches data from federal and state returns, as well as the US Census. Since this module includes federal tax information, it incorporates strict protocols approved by the IRS to protect taxpayer confidentiality. The IRS approved solution uses PolicyLinks, a robust, quick analytical software that will allow JFO to send Tax data queries and receive reports based on aggregate data, eliminating confidentiality issues.

The Chainbridge models have been completed and installed, and staff is currently training and testing. FAST will be paid a total of \$278,265 for the Chainbridge work to date, drawn from the CSMF with contribution from JFO.

Independent Review

An Independent Review of FAST's bid was conducted by Mathtech, Inc. while Tax negotiated the contract, and its final report issued on January 15, 2014. In doing its cost-benefit analysis, Mathtech used a very conservative methodology which included possible costs for outside staff augmentation, and did not count all anticipated revenue. Even so, Mathtech concluded that over the 10 year period, Vermont will realize \$36M in increased revenue as a result of the project, after payment to the vendor.

Mathtech's findings are summarized in Section 1.3 of the report:

The implementation of the FAST GenTax ITS should be pursued with a few critical steps prior to contract finalization and project commencement. FAST has a proven track record of success across multiple states and has extensive experience with Taxation operations and technology. Vermont will be joining a network of states that have implemented the GenTax system, and will be able to leverage that network as required for support, knowledge sharing and innovation.

With respect to the FAST implementation cost, Mathtech summarized in Section 2.4 of the report that the contract price was slightly outside the range anticipated in the Business Case, however:

Acknowledging the premium associated with the benefits-based acquisition model of GenTax, FAST's proposed cost for implementation is considered reasonable as compared to other states similar to Vermont.

In Section 7.3 of the report, Mathtech made a number of findings to support its conclusion that Vermont likely would realize a significant overall benefit from the project:

Finding 29: While FAST has only completed a single benefits-based implementation, they have provided a listing of multiple states that attribute increased revenues with the implementation of GenTax. This is a positive indication that Vermont will be able to achieve benefits from the implementation of GenTax.

Finding 34: If benefits estimates are achieved, over the period of FY14-FY23, VT will realize a benefit in excess of \$36M. Fiscal years 14-19 will incur a net cost to VT while Fiscal Years 20-23 will incur a net benefit, due to the total repayment of FAST Implementation costs by the end of FY20. The values shown in the Cost Benefit Analysis portray an increase in revenue flowing to the state as a result of the ITS implementation.

Mathtech's legislative summary of its Cost Benefit Analysis, which demonstrates cash flow and the overall anticipated revenue levels, is attached hereto.

Conclusion

With its contract with FAST, Tax is well-positioned to realize its goal of an integrated tax system, which will provide modern convenience to taxpayers, efficiency in tax collection, and ultimately result in more revenue to the state. FAST is a company with a flawless record of on-time and on-budget implementations, and its product is used successfully in numerous other states. Tax has negotiated a favorable contract, with a four year implementation schedule, benefits based payment over ten years, and fixed price maintenance and support over that time. The Independent Review has confirmed that Vermont should be able to repay the vendor in six years, and as a result, Vermont is very likely to achieve a significant cost benefit by the end of the ten year term.

Vermont ITS Independent Review
 Cost Benefit Analysis (December 2013)

	1	2	3	4	5	6	7	8	9	10	Total
	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	
61 Total FAST Implementation and Related Systems / Services Cost (Cashflow & Accrued Bases)	\$13,819,991	\$10,147,324	\$7,605,334	\$8,145,144	\$5,430,366	\$2,971,045	\$2,248,545	\$2,229,686	\$2,171,045	\$2,171,045	\$56,939,525
81 Budget Offset, FAST GenTax + RSI/FAST DW Benefits Total	\$5,231,628	\$5,453,214	\$7,872,830	\$7,110,538	\$9,137,500	\$11,225,000	\$11,562,500	\$13,262,500	\$13,262,500	\$13,262,500	\$97,380,712
92 Benefit / (Cost) to VT (Cashflow)	(\$2,260,593)	(\$807,317)	\$686,146	(\$798,111)	\$1,130,959	\$273,955	\$5,023,978	\$11,032,814	\$11,091,455	\$11,091,455	\$36,464,741
90 Total Benefit to VT General Fund (Cashflow)	\$3,363,473	\$3,810,556	\$4,569,529	\$2,228,208	\$1,827,500	\$2,245,000	\$7,195,023	\$13,262,500	\$13,262,500	\$13,262,500	\$65,026,789

Footnotes

61 due to the "Benefits Based" model of deferred payment, total costs to VT consist of cashflow costs (e.g., backfill resources) and accrued costs (FAST Services for Implementation)

81 Budget Offset is not included in FAST Payables or VT General Fund values; only 20% of FAST and RSI benefits go to VT General Fund until FAST is paid in full for implementation, at which time 100% of FAST benefits go to VT General fund

92 cashflow basis cost or benefit to VT per year

90 total cashflow to VT General Fund per year - based on 20% of benefits from RSI DW (74) + 20% of benefits from FAST (82) until Accrued Implementation Cost is paid in full (66) + 100% of remaining benefits from FAST (82)

