

**REPORT BY THE STATE AUDITOR
OF CALIFORNIA**

**THE FRANCHISE TAX BOARD'S TAX SETTLEMENT PROGRAM
HAS ACHIEVED THE LEGISLATURE'S INTENT**

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MARCH 1994

March 17, 1994

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The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

Summary The Franchise Tax Board's (FTB) tax settlement program is both more efficient than and equally as effective as FTB's other methods of resolving tax disputes. We could not quantify the number of hours FTB staff charged to settlement cases as compared with cases in the protest, appeals, and litigation processes. However, we were able to determine that the settlement program generally shortens the lengthy tax dispute process. For bank and corporation taxpayers, which comprise 98 percent of the taxes collected, the FTB's fiscal year 1992-93 settlement program resolved 99 cases in an average of 3 months as compared with an average ranging from 36 to 46 months in each of the FTB's three other administrative tax dispute processes. It also creates a better working relationship between the FTB and taxpayers when tax disputes arise. While reducing expenses incurred by the State and taxpayers, the FTB settlement program has also generally proven to sustain taxes at rates comparable to other administrative processes the FTB uses to resolve tax disputes. For bank and corporation cases, the settlement program achieved a tax-sustained rate of 61 percent during fiscal year 1992-93 as compared with a range of 43 to 68 percent in the FTB's other administrative processes. Therefore, the FTB tax settlement program is equally as effective in resolving tax disputes as the other administrative processes.

Through the settlement program, the FTB resolved tax disputes totaling \$926 million related to 99 bank and corporation cases and 25 personal income tax cases. Of this amount, the settlement process sustained taxes totaling \$563 million, or 61 percent of the taxes in dispute. The remaining taxes, \$363 million, were written off by the FTB. Of the \$563 million in sustained taxes, the FTB collected \$325 million as cash and had previously collected the remaining \$238 million.

Estimated accelerated collections of \$300 million from fiscal year 1992-93 tax settlements made resources available for appropriation during fiscal year 1992-93 that would not otherwise have been available until later fiscal years. In addition, the accelerated collections eliminated the possibility that the State would not realize the collections because of a decision against the State in protest, appeals, or litigation or because of a taxpayer's insolvency. Moreover, the settlement of the 124 cases in fiscal year 1992-93 allows the FTB to direct its resources to the resolution of other new or existing tax disputes. However, the accelerated collections did not provide an economic benefit to the State resulting from increased interest earnings or decreased interest expense because the interest rate paid by taxpayers on unpaid taxes exceeds both the interest rate earned on the State's investments and the interest paid on the State's borrowings during fiscal year 1992-93.

The FTB estimates that accelerated collections will range between \$150 to \$200 million for fiscal year 1993-94. The estimated fiscal year 1993-94 accelerated collections are less than those of fiscal year 1992-93 because the FTB gave priority to resolving cases during fiscal year 1992-93 with the highest likelihood of generating net cash receipts and because the FTB anticipates more refunds resulting from fiscal year 1993-94 tax settlements.

Because of the overall positive results, we recommend that the Legislature continue the settlement program at the FTB with a review scheduled in five years to determine whether the settlement program continues to be more efficient and as effective as the FTB's other methods of resolving tax disputes.

Background Chapter 449, Statutes of 1992, expanded for fiscal year 1992-93, the FTB authority for settling income tax disputes. A part of the Legislature's intent in enacting the tax settlement program was to empower the FTB to resolve many long outstanding tax disputes without resorting to lengthy and expensive court battles. The settlement program was also intended to encourage speedy resolution of outstanding tax disputes to generate an estimated \$300 million in additional revenue for fiscal year 1992-93.

Chapter 449 allows the FTB to settle tax disputes only under certain conditions. To be eligible, a civil tax matter dispute must have existed on July 1, 1992. The FTB is responsible for reviewing each case for

eligibility and appropriateness for settlement. Once the FTB negotiates with the taxpayer and reaches a proposed settlement, the law requires that the FTB submit the case for a review by the Attorney General's Office (AGO). The AGO has 30 days to conclude on whether the proposed settlement is reasonable from an overall perspective. If it concludes that the tax settlement is reasonable, the FTB's staff then submits the tax settlement to the three-member Franchise Tax Board for approval. The three-member Franchise Tax Board has 45 days to approve a settlement. If it does not act within 45 days, the recommendation is deemed approved. This law was scheduled to expire on June 30, 1993, but has been extended for one year under Chapter 155, Statutes of 1993.

Tax disputes arise from the FTB's enforcement of the State's income and franchise tax laws. The tax dispute process normally consists of four steps: audit, protest, appeal, and litigation. A dispute generally occurs after the FTB audits a taxpayer and assesses additional taxes. If the taxpayer disagrees with the FTB's assessment, the assessment becomes a protest. In the protest phase, the FTB's staff performs a detailed review of the case and issues a conclusion on the case. If the FTB concludes against the taxpayer and the taxpayer still disagrees, the taxpayer can appeal the case to the State Board of Equalization (BOE). The BOE will rule on the case based on information from the FTB and the taxpayer. If the BOE decides in favor of the FTB, the taxpayer must pay the tax and either drop the dispute or litigate the case if they still dispute the assessed tax. When deciding to litigate the case, the taxpayer must prepay the disputed tax. If the taxpayer is successful in court, the prepayment is refunded with interest. The taxpayer may also avoid the protest and appeals processes by paying the tax and then taking the case to litigation.

During the protest and appeals processes, the taxpayer may also pay the disputed taxes to stop the accrual of interest. If the FTB eventually loses the dispute, it will generally be liable to refund the disputed tax along with accumulated interest to the taxpayer. The taxpayer may also elect not to pay the disputed tax during the protest and appeals processes. However, upon losing the tax dispute, the taxpayer will be liable for the tax and accumulated interest.

Not all tax disputes are appropriate for the settlement program. The settlement program is voluntary for the FTB and the taxpayer. To be considered for settlement, the minimum amount the FTB would be willing to accept would have to be less than the maximum amount the

taxpayer would be willing to pay. In making these determinations, both the FTB and taxpayer estimate the expected value of the disputed taxes that would be sustained in the alternate protest, appeals, and litigation processes. They both also consider when the dispute would be resolved, the expenses of the protest, appeals, and litigation processes, and the value each party places on receiving or paying money sooner rather than later.

Chapter 449 requires that the Office of the Auditor General report to the Legislature no later than December 1, 1993, concerning the merits of the settlement program established by this act. However, the Office of the Auditor General closed in December 1992. The Bureau of State Audits, created in California Government Code, Section 8543, has assumed responsibility for the audits formerly conducted by the Office of the Auditor General. The FTB was to submit a similar report by October 1, 1993, which it submitted to the Legislature on December 9, 1993.

**Scope and
Methodology**

To determine the merits of the tax settlement program, we performed the following procedures.

We compared the average number of months needed to resolve cases in the settlement program with the average number of months to resolve cases in the protest, appeals, and litigation processes to determine whether the settlement program shortened the tax dispute process.

We also compared the tax-sustained rate of the settlement program to the tax-sustained rate of cases resolved in the protest, appeals, and litigation processes to determine if the settlement program had similar results. The tax-sustained rate is the ratio of taxes agreed by both parties to be paid to the State divided by the total taxes in dispute.

The information we used to compute the average time in process and the historical tax-sustained rates described above is based on the following:

Protest

- For the average time in protest, we selected a sample of 100 of approximately 1,200 bank and corporation cases and a sample of 50 of approximately 300 personal income tax cases closed from January 1984 through October 1993. However, the data in this report could understate the time in the protest process because, in some cases, the FTB changed the assigned date when the case was reassigned to a different employee. For the tax-sustained rates, we included all bank and corporation and personal income tax cases closed from January 1984 through October 1993.

Appeals

- All bank and corporation and personal income tax cases closed from January 1990 through October 1993.

Litigation

- All bank and corporation and personal income tax cases closed in fiscal years 1991-92 and 1992-93.

We attempted to compute the average number of hours to resolve a case in the settlement, protest, appeals, and litigation processes and use this average for comparison. However, we could not perform this comparison because the FTB's legal division and settlement bureau staff were not consistently charging their time to individual cases.

Most cases resolved in the settlement program had previously been in the protest and appeals processes. Therefore, when the cases moved to the settlement program, the effort the FTB and taxpayers previously expended in establishing the facts of the various cases influenced the time needed to resolve the cases and the tax-sustained rates. To minimize this influence, we identified 11 closed settlement cases that came directly to the settlement program from audit or that spent minimal time in protest and appeals. We then identified 14 cases closed in protest, 14 cases closed in appeals, and 18 cases closed in litigation that were similar in issue and dollar amount and compared the

months in process and tax-sustained rates with the 11 settlement cases. We performed this analysis for bank and corporation cases only as we could identify only one personal income tax case that came directly to the settlement program.

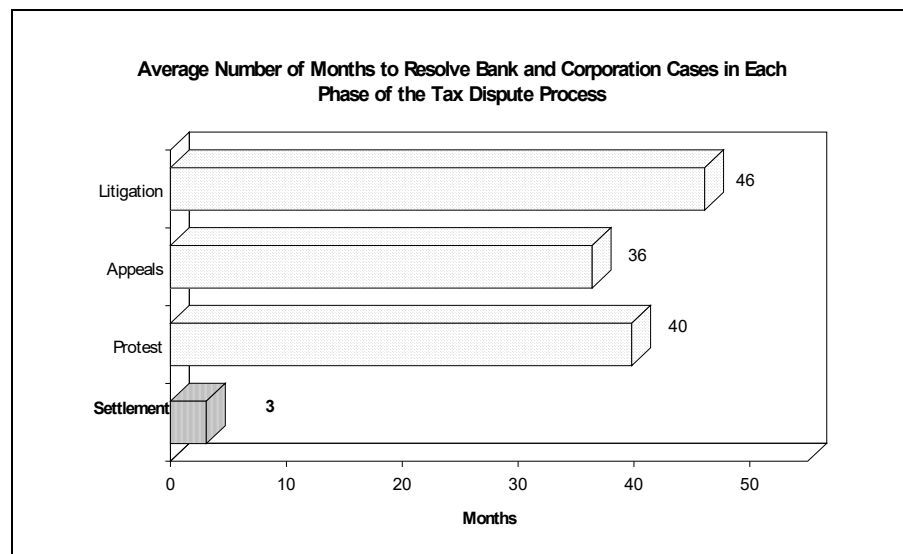
We reviewed and analyzed the accelerated collections resulting from fiscal year 1992-93 tax settlements and computed the overall results for the cases settled. We also reviewed the reasonableness of the FTB's projected collections from fiscal year 1993-94 tax settlements.

We computed the cost to administer the FTB settlement program during fiscal year 1992-93. We also determined the cost for the AGO's review of FTB-proposed tax settlements.

**Settlement
Program Cases
Require Fewer
Months To
Resolve**

In comparison with cases closed in the protest, appeals, and litigation processes, settlement cases require less time, in terms of months, to close and obtain payment from the taxpayers. As shown in Figure 1, the 99 bank and corporation settlement cases required an average of approximately 3 months to process. This is significantly less than the time the FTB has taken historically to resolve bank and corporation cases in the protest, appeals, and litigation processes.

Figure 1

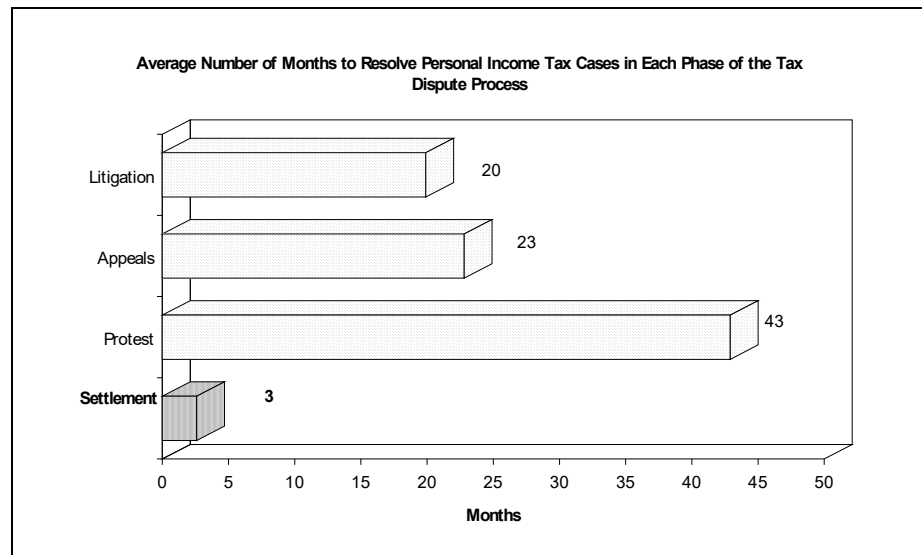


The 46 months on average spent in litigation does not include time previously spent in protest and appeals. For example, we identified a bank and corporation case that spent 48 months in protest, 71 months in appeals, and 19 months in litigation for a total of 138 months in dispute.

In another instance, a bank and corporation case spent 19 months in protest, 60 months in appeals, and 36 months in litigation for a total of 115 months in dispute.

In addition, the 25 personal income tax settlement cases required an average of approximately 3 months to process. As shown in Figure 2, this is also significantly less time than the FTB has taken historically to resolve personal income tax cases in the protest, appeals, and litigation processes.

Figure 2



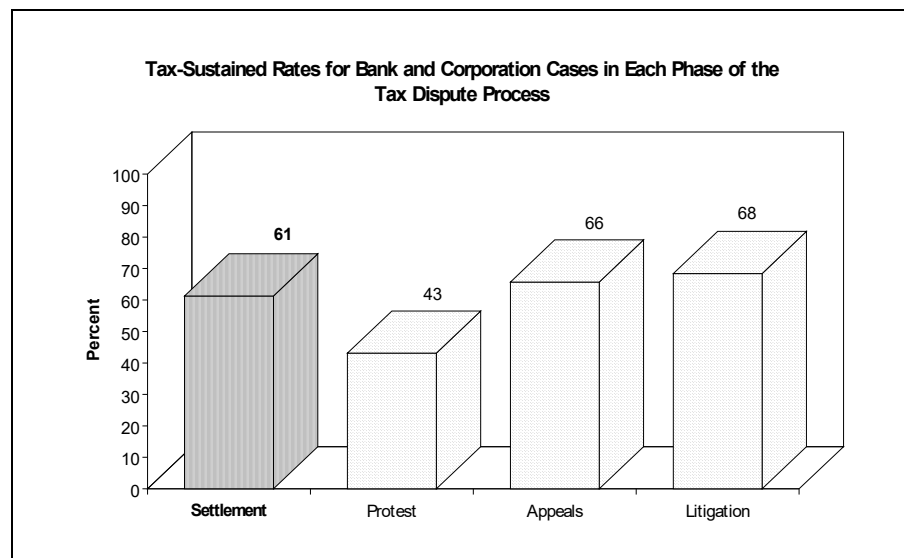
Settling the 124 cases reduced the FTB's current and future workload for resolving cases in the protest, appeals, and litigation processes. As noted earlier, we could not quantify the number of FTB staff hours charged to cases in the settlement program or compare them with the hours charged to cases in the protest, appeals, and litigation processes. However, the settlement program brings resolution to cases in one process without taking a case through up to three separate processes, including expensive litigation. Moreover, under provisions of Chapter 449, the settlement agreement is final and nonappealable. Therefore, it appears that the settlement process is less expensive to the State. Businesses involved in tax disputes also benefit because of the reduced costs for settling their disputes. Thus, it also creates a better working relationship between the FTB and taxpayers when tax disputes arise.

The settlement program may have resolved the disputed taxes for an amount that is different from what would have been eventually collected through the protest, appeals, and litigation processes. However, as the following section discusses, the settlement program for bank and corporation taxpayers sustains taxes at a rate comparable to the protest, appeals, and litigation processes.

**Settlement
Program Sustains
Taxes at a
Favorable Rate**

The 99 bank and corporation cases resolved from the fiscal year 1992-93 settlement program achieved a tax-sustained rate of approximately 61 percent. As Figure 3 shows, the settlement program rate compares favorably to the historical tax-sustained rates for bank and corporation cases resolved in the protest, appeals, and litigation processes.

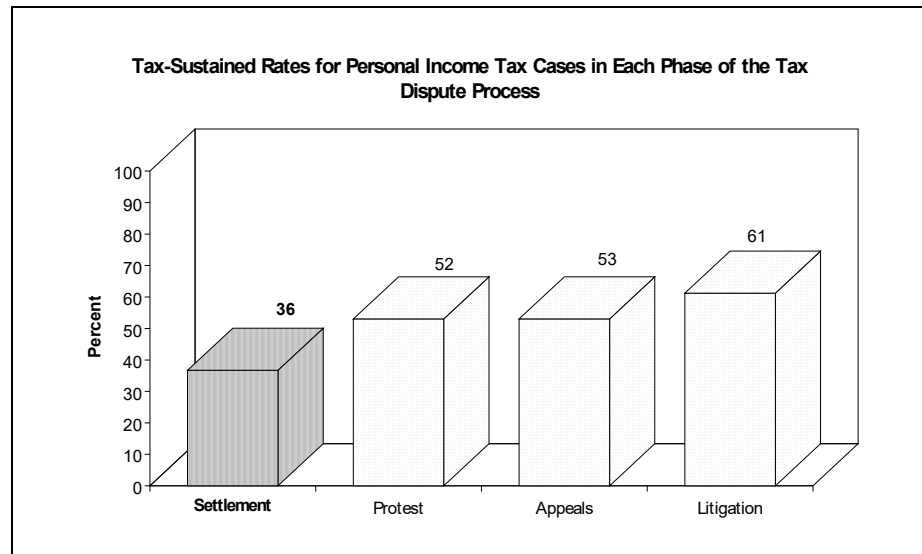
Figure 3



However, the 25 personal income tax cases resolved in settlement from fiscal year 1992-93 achieved a tax-sustained rate of approximately

37 percent. As shown in Figure 4, this rate is significantly less than the historical tax-sustained rates of the protest, appeals, and litigation processes.

Figure 4



The settlement results for personal income tax cases may not be representative because the population of settled cases is small. Also, the lower tax-sustained rate did not have a negative effect on overall accelerated collections as personal income taxes were approximately \$6 million, or only 2 percent of the total collections from fiscal year 1992-93 settlements.

Generally, the tax-sustained rate in the tax settlement program should approximate the tax-sustained rate in the protest, appeals, and litigation processes. As discussed earlier, both the FTB and the taxpayer estimate the expected value of the disputed taxes that would be sustained in the protest, appeals, and litigation processes when determining the amount for which they are willing to settle. However, an important distinction when comparing the settlement program's sustained rate with the rates achieved in the protest and appeals processes is that the settlement program actually brings in cash. Whereas cases closed in litigation also result in the collection of cash, cases closed in protest may enter the appeals process, and cases closed in appeals may enter litigation. Since the law does not require the taxpayer to pay the disputed taxes until all administrative remedies have been exhausted, the collection of cash may be delayed until the

taxpayer decides to sue the FTB.

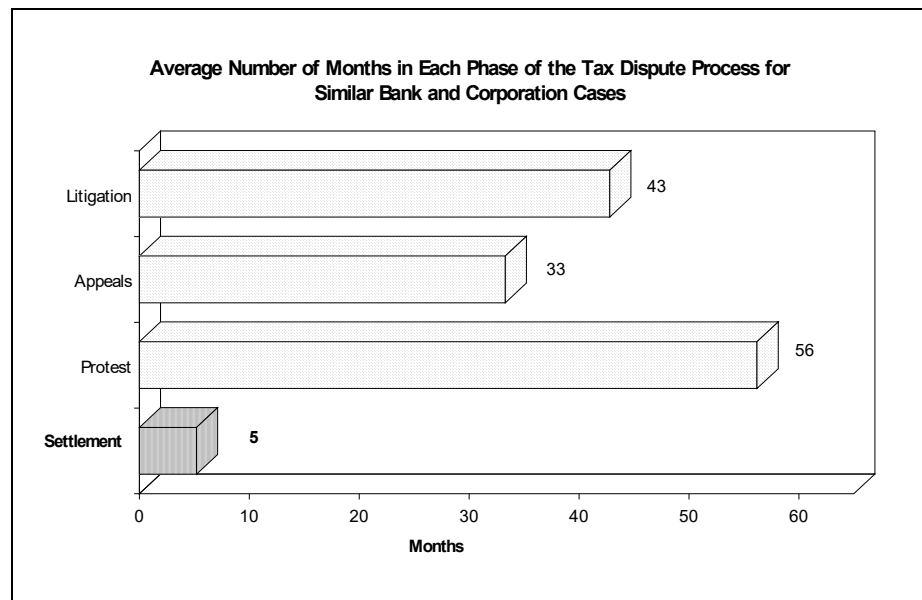
Another consideration is that most of the settled cases spent time in the protest and appeals processes. Thus, the FTB and the taxpayers have already put effort into building their cases. Their previous efforts should contribute to determining the amount of tax the two parties would finally agree to settle on. Also, their previous efforts may result in less time needed to achieve the settlement. Therefore, time spent in the FTB's other administrative processes has contributed to the tax settlement program results. This will continue if the tax settlement program is maintained because some taxpayers will begin in the protest and appeals processes and then transfer to the tax settlement program.

**For Similar
Cases, the
Settlement
Program
Achieves Similar
Results In Fewer
Months**

We compared 11 bank and corporation cases that came directly to the settlement program with 46 similar bank and corporation cases that were closed in the FTB's other administrative tax dispute processes. We found that the FTB achieved similar results in terms of taxes sustained with both the 11 settlement cases and the 46 other cases. More significant, though, is that the 11 settlement cases were resolved in significantly fewer months, thus saving the FTB and the taxpayers the expense of pursuing the cases through the lengthy tax dispute processes.

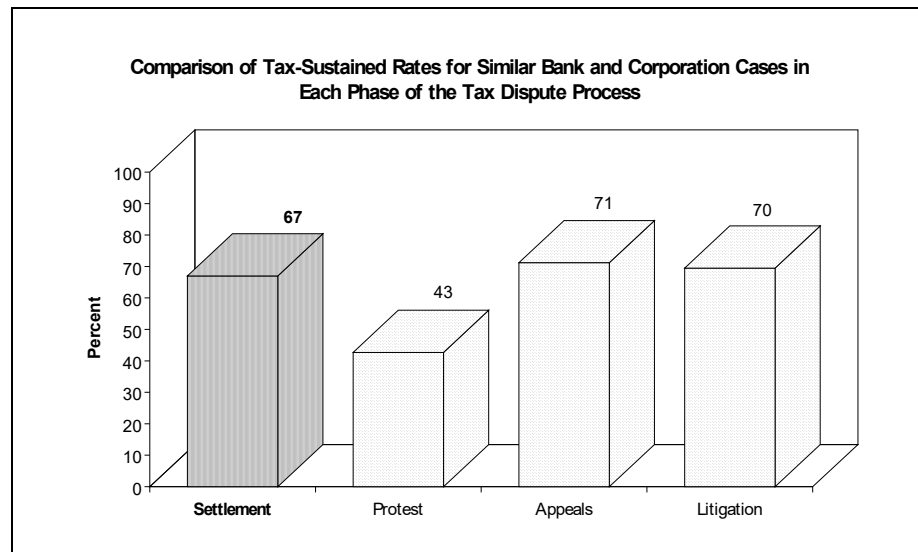
The 11 settlement cases required an average of approximately five months to process. As Figure 5 shows, the settlement cases took significantly fewer months to resolve as compared with the similar nonsettlement cases.

Figure 5



In addition, in the 11 settlement cases we reviewed, the FTB achieved a tax-sustained rate of approximately 67 percent. As shown in Figure 6, this rate is comparable to the rates for the similar nonsettlement cases.

Figure 6



Thus, for similar cases, the settlement program achieves approximately the same result in terms of the percentage of taxes sustained. Further, since the settlement agreement results in closure of the case, the

settlement process accelerates cash collection to the State and ends the workload for the FTB.

Although this comparison attempts to minimize the influence of time spent previously in the protest and appeals processes, the 11 settlement cases and 46 nonsettlement cases we compared are not exactly alike. Differences such as the taxpayers' extent of cooperation, financial positions, and types of business affect the comparison. However, since the results from this comparison are similar to the results achieved with the total population of 99 settled bank and corporation cases, we do not believe the differences between the 11 settlement cases and 46 other cases had a significant effect on the comparison.

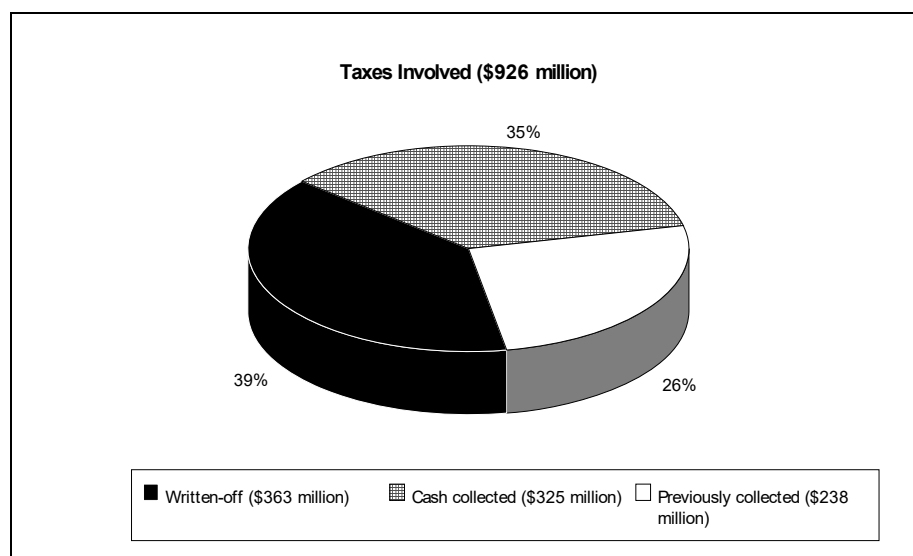
As noted earlier, we were unable to perform this analysis on personal income tax cases.

**Accelerated
Collections Under
the Settlement
Program**

Implementation of the settlement program has resulted in additional cash flow to the State. In fiscal year 1992-93, the FTB's settlement program accelerated the collection of approximately \$325 million in disputed taxes. This exceeded the FTB's goal of \$300 million in accelerated collections. The \$325 million in accelerated collections is the net of tax refunds totaling \$36 million that resulted from settlements.

The accelerated collection of cash needs to be put in perspective relative to the amount of taxes involved. Through the settlement program, the FTB resolved tax disputes totaling \$926 million. Of this amount, the settlement process sustained taxes totaling \$563 million, or 61 percent of the taxes in dispute. The remaining taxes, \$363 million, were written off by the FTB. Of the \$563 million in sustained taxes, the FTB collected \$325 million as cash and had previously collected the remaining \$238 million. Figure 7 displays how the FTB resolved the \$926 million of tax disputes.

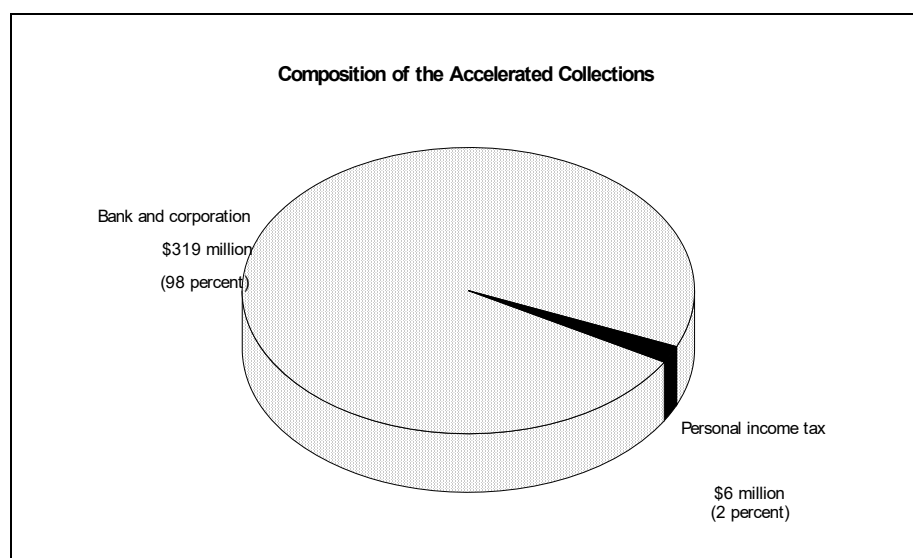
Figure 7



Thus, the settlement program has been effective in resolving large amounts of tax disputes and accelerating the related collection of cash.

As shown in Figure 8, most of the cash collected through the settlement program is from bank and corporation taxpayers. Of the \$325 million in cash collected on fiscal year 1992-93 settlements, approximately \$319 million relates to the 99 bank and corporation taxpayers, and \$6 million relates to the 25 personal income taxpayers.

Figure 8



The FTB currently projects that it will collect between \$150 to

\$200 million from fiscal year 1993-94 tax settlements. The FTB's estimate of accelerated collections for fiscal year 1993-94 are less than for fiscal year 1992-93 because the FTB gave priority to resolving cases during fiscal year 1992-93 with the highest likelihood of generating net cash receipts and because the FTB expects to make more refunds as a result of tax settlements. Based on the FTB's inventory of cases and collections of approximately \$97 million through November 16, 1993, the FTB's projected collections of \$150 to \$200 million is reasonable.

One benefit the State receives from the accelerated collections was that it could make estimated revenues of \$300 million available for appropriation during fiscal year 1992-93 that would not otherwise have been available for appropriation until later fiscal years. Additionally, the accelerated collections eliminated the possibility that the State would not realize the collections because of a decision against the State in protest, appeals, or litigation or because of a taxpayer's bankruptcy. Although it increased cash flow, the accelerated collections did not provide an economic benefit to the State resulting from increased interest earnings or decreased interest expense. Depending on when the tax liability was incurred, the interest rate for income taxes determined to be owed but not paid to the State can vary from 7 to 18 percent. However, during fiscal year 1992-93, the State earned only 4.7 percent interest on its investments and paid an average of 3.3 percent interest to borrow funds through Revenue Anticipation Notes.

**Cost of the
Settlement
Program**

The FTB spent \$1.5 million to administer the settlement program during fiscal year 1992-93. This amount includes the FTB's overhead cost allocation of \$300,000 which is incurred regardless of the settlement program's existence. Thus, \$1.2 million represents the incremental cost to the FTB to avoid future protest, appeals, and litigation costs and to accelerate the collection of these disputed taxes. However, we could not quantify the cost for the FTB and taxpayers to factually develop these cases so that they could be considered for settlement.

Chapter 449 requires that the AGO review each proposed settlement for reasonableness from an overall perspective. We feel this control is cost beneficial because it adds an independent verification of the facts

involved in each proposed tax settlement. The AGO spent approximately \$85,000 to review the FTB's fiscal year 1992-93 tax settlement agreements.

Other cost considerations include how long it takes to process cases through the tax settlement program as opposed to protest, appeals, and litigation. The longer tax disputes take to resolve, the greater the processing costs to the State and the delay in collecting disputed taxes. Another consideration is whether the settlement program sustains taxes at rate comparable to the protest, appeals, and litigation. However, as discussed earlier, the tax settlement program resolves tax disputes quickly and, for bank and corporation taxpayers, sustains taxes at a rate that is comparable to protest, appeals, and litigation.

**Ongoing
Benefits of a
Tax Settlement
Program**

Accelerated collections under the settlement program will not continue at the same level achieved in the first years of the program. The FTB settled many of its large long outstanding tax disputes during the first year of the tax settlement program. Of the \$325 million in cash collections from fiscal year 1992-93 tax settlements, \$273 million, or 84 percent, was collected from 18 of the 124 cases settled. Once the FTB resolves the present large dollar cases in its backlog, new large dollar cases will be limited to new tax disputes.

Therefore, resolving tax disputes more quickly and for amounts comparable to the protest, appeals, and litigation processes are the main long-term benefits of the FTB's tax settlement program. As our analysis shows, the cases processed through the settlement program have taken, on average, significantly less time to process. Thus, the tax settlement program can be a mechanism to avoid costly and drawn out income tax disputes. In addition, cases closed in settlement end the tax dispute for amounts that approximate what would have been collected through the protest, appeals, and litigation processes.

Also, since many other states have similar tax settlement programs, the establishment of a California income tax settlement program makes the State's tax environment similar to those states.

Recommendation

The FTB settlement program has merit, and the Legislature should pass legislation to continue its existence. However, the Legislature should include a provision for a review in five years to determine whether the

settlement program continues to resolve tax disputes more efficiently than and as effectively as those resolved in the protest, appeals, and litigation processes.

We conducted this review under the authority vested to the state auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to the those areas specified in the audit scope of this letter report.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

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The responses of the Consumer Affairs Agency and the Franchise Tax Board are attached to this letter report.