

**REPORT BY THE STATE AUDITOR
OF CALIFORNIA**

**THE BOARD OF EQUALIZATION'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 State Board of Equalization's (board) settlement program is both more efficient than and as effective as the board's other methods of resolving tax disputes. We could not quantify the number of hours the board's staff charged to settlement cases as compared with cases in petition, appeals, board hearing, and litigation; however, we were able to determine that the settlement program generally shortens the lengthy tax dispute process. Specifically, the board's settlement program resolved 94 cases in fiscal year 1992-93 in an average of 9 months as compared with a range of 7 to 46 months on average during the same period in the board's other administrative appeals processes. The settlement program creates a better working relationship between the board and taxpayers when tax disputes arise. The board settlement program also generally sustains taxes at rates comparable to the other processes the board uses to resolve tax disputes. The settlement program achieved a tax-sustained rate of 43 percent during fiscal year 1992-93 as compared with a range of 44 to 51 percent on average in the board's other administrative processes, making it as effective in resolving tax disputes as the other administrative processes.

Through the settlement program, the board resolved tax disputes totaling \$41.3 million. Of this amount, the settlement process sustained taxes, penalties, and interest totaling \$17.8 million, or 43 percent, of the amounts in dispute. The remaining amount, \$23.5 million, was written off by the board. Of the \$17.8 million in sustained taxes, penalties, and interest, the board collected \$2.4 million as cash, has \$1.4 million

outstanding on installment payment programs, and had previously collected the remaining \$14 million. The \$2.4 million of cash collections is the net of tax refunds totaling \$4.5 million that resulted from settlements.

The accelerated collections of \$2.4 million made cash available earlier for the State's needs, eliminating the possibility that the State would not realize the cash because of an adverse decision against it in petition, appeals, board hearing, litigation, or because of a taxpayer's insolvency. Moreover, the settlement of the 94 cases in fiscal year 1992-93 allows the board 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.

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

Background

Chapter 708, Statutes of 1992, expanded, for fiscal year 1992-93, the board's authority for settling sales and use tax disputes. The Legislature's intent in enacting the tax settlement program was to eliminate time consuming and costly litigation of tax issues in cases wherein neither the taxpayer nor the board is entirely confident of winning in court and to remove the low \$5,000 limit on settlements, thus allowing the board to resolve disputes without resorting to litigation.

Chapter 708 allows the board to settle tax disputes only under certain conditions. To be eligible, the civil tax dispute must have existed on July 1, 1992. The board is responsible for reviewing each case for eligibility and appropriateness for settlement. Once the board negotiates with the taxpayer and reaches a proposed settlement, the law requires that the board 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 the AGO concludes that the tax settlement is reasonable, the board's staff then submits the tax settlement to the

five-member board for approval. The board has 45 days to approve a settlement. If the board does not act within 45 days, the settlement 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 board's enforcement of the State's sales and use tax laws. The tax dispute process normally consists of five steps: audit, petition, appeal, board hearing, and litigation. A dispute generally occurs after the board audits a taxpayer and assesses additional taxes, called a Notice of Determination. If the taxpayer disagrees with the board's assessment, the taxpayer can file a petition for redetermination. In the petition phase, the board's staff performs a detailed review of the case, which can include additional information provided by the taxpayer; it then issues a conclusion on the case. If the board's staff concludes against the taxpayer and the taxpayer still disagrees, the taxpayer can request that the petition proceed to an appeals conference. At the conference, the appeals attorney or auditor will consider all pertinent information from the taxpayer and the board's staff. After the conference, the appeals attorney or auditor will prepare a written decision containing an analysis, conclusion, and recommendation on the case. If the taxpayer or the board's staff disagrees with the recommendation, the board may hear the case, ruling on the basis of information from its staff and the taxpayer. If the board decides in favor of the staff's recommendation, the taxpayer must pay the tax. If the taxpayer still believes the tax is incorrect, he or she may file a claim for refund, which must set forth all the grounds or reasons for asserting that the items are not subject to tax. If the board denies the claim for refund, the taxpayer may then take the case to court. The taxpayer may also avoid the petition and appeals process by paying the tax and filing a claim for refund. If the board denies the claim, the taxpayer may start court action.

During the petition and appeals processes, the taxpayer may pay the disputed taxes to stop the accrual of interest. If the board eventually loses the dispute, it will generally be liable to refund the disputed tax plus accumulated interest to the taxpayer. The taxpayer may also elect not to pay the disputed tax during the petition and appeals processes. However, if the taxpayer loses 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 board and the taxpayer. To be considered for the settlement program, the minimum amount the board

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 board and taxpayer estimate the expected value of the disputed taxes that would be sustained in the petition, appeals, board hearing, and litigation processes. They both also consider when the dispute would be resolved, the expenses of the petition, appeals, and litigation processes, and the value each party places on receiving or paying money sooner rather than later.

Chapter 708 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 the responsibility for the audits formerly conducted by the Office of the Auditor General. The statute requires the board to submit a similar report to the Legislature by October 1, 1993, which it did.

Scope and Methodology

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

We compared the average months for resolving cases in the settlement program with the average months for resolving cases in petition, appeals, board hearing, and litigation to determine whether the settlement program shortened the tax dispute process.

We also compared the tax-sustained rate of the settlement program with the fiscal year 1992-93 tax-sustained rate of cases resolved in the petition, appeals, and board hearing 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. All of the cases include interest accrued to the date the case was resolved, which can result in the amount of tax sustained being greater than the amount of tax originally assessed.

The information used to compute the tax sustained rates and average time in process described above is from a database maintained by the board's petition section for cases cleared during fiscal year 1992-93. The database includes the taxpayer account number, the amount of tax originally determined, the redetermined amount, the status at which the dispute was resolved, and the number of days the case was held in the dispute process. In fiscal year 1992-93, it was not mandatory that the redetermined amount be entered into the database when the cases were

cleared from the system. Thus, a zero in this field could mean that the redetermined amount was zero or that the redetermined amount was not entered. Therefore, we selected nine business codes that made up approximately 47 percent of the amount of tax determined to be owed by taxpayers as reported in the board's database for sales and use tax cases and accumulated the actual redetermined amounts for all cases in which the database showed the redetermined amount as zero. In addition, we tested another 21 cases to validate the redetermined amount listed on the petition database.

We attempted to compute the average number of hours to resolve a case in settlement, petition, appeals, board hearing, and litigation processes and use this average as a comparison. However, we could not perform this comparison because the board's legal division and settlement section staff were not consistently charging their time to individual cases. Thus, we could not obtain complete data from which to make a comparison.

Most cases resolved in the settlement program during fiscal year 1992-93 had previously been in the petition and appeals processes. Therefore, when the cases moved to the settlement program, the effort the board and taxpayers 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 seven settlement cases in fiscal year 1993-94 that were at or nearing resolution and that had come directly to the settlement program from audit or had spent minimal time in petition or appeals. We then identified nine cases closed in petition, two cases closed in appeals, and two cases closed in board hearing that were similar in issue and dollar amount, and we compared the tax-sustained rates and months in process with the seven settlement cases. To obtain the largest population of settlement cases possible, we used fiscal year 1993-94 settlement cases in which the taxpayer had returned a signed settlement agreement but the approval process was still in progress.

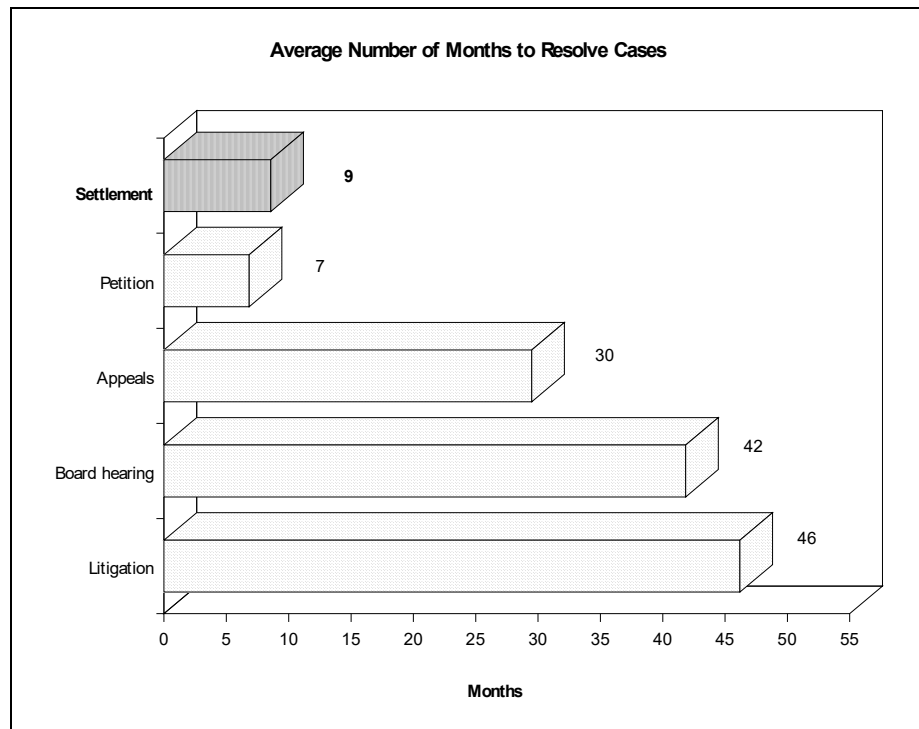
We reviewed and analyzed the accelerated collections resulting from fiscal year 1992-93 tax settlements and computed the overall results for the cases settled. We also reviewed the reasonableness of the board's projected resolution of fiscal year 1993-94 tax settlement cases.

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

In comparison with cases closed in petition, appeals, board hearing, and litigation, settlement cases require less time, in terms of months, to close and obtain payment from the taxpayers. As shown in Figure 1, the 94 settlement cases, settled in fiscal year 1992-93 required an average of nine months to process. This is comparable to the time it took in fiscal year 1992-93 for the board to resolve sales and use tax cases in petition and significantly less than the time it took for cases that closed in the appeals, board hearing, and litigation processes. Resolution time for cases that closed in appeals, board hearings, and litigation include time spent in all administrative processes from the time the tax dispute was originally filed.

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

Figure 1



Settling the 94 cases reduced the board's current and future workload of

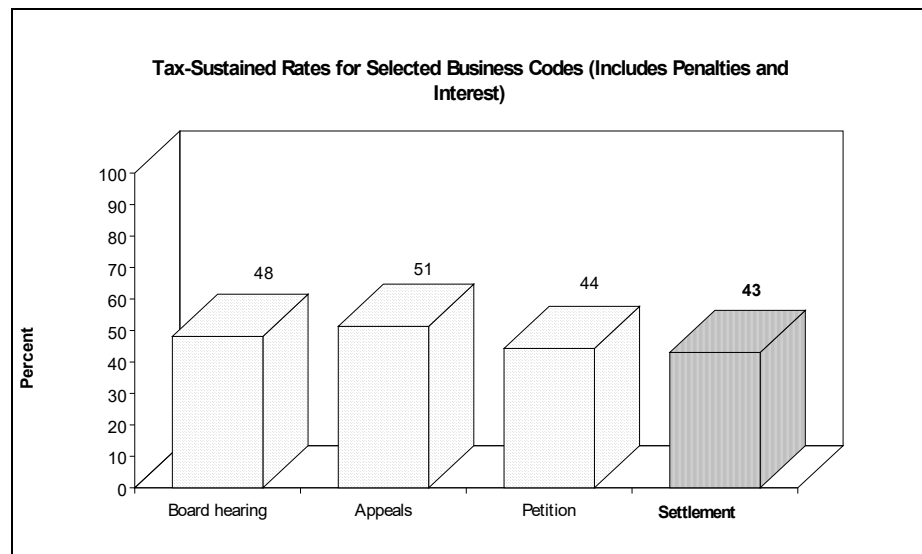
resolving the cases in petition, appeals, board hearing, and litigation. As noted earlier, we could not quantify the number of hours the board's staff charged to individual cases in the settlement program or compare them with the hours charged to individual cases in petition, appeals, board hearing, and litigation. However, the settlement program brings resolution to cases in one process without taking a case through up to four processes, including expensive litigation. Moreover, as required by Chapter 708, the settlement agreement states that the settlement is final and not appealable. 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, the settlement program creates a better working relationship between the board and the taxpayer when tax disputes arise.

The settlement program may have resolved the disputed taxes for an amount that is different from what would have eventually been achieved through petition, appeals, and board hearing. However, as the following section discusses, the settlement program for sales and use taxpayers sustains taxes at a rate comparable to petition, appeals, and board hearing.

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

The 94 sales and use tax cases resolved in the settlement process from fiscal year 1992-93 achieved a tax-sustained rate of 43 percent. As Figure 2 shows, the settlement program rate compares favorably to the fiscal year 1992-93 tax-sustained rates (for selected business codes) of 44 percent in petition, 51 percent in appeals, and 48 percent in board hearing. For the selected business codes, there were too few litigation cases to develop a tax-sustained rate for the litigation process. As noted earlier, all of the cases in this analysis include interest accrued to the date the case was resolved, which can result in the amount of tax sustained being greater than the amount of tax originally assessed.

Figure 2



Generally, the tax-sustained rate in the tax settlement program should approximate the tax-sustained rate in the petition, appeals, and board hearing processes. As discussed earlier, both the board and the taxpayer estimate the expected value of the disputed taxes that would be sustained in the petition, appeals, and board hearing processes when determining the amount for which they are willing to settle. However, an important distinction when comparing the settlement program's tax-sustained rate with the rates achieved in petition, appeals, and board hearing is that the settlement program actually brings in cash. Whereas cases entering litigation also result in the collection of cash, cases closed in petition may be reopened at a later date and enter the appeals process, and cases closed in appeals may enter litigation. For example, in our review of petition files, we identified two cases that were closed in fiscal year 1992-93 and subsequently reopened in fiscal year 1993-94. 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 board.

Another consideration is that most of the settlement cases spent time in petition and appeals. Thus, the board and the taxpayers have already put some effort into building their cases. Their previous efforts would contribute to determining the amount of tax the two parties would finally agree to settle on. Also, these previous efforts may result in less time needed to achieve the settlement. Therefore, time spent in the board's other administrative appeals processes has contributed to the

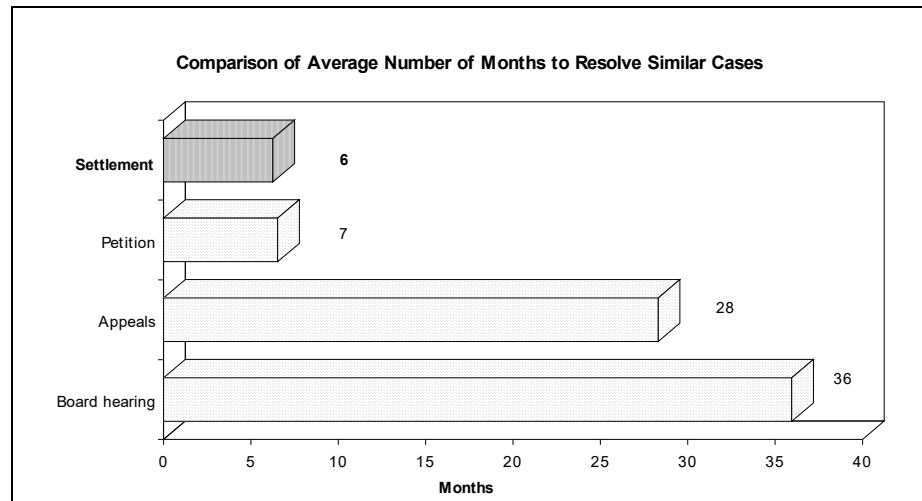
settlement program results. This will continue if the tax settlement program is maintained because some taxpayers will begin in the petition and appeals processes and then transfer to the settlement program.

For Similar Cases, the Settlement Program Achieves Similar Results in Fewer Months

We compared 7 sales and use tax cases that came directly to the settlement program with 13 similar cases that were closed in the board's other administrative dispute processes. We found that the board achieved similar results in terms of taxes sustained with both the 7 settlement cases and the 13 other cases. More significant, though, is that the 7 settlement cases were generally resolved in fewer months, thus saving the board and the taxpayer the expense of pursuing the cases through the lengthy tax dispute processes.

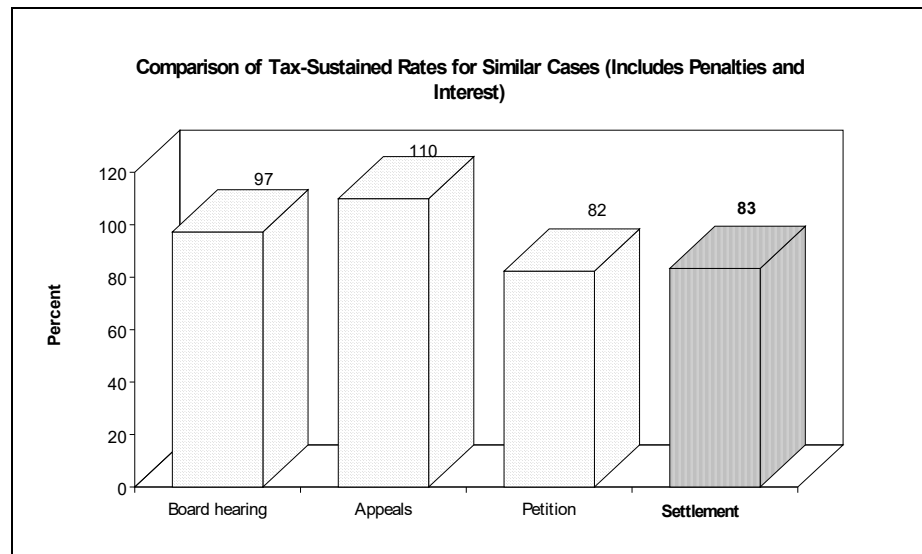
The 7 settlement cases required an average of six months to process. As Figure 3 shows, the settlement cases took fewer months to resolve as compared with the similar nonsettlement cases. All of the nonsettlement cases include time spent in all administrative processes from the time the tax dispute was originally filed.

Figure 3



In addition, in the 7 fiscal year 1993-94 settlement cases we reviewed the board achieved a tax-sustained rate of 83 percent. As shown in Figure 4, this rate is comparable to the rates for the similar nonsettlement cases. As noted earlier, all of the cases in this analysis include interest accrued to the date the case was resolved, which can result in the amount of tax sustained being greater than the amount of tax originally assessed.

Figure 4



Thus, for similar cases, the settlement program achieves approximately the same results in terms of the percentage of taxes sustained. Further, since the settlement agreement results in closure of the case, the settlement process accelerates cash collections to the State and ends the workload for the board.

Although this comparison attempts to minimize the influence of time spent previously in petition and appeals, the 7 settlement cases and 13 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. The specific tax-sustained rates for this comparison are significantly higher than those achieved for fiscal year 1992-93. We believe this is because of the few individual businesses we were able to include in our analysis of similar cases.

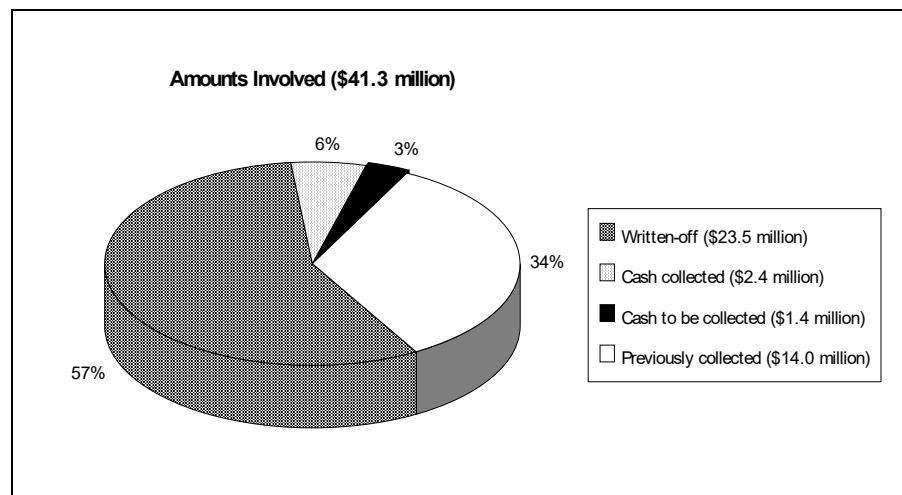
Those businesses were cocktail lounges, grocery stores, and contractors, which have a higher tax-sustained rate than the population of all industries.

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 board's settlement program accelerated collection of \$2.4 million in disputed taxes, with an additional \$1.4 million to be collected over the next 18 months under installment payment programs. This \$2.4 million is the net of tax refunds totaling \$4.5 million that resulted from settlements.

The accelerated collection of cash should be put in perspective relative to the amounts involved. Through the settlement program, the board resolved tax disputes totaling \$41.3 million. Of this amount, the settlement process sustained taxes, penalties, and interest totaling \$17.8 million, or 43 percent of the amounts in dispute. The remaining taxes, penalties, and interest, \$23.5 million, were written off by the board. Of the \$17.8 million in sustained amounts, the board collected \$2.4 million as cash, has \$1.4 million outstanding on installment payment programs, and had previously collected the remaining \$14 million. Figure 5 details how the board resolved the \$41.3 million of tax disputes.

Figure 5



Thus, the settlement program has been effective in resolving significant amounts of tax disputes and accelerating the related collection of cash. As part of the settlement agreement with 30 taxpayers, the board allowed payment of the settled amount through an installment payment

program, with all but two installment payment programs to be completed by June 1, 1994. The remaining two payment programs are to be completed by June 1, 1995. The 30 taxpayers constitute 32 percent of the 94 taxpayers with whom the board settled tax disputes. As of December 30, 1993, 3 of the 30 cases had been fully paid, all before the agreed-upon date. The amount owed to the board for the remaining 27 cases totaled \$1.4 million. We also identified 5 cases in which the taxpayer is late with the agreed-upon installment payments.

The tax settlement program accelerated collections and eliminated the possibility that the State would not realize the cash because of an adverse decision against the State in petition, appeals, board hearing, or litigation or because of a taxpayer's insolvency. Although it increased cash flow, the accelerated collections did not provide such other economic benefits to the State as increased interest earnings or decreased interest expense. During fiscal year 1992-93, the State charged taxpayers 11 percent interest for all amounts determined to be owed, but not paid, to the State, whereas it earned 4.7 percent interest on its investments and paid an average of 3.3 percent interest to borrow funds through Revenue Anticipation Notes.

For fiscal year 1993-94, the board estimates that it will resolve tax disputes totaling approximately \$5 million.

**Cost of the
Settlement
Program**

The board spent approximately \$315,000 to administer the settlement program during fiscal year 1992-93. This amount does not include the board's overhead cost allocation, which is incurred regardless of the settlement program's existence. Thus, the \$315,000 represents the incremental cost to the board to reduce future petition, appeals, board hearing, and litigation costs and to accelerate the collection of these disputed taxes.

Chapter 708 requires that the AGO review each proposed settlement for reasonableness from an overall perspective. We believe this control is cost beneficial because it adds an independent verification of the facts

involved in each proposed settlement. The AGO spent approximately \$28,000 to review the board's fiscal year 1992-93 proposed tax settlement agreements.

Other cost considerations include how long it takes to process cases through the settlement program as opposed to petition, appeals, board hearing, 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 a rate comparable to petition, appeals, board hearing, and litigation. However, as discussed earlier, the settlement program resolves tax disputes in fewer months and sustains taxes at a rate that is comparable to petition, appeals, and board hearing.

**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 board settled several large, long outstanding tax disputes during the first year of the tax settlement program. Of the \$17.8 million in sustained taxes from fiscal year 1992-93 tax settlements, \$11.8 million, or 67 percent, relates to six cases. Once the board resolves the 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 petition, appeals, and board hearing processes are the main long-term benefits of the board'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 sales and use tax disputes. In addition, cases closed in settlement end the tax dispute for amounts that approximate what would have been achieved through the petition, appeals, and board hearing processes.

Recommendations

The board's settlement program has merit and the Legislature should pass legislation to continue its existence. However, the Legislature should also 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 board's other administrative appeals 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 those areas specified in the audit scope of this letter report.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

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The response of the Board of Equalization is attached to this letter report.