

California State Auditor

B U R E A U O F S T A T E A U D I T S

State Board of Equalization:

*Its Tax Settlement Program
Continues to Have Merit*



July 1999
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SUMMARY

Audit Highlights . . .

Our review of the State Board of Equalization's (BOE) tax dispute settlement program found that the program continues to have value. Specifically, it has:

- Generally resolved tax disputes more quickly than the other tax dispute resolution processes.*
- Sustained taxes at 71 percent as compared to 28 percent to 65 percent in BOE's other tax dispute processes. However, total taxes sustained in settlement has decreased since fiscal year 1992-93.*
- Increased its cash collections at the time of settlement from an initial \$2.4 million to an average of \$6.8 million in the past three years.*

Moreover, the settlement program may create a better working relationship between the taxpayer and the BOE.

RESULTS IN BRIEF

The settlement program of the State Board of Equalization (BOE) has remained both more efficient than and as effective as the BOE's other methods of resolving tax disputes. We reported similar results when we audited the program for fiscal year 1992-93, its first year. We could not quantify the number of hours the BOE's staff charged to settlement cases as compared with hours charged to cases in petition, appeal, board hearing, and litigation; however, we did determine that the settlement program generally shortens the lengthy tax dispute resolution process. Specifically, the settlement program resolved 422 cases during fiscal years 1995-96 through 1997-98 in an average of 10 additional months after they had been in other dispute resolution processes for an average of 9 months. In comparison, the BOE's other dispute resolution processes resolved 7,350 cases in an average time ranging from 8 months for petition to 66 months for litigation. These times represent cumulative time elapsed from the date of petition through final resolution and include time for the Attorney General's Office (attorney general) to review proposed settlements and time for any board approval of disputes except those litigated. We previously reported that the BOE's settlement program resolved 94 cases in fiscal year 1992-93 in an average of 9 months, excluding time spent in other dispute resolution processes.

The settlement program potentially creates a better working relationship between the BOE and taxpayers when tax disputes arise. It also generally sustains taxes at rates comparable to or better than those for the other processes the BOE uses to resolve tax disputes. The settlement program had an average tax-sustained rate of 71 percent for fiscal years 1995-96 through 1997-98, while other dispute resolution processes had rates ranging from 28 percent to 65 percent in fiscal year 1997-98. The settlement program's rate represents a significant increase over the 43 percent rate reported for fiscal year 1992-93 in our initial audit.

Through the settlement program, the BOE resolved tax disputes totaling \$53.6 million including penalties and interest during the past three fiscal years. Of the total disputed amount, the settlement process sustained \$38 million in taxes, with the

remainder settled in the taxpayers' favor. As a result of the settlement agreements, the BOE collected \$20.2 million and allowed \$4.8 million to be collected through payment plan programs. In addition, it had collected approximately \$13 million before the settlement agreements were reached.

As a result of the settlement program collections, the BOE eliminated the possibility that the State would lose this money through an adverse decision or because of a taxpayer's insolvency. Moreover, settlement of an average of 141 cases per year, an increase of 50 percent over the fiscal year 1992-93 caseload, allowed the BOE to direct its resources to resolve other new or existing tax disputes.

Although the settlement program has many merits, it shows diminishing returns in some areas. Specifically, the total dollar amount sustained declined nearly 30 percent, from \$17.8 million in fiscal year 1992-93 to a yearly average of \$12.7 million during the three fiscal years ending with fiscal year 1997-98. The BOE expected the decline in tax-sustained amounts because several large, long-outstanding tax disputes were settled during the first fiscal year of the settlement program. In addition, although we found the costs to be reasonable, the costs to administer the program increased from \$315,000 for the 10 months the program operated in fiscal year 1992-93 to an average of \$637,000 per year for the three fiscal years ending with fiscal year 1997-98.

RECOMMENDATIONS

The BOE's settlement program has merit and should be continued. However, given the mixed results of the settlement program, the BOE should perform annual reviews and compare the program to other administrative dispute resolution processes to ensure its continued viability. In addition, the BOE should report to the Legislature biennially on the results of its reviews. This monitoring will determine whether the settlement program continues to resolve tax disputes more efficiently and effectively than do the BOE's other dispute resolution processes.

AGENCY COMMENTS

The BOE agrees that its settlement program has merit and should be continued; however, it disagrees with our recommendation that it perform periodic assessments of the program similar to the assessment in this report. The BOE argues that it has other ways of assessing the program and generating additional comparative data would be costly. ■

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INTRODUCTION

BACKGROUND

Chapter 708, Statutes of 1992, expanded the Board of Equalization's (BOE) authority for settling tax disputes for fiscal year 1992-93. The Legislature's intent in enacting the settlement program was to eliminate time-consuming and costly litigation of tax issues in cases where neither the taxpayer nor the BOE is entirely confident of winning in court, and to remove the low \$5,000 limit on settlements. Chapter 138, Statutes of 1994, extended indefinitely the BOE's authority for settling any civil tax matter in dispute.

Current law allows settlements of disputed civil tax matters that are the subject of petitions, appeals, or refund claims, consistent with a reasonable evaluation of the costs and risks associated with litigation of the dispute. The BOE is responsible for reviewing each case for its appropriateness for settlement. Once the BOE negotiates with the taxpayer and reaches a proposed settlement, the law requires that it submit the case for a review by the Attorney General's Office (attorney general). The attorney general has 30 days to conclude whether the proposed settlement is reasonable from an overall perspective. The BOE's five-member board (board) has 45 days to approve any settlement the attorney general finds reasonable.

Tax disputes arise from the BOE's enforcement of the State's tax laws, primarily for sales and use taxes. The tax dispute process normally consists of five steps: audit, petition, appeal, board hearing, and litigation. A dispute generally occurs after the BOE audits a taxpayer and assesses additional taxes by issuing a Notice of Determination. A taxpayer who disagrees with the assessment can file a petition for redetermination. In the petition phase, the BOE's staff performs a detailed review of the case, which can include additional information provided by the taxpayer, and then issues a conclusion on the case. If the staff and the taxpayer still disagree, the taxpayer can request that the petition proceed to an appeal conference. At the conference, the appeal attorney or auditor considers all pertinent information from the taxpayer and the BOE's staff. After the conference, the appeal attorney or auditor prepares a written decision containing an analysis, conclusion, and recommendation. If the

taxpayer or staff disagree with the recommendation, the board may hear the case, ruling on the basis of information from its staff and the taxpayer. When the board decides in favor of the staff's recommendation, the taxpayer must pay the tax. A taxpayer who still believes the tax is incorrect 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 BOE denies the claim for refund, the taxpayer may then take the case to court. Taxpayers who have not been audited or assessed but believe they have overpaid may also file a claim for refund. Review of the claim may include an appeal conference or a board hearing. The taxpayer may initiate court action if the board denies the claim.

During petition and appeal, the taxpayer may pay the disputed taxes to stop the accrual of interest. If the BOE 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 petition and appeal. However, the taxpayer will be liable for the tax and accumulated interest upon loss of the tax dispute.

Not all tax disputes are appropriate for the settlement program. The minimum amount the BOE is willing to accept must be equal to or less than the maximum amount the taxpayer is willing to pay. In making these determinations, both the BOE and taxpayer estimate the expected value of the disputed taxes that would be sustained in the petition, appeal, board hearing, and litigation processes. They both also consider when the dispute would be resolved, the expenses of the petition, appeal, and litigation processes, and the value each party places on receiving or paying money sooner rather than later.

SCOPE AND METHODOLOGY

In addition to revising the statutory authority for the settlement program, Chapter 138, Statutes of 1994, requires that the Bureau of State Audits report to the Legislature concerning the merits of the settlement program established by this act. This report follows up on our prior report issued in March 1994.

We compared the average months for resolving settlement cases with the average months for resolution reported in our prior audit and with the average months for resolving cases in

petition, appeal, board hearing, and litigation for fiscal years 1995-96 through 1997-98 to determine whether the settlement program shortened the tax dispute process.

We compared the settlement program's average tax-sustained rate for fiscal years 1995-96 through 1997-98 with the average tax-sustained rate of cases resolved in the petition, appeal, board hearing, and litigation processes for fiscal year 1997-98 to determine if the settlement program had similar results. The tax-sustained rate is the ratio of taxes agreed upon by both parties to be paid to the State divided by the total taxes in dispute. In addition, we compared these rates to the settlement program tax-sustained rate from fiscal year 1992-93.

We reviewed and compared settlement program cash collections for resolved tax disputes from three fiscal years, 1995-96 through 1997-98, with the cash collected during the first fiscal year of the program, 1992-93.

For all resolution processes, we vouched selected data provided by BOE from the most recent period's summary report to case files or other supporting documentation. For the settlement program, we also vouched selected data provided by BOE from the past three complete years' summary reports to case files.

We attempted to compute the average number of hours to resolve a case in settlement, petition, appeal, board hearing, and litigation. However, we could not perform this comparison because the BOE's staff did not consistently charge their time to individual cases. Thus, we could not obtain complete data from which to make a comparison.

We computed the average cost to administer the BOE's settlement program during three fiscal years, 1995-96 through 1997-98, to determine its cost-effectiveness. We also determined the average cost for the attorney general's review of the BOE's proposed tax settlements for those same three fiscal years. ■

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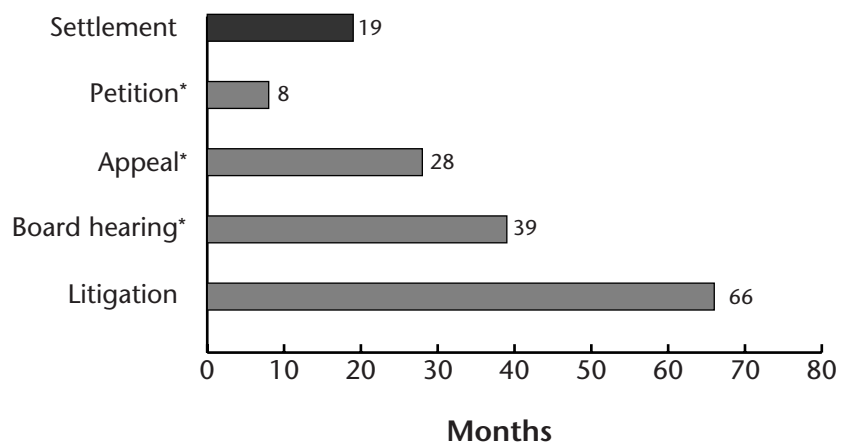
AUDIT RESULTS

SETTLEMENT PROGRAM CASES GENERALLY REQUIRE FEWER MONTHS TO RESOLVE

In comparison with cases closed in appeal, board hearing, and litigation, settlement cases require less time on average to close and obtain payment from the taxpayers. However, as shown in Figure 1, the 422 cases resolved during fiscal years 1995-96 through 1997-98 required an average of 10 additional months to process in settlements after spending 9 months in other resolution processes. This is longer than it takes to resolve disputes through petitions alone and approximately 1 month longer than the average of 9 months specifically for settlements for fiscal year 1992-93. The Board of Equalization (BOE) resolved approximately 7,350 cases through these other processes during this time period. Figure 1 depicts the cumulative time elapsed from the date of petition through final resolution and includes time for the Attorney General’s Office (attorney general) to review proposed settlements and time for BOE’s five-member board (board) to approve any disputes except those litigated.

FIGURE 1

Average Cumulative Months from Taxpayers’ Filing of Dispute to Final Resolution for Each Process (Fiscal Years 1995-96 Through 1997-98)



* Averages for petition, appeal, and board hearing include cases closed in settlement; however, the effect is minimal.

Settling the 422 cases reduced the BOE's current and future workload of cases in petition, appeal, board hearing, and litigation. We could not quantify the number of hours the BOE's staff charged to individual cases in the settlement program or compare them with the hours charged to individual cases in petition, appeal, board hearing, and litigation. However, the settlement program may bring resolution to cases in one step without the case progressing through up to four additional steps, including expensive litigation. Moreover, as required by Chapter 138, the settlement agreement specifies that the settlement is final and not appealable, unless there is evidence of fraud or misrepresentation of material facts. Therefore, the settlement process appears to be less expensive for the State. Businesses involved in tax disputes also benefit because of the potential for reduced costs for settling their disputes. Thus, the settlement program potentially creates a better working relationship between BOE and the taxpayer when tax disputes arise.

The 422 cases resolved in the settlement program represent one-third of the 1,270 cases considered during the three years reviewed. Of the remaining 848 cases, 80 (6 percent) did not qualify for settlement and 140 (11 percent) were withdrawn from the program by taxpayers for other reasons, while the BOE and the taxpayers in 628 (49 percent) of the cases could not agree on a settlement amount or terms.

THE SETTLEMENT PROGRAM SUSTAINS TAXES AT A FAVORABLE RATE TO THE STATE

The settlement program increased its tax-sustained rate from 43 percent to 71 percent.

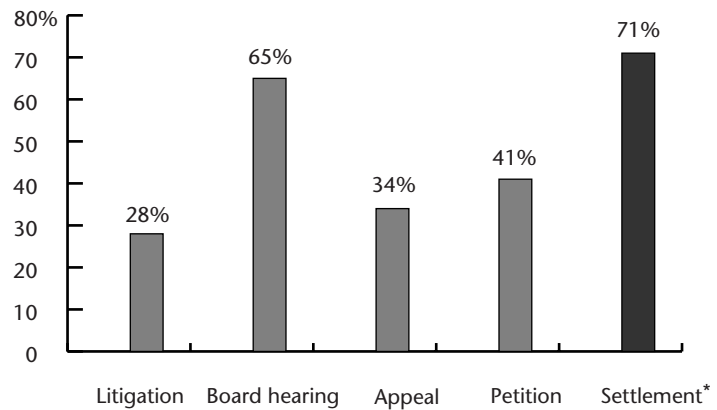
The settlement program may resolve disputed taxes for an amount that is different from what would have eventually been achieved through other resolution processes. However, the settlement program sustains taxes at a rate comparable to or better than petition, appeal, board hearing, and litigation.

The 422 cases resolved in the settlement process from fiscal years 1995-96 through 1997-98 achieved an average tax-sustained rate of 71 percent, ranging from an average of 68 percent to 76 percent annually. As Figure 2 shows, the settlement program rate compares very favorably to the fiscal year 1997-98 tax-sustained rates of 41 percent in petition, 34 percent in appeal, 65 percent in board hearing, and 28 percent in litigation. However, the tax-sustained rate for litigation was adversely affected by a large case resolved in the taxpayer's favor that represents 61 percent of all amounts disputed through litigation

for the year. Without this large case, the litigation tax-sustained rate is 72 percent. Finally, the settlement program's average tax-sustained rate of 71 percent for fiscal years 1995-96 through 1997-98 exceeded the 43 percent rate achieved in the program's first fiscal year, 1992-93.

FIGURE 2

The Settlement Program Sustains Taxes at a Rate Comparable to or Better Than Those for Other Processes



* Settlement percentage averages data from fiscal years 1995-96 through 1997-98. Other percentages are based on fiscal year 1997-98 data.

Generally, the settlement program's tax-sustained rate should approximate that of the other dispute resolution processes. However, an additional distinction when comparing its tax-sustained rate with the rates achieved in petition, appeal, and board hearing is that the settlement program actually begins collection of the amounts sustained. While cases entering litigation also result in cash collections, cases in petition, appeal, and board hearing may not result in any immediate cash collections since the law does not require the taxpayer to pay the disputed taxes until all administrative remedies have been exhausted. Cash collections may be delayed until the taxpayer resolves the case with the BOE or decides to begin litigation by suing the BOE.

Another consideration is that most of the settlement cases have already spent time in petition and appeal. Thus, the BOE and the taxpayers have already put some effort into building their cases. These previous efforts probably contribute to determining

the amount of tax the two parties finally agree to settle on. This will continue because some taxpayers will begin by petitioning and appealing and will then transfer to the settlement program.

CASH COLLECTIONS FROM THE SETTLEMENT PROGRAM INCREASED

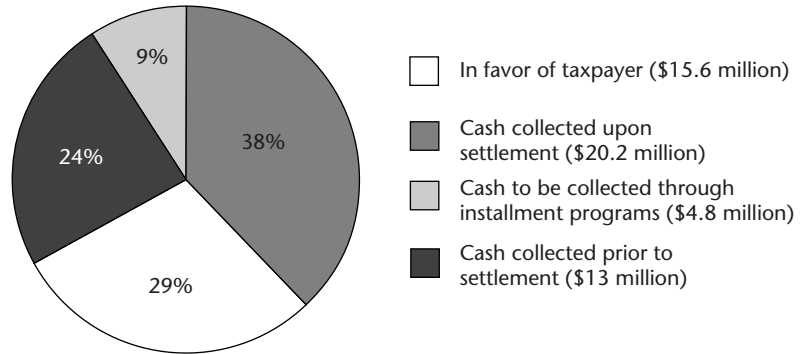
In fiscal year 1992-93, the BOE's settlement program collected \$2.4 million in disputed taxes, with an additional \$1.4 million collected over the following 18 months under payment plans. This \$2.4 million is the difference between total collections of \$6.9 million and tax refunds of \$4.5 million. During our initial review, we noted that the BOE had resolved several long-outstanding cases in which the taxpayer had already paid the disputed amounts. The effect of these cases was to eliminate the collection of cash at settlement and to increase refunds to the taxpayer. Therefore, the resolution of these older cases resulted in lower cash collections during the initial year of the program. In the three most recent fiscal years we reviewed, the settlement program increased its average cash collections, net of refunds, to \$6.8 million per year with an average of \$1.6 million to be collected through payment plans not exceeding 12 months in duration.

Cash collections at the time of settlement increased from \$2.4 million to \$6.8 million per year.

The settlement program collection of cash over the three fiscal years we reviewed should be put in perspective relative to the amounts involved. Through the settlement program, the BOE resolved tax disputes totaling \$53.6 million. Of this amount, the settlement process sustained taxes, penalties, and interest totaling \$38 million, or 71 percent, of the amounts in dispute. Decisions on the remaining taxes, penalties, and interest were in favor of the taxpayer. Of the \$38 million, the BOE collected \$20.2 million in cash and allowed \$4.8 million to be collected through installment payment programs. Taxpayers had previously paid the remaining \$13 million. Figure 3 details how the BOE resolved the \$53.6 million in tax disputes.

FIGURE 3

**Results of \$53.6 Million in Settlement Agreements
(Fiscal Years 1995-96 Through 1997-98)**



Thus, the settlement program has been effective in resolving significant amounts of tax disputes and accelerating the related collection of cash. However, as part of settlement agreements in fiscal year 1997-98, the BOE allowed 42 taxpayers to make payments in installments, with the payment plans for all \$1.9 million due to be completed by June 1, 1999. The 42 taxpayers constitute 29 percent of the 143 taxpayers with whom the BOE settled tax disputes in fiscal year 1997-98. The BOE reported four cases in which taxpayers were late with the agreed-upon installment payments.

Finally, the settlement program collected actual cash that the State may not have received if petition, appeal, board hearing, or litigation resulted in an adverse decision or because of taxpayer insolvency.

THE COSTS OF ADMINISTERING THE SETTLEMENT PROGRAM INCREASED

The BOE reports it spent an average \$637,000 annually to administer the settlement program during fiscal years 1995-96 through 1997-98. This amount does not include the overhead cost allocation, most of which is incurred regardless of the settlement program's existence. Thus, the \$637,000 represents the incremental cost to the BOE to reduce future petition, appeal, board hearing, and litigation costs and to accelerate the collection of these disputed taxes. The BOE reported the incremental costs of the program at \$315,000 for approximately

10 months in fiscal year 1992-93. The additional costs are partially due to an increase in staff needed to handle a 50 percent increase in settlement caseload.

Chapter 138 requires that the attorney general review each proposed settlement for reasonableness. We believe this control is cost beneficial because it adds an independent verification of the facts involved in each proposed settlement. The attorney general spent an average of \$37,000 annually to review the BOE's proposed tax settlement agreements for fiscal years 1995-96 through 1997-98. The increase from approximately \$28,000 for the attorney general to review the BOE's fiscal year 1992-93 proposed tax settlements appears reasonable considering the 50 percent increase in settlement program cases resolved.

In addition to resolving tax disputes quickly, the settlement program potentially creates a better working relationship between the taxpayer and the BOE.

THE SETTLEMENT PROGRAM HAS ONGOING BENEFITS

Resolving tax disputes more quickly and for amounts comparable to the petition, appeal, and board hearing processes while accelerating the related collection of cash are the long-term benefits of the BOE's settlement program. As our analysis shows, the cases processed through the settlement program have generally taken less time on average. Thus, it can be a mechanism to avoid costly and drawn-out tax disputes. Further, the number of cases the BOE has resolved through settlement has increased from 94 in fiscal year 1992-93 to an average of 141 for fiscal years 1995-96 through 1997-98, allowing it to direct its resources to resolve other new or existing tax disputes. In addition, the tax-sustained rates for cases closed in settlement approximate or exceed what would have been achieved through other resolution processes and represent a considerable improvement over rates sustained during fiscal year 1992-93. Moreover, cash collected upon settlement has increased since fiscal year 1992-93. These immediate cash collections may reduce the possibility of future losses caused by adverse decisions or because of a taxpayer's insolvency. Finally, the settlement program potentially creates a better working relationship between the taxpayer and the BOE.

Although the settlement program has merits as described above, the program shows diminishing returns in certain areas. Specifically, tax-sustained amounts are nearly 30 percent lower, going from \$17.8 million in fiscal year 1992-93 to an average of \$12.7 million over the most recent three fiscal years. However, the BOE expected the decline in these amounts because it had

settled several large, long-outstanding tax disputes during the initial year of the program. Additionally, as mentioned above, the BOE reported an increase in its costs to administer the program. Given the increase in the caseload and the BOE's stated need to include attorneys in the program, the increase in costs appears reasonable.

RECOMMENDATIONS

The BOE's settlement program has merit and should be continued. However, given the mixed results of the settlement program, the BOE should perform annual reviews of program trends and compare the program to the other dispute resolution processes to ensure its continued viability. Specifically, the BOE should do the following:

- Compare the time to resolve cases through settlement to the time to resolve cases through the other dispute resolution processes.
- Compare the tax-sustained rates achieved by settlements to those achieved by the other dispute resolution processes.
- Monitor the costs of the settlement program and compare them to the amount of revenue generated.

Further, the BOE should report to the Legislature biennially on the results of its reviews. This monitoring will determine whether the settlement program continues to resolve tax disputes more efficiently than, and as effectively as, those resolved in other dispute resolution processes and at a reasonable cost.

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

Respectfully submitted,



KURT R. SJOBERG
State Auditor

Date: July 1, 1999

Staff: Lois Benson, CPA, Audit Principal
Arthur Monroe, CPA
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Agency's response provided as text only:

State Board of Equalization
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June 21, 1999

Mr. Kurt R. Sjoberg
State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, CA 95814

Subject: Report on the Board of Equalization's Settlement Program

Dear Mr. Sjoberg:

Thank you for the opportunity to comment on the above report. My staff and I share your conclusion that the Board's settlement program has merit and should continue.

Your analysis accurately points out that settlement authority increased state revenue by millions of dollars in fiscal years 1995-96 through 1997-98 and did so with a savings of time and resources to the benefit of the State and the taxpayers who participated in the program.

The report recommends that, to ensure the settlement program's continued viability, the BOE perform annual reviews and compare the settlement program to other BOE dispute resolution processes. It recommends that the BOE report biennially to the Legislature on the results of these reviews. As data required to make the recommended comparisons is not generated in the normal operations of the other dispute programs, this would place an extraordinary requirement on the BOE. However, review of the settlement program can be readily accomplished through data generated in the operation of that program, and through existing mechanisms including the annual budget process.

Your recommendation that the settlement program has merit and should continue is appreciated. Our seven-year experience with the program indicates that it promotes sound tax administration and a better working relationship between the state and its taxpayers.

Sincerely,

(Signed by: E.L.Sorensen,Jr.)

E. L. Sorensen, Jr.
Executive Director