

California State Auditor

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

Franchise Tax Board:

*Its Tax Settlement Program Remains an
Important Alternative for Dispute Resolution*



July 1999
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SUMMARY

Audit Highlights . . .

Our review of the Franchise Tax Board's tax dispute settlement program found that the program continues to have value. Specifically, it has:

- Resolved tax disputes more quickly than the other tax dispute resolution processes.*
 - Sustained taxes at a rate of at least 61 percent since the program was initiated, recovering \$1.52 billion in taxes.*
-

RESULTS IN BRIEF

The settlement program of the Franchise Tax Board (FTB) has remained both more efficient in terms of time elapsed and generally as effective as the FTB's other methods of resolving tax disputes. We reported similar results during a previous audit of the settlement program for fiscal year 1992-93, the program's first year of operation. Although we could not quantify the number of hours the FTB staff spent on settlement cases as compared with hours spent on cases in the protest, appeal, and litigation processes, we were able to determine that the settlement program generally shortens the lengthy tax dispute process. For bank and corporation taxpayers who pay 95 percent of the taxes collected through settlements, the FTB's settlement program resolved cases in an average of 13.5 months during fiscal years 1993-94 through 1997-98, as compared with an average of 31 to 43 months in the FTB's three other administrative tax dispute processes. We previously reported that bank and corporation cases were resolved in an average of 3 months during fiscal year 1992-93. The settlement program may also create a better working relationship between the FTB and taxpayers when tax disputes arise.

The settlement program has generally sustained taxes at rates that fall within the range of rates for other administrative processes the FTB uses to resolve tax disputes. For bank and corporation cases, it achieved a tax-sustained rate of 62.7 percent during fiscal years 1993-94 through 1997-98, as compared with a range of 37.5 percent to 79.1 percent in the FTB's other administrative processes. We previously reported that bank and corporation settlements achieved a 61 percent tax-sustained rate during fiscal year 1992-93. For personal income taxpayers, who contribute the remaining 5 percent of the taxes collected through the settlement program, we found similar results.

During fiscal years 1993-94 through 1997-98, the settlement program resolved 283 bank and corporation disputes and 165 personal income tax disputes worth a total of \$2.43 billion. It sustained \$1.52 billion, or 62.7 percent, of the taxes in dispute. The remaining \$905 million was resolved in favor of the

taxpayers. Of this \$1.52 billion, the FTB actually collected \$759 million immediately upon settlement, money the State may not have otherwise received. The remainder was previously collected.

The settlement program eliminated the possibility that the State would not realize those collections because of a decision against the State in protest, appeal, or litigation or because of a taxpayer's insolvency. Moreover, because the 448 settlements resolved in fiscal years 1993-94 through 1997-98 cannot be appealed unless fraud or misrepresentation of important facts is involved, the FTB can direct its resources to resolving other new or existing tax disputes.

RECOMMENDATIONS

The FTB settlement program has merit and should be continued. However, the FTB should perform annual reviews of the program and compare the program to its other dispute resolution processes. Further, the FTB should report the results of the reviews to the Legislature every two years. This monitoring will help to ensure the settlement program's continued viability.

AGENCY COMMENTS

The FTB agrees with our conclusion concerning its tax settlement program. It also agrees to provide periodic reports of program results to the Legislature but suggests using a longer reporting cycle. ■

INTRODUCTION

BACKGROUND

Chapter 449, Statutes of 1992, expanded the authority of the Franchise Tax Board (FTB) to settle income tax disputes for fiscal year 1992-93. A part of the Legislature's intent in enacting the 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 and thereby generate an estimated \$300 million in additional revenue for fiscal year 1992-93. Through the settlement program, the FTB collected \$325 million of additional revenue during fiscal year 1992-93. Chapter 138, Statutes of 1994, eliminated the temporary nature of the settlement program and provided the necessary funding for continued operation.

Current law directs the FTB, its staff, and the Attorney General's Office (attorney general) to handle settlements of civil tax matters that are the subject of protest, appeal, or refund claims. The FTB is to base these settlements on a reasonable evaluation of the costs and risks associated with litigation. Once it negotiates a tentative settlement with the taxpayer, the FTB's executive officer and chief counsel may give final approval if the settlement results in no more than a \$5,000 reduction in taxes or penalties or both. When a proposed settlement exceeds a \$5,000 reduction in taxes and penalties, it must be reviewed by the attorney general. The attorney general has 30 days to determine if the proposed settlement is reasonable. If the attorney general finds it reasonable, the proposed settlement may then be submitted to FTB's three-member board (board) for approval. This board has 45 days to approve the settlement. If it does not act within 45 days, the recommendation is deemed approved.

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. A taxpayer who disagrees with the FTB's assessment may protest. In the protest phase, the FTB's

staff perform a detailed review of the case and issue a conclusion. If the FTB concludes against the taxpayer, the taxpayer can appeal the case to the State Board of Equalization (BOE). The BOE rules 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 may either drop the dispute or litigate the case. Even if litigating the case, the taxpayer must generally prepay the disputed amount. If the taxpayer is successful in court, the prepayment is refunded with interest. The taxpayer may also avoid the protest and appeal processes by paying the disputed amount and then taking the case to litigation immediately.

During the protest and appeal steps, the taxpayer may also pay the disputed taxes to stop the accrual of interest. If the FTB eventually loses the dispute, it is generally liable to refund accumulated interest, along with the disputed tax, to the taxpayer. The taxpayer may also elect not to pay the disputed tax during the protest and appeal steps. However, if the dispute is decided in favor of the FTB, the taxpayer is liable for both 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. The FTB can only enter into settlement agreements that are consistent with a reasonable evaluation of the costs and risks associated with litigation of the dispute. The FTB generally will not accept cases that represent little or no risk to its position or cases in which it has not fully developed the facts for a settlement.

Settlements can only be executed if there are civil tax matters in dispute and the cases contain issues for which there is some risk of loss to the State. For cases to be considered for settlement, taxpayers must make a “good faith” offer, which includes the factual and legal grounds in support of the offer. The FTB evaluates the good faith offer, considering both the law and estimated litigation risk based on the issues of each case.

Before settlement authority was granted to the FTB in fiscal year 1992-93, the taxpayer and the FTB litigated disputes that could not be otherwise resolved. In contrast, the settlement program finalizes tax liability by recognizing the risks and costs of litigating tax disputes. To illustrate this process, assume a tax dispute case with some facts that support the State’s position, while other facts support the taxpayer’s position. This creates a

situation where the State risks some loss. Similar risk arises when a dispute involves a question of law where statutory authority can be interpreted in more than one way. The settlement program allows the FTB to settle the dispute by making a concession consistent with the risk of loss to the State and the cost of anticipated litigation. Thus, if the FTB believes it faces a 25 percent risk of loss in a particular dispute, it can agree to concede up to 25 percent of the disputed tax liability.

The settlement program's intent is to provide taxpayers with an expedient method of resolving civil tax matters in dispute. The FTB's current expectation is to reach tentative settlements (subject to the approval of the board itself or, for small case settlements, the executive officer and chief counsel) in all cases accepted into the settlement program within nine months following receipt of the taxpayer's initial written request for settlement consideration and a good faith offer.

SCOPE AND METHODOLOGY

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

We compared the average time to resolve cases under the settlement program for fiscal years 1993-94 through 1997-98 with the average time to resolve cases that were protested, appealed, or litigated to determine whether the settlement program shortened the tax dispute process. Using a summary of the average number of months to resolve both personal income and bank and corporation tax cases under the settlement program for fiscal years 1993-94 through 1997-98, we verified selected data from the most recent period's summary report to case files. We could not quantify staff hours spent because, during this period, the FTB staff did not consistently charge their time to individual cases. Most cases resolved in the settlement program had previously been protested or appealed. Therefore, when the cases moved to the settlement program, the effort previously expended by the FTB and the taxpayers in establishing the facts of the various cases influenced the time needed to resolve the cases.

To determine if the settlement program had similar results, we compared the settlement program's average tax-sustained rate for fiscal years 1993-94 through 1997-98 to the average tax-sustained rate for both personal income and bank and corporation tax cases resolved in protest, appeal, and litigation over that same period. 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. We obtained the FTB's summary of the dollar amounts in dispute, the amounts sustained, and the ratio of tax sustained to the total amounts in dispute for each of the previous five fiscal years and vouched selected data from fiscal year 1997-98 to case files. We obtained the FTB's summary of similar data for the other three resolution units, vouched selected data for fiscal year 1997-98, and compared the results to those of the settlement unit for the previous five fiscal years.

We assessed the FTB's collection efforts using settlement collections for fiscal years 1993-94 through 1997-98. We compared selected data from the most recent period's summary report to case files. While the FTB established a goal of collecting an additional \$300 million through accelerated collections during fiscal year 1992-93, such specific goals were not established for subsequent years. Subsequent legislation does not establish or address any collection goals related to accelerated collections.

Finally we attempted to evaluate costs of administering the FTB's settlement program for fiscal years 1993-94 through 1997-98. Cost figures were not available for fiscal years 1996-97 through 1997-98. We also determined the cost for the attorney general's review of the FTB's proposed tax settlements. ■

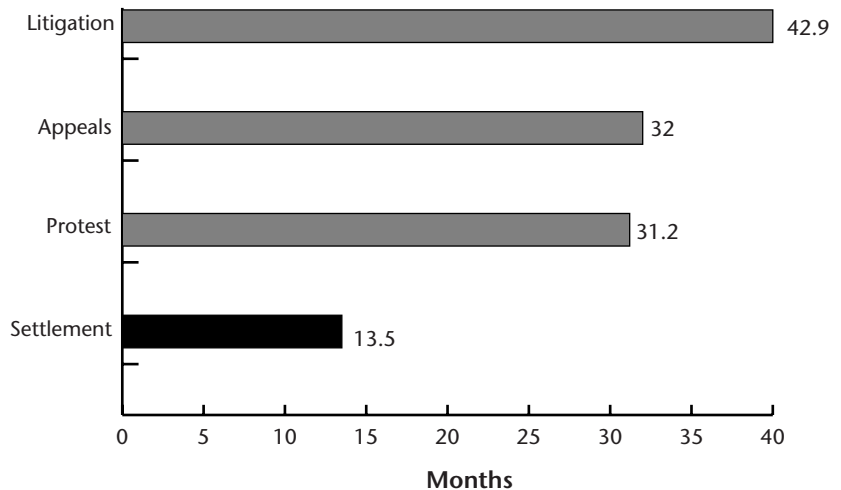
AUDIT RESULTS

SETTLEMENT PROGRAM CASES REQUIRE FEWER MONTHS TO RESOLVE

In comparison with cases closed by protest, appeal, or litigation processes, settlement cases require fewer months, on average, to obtain payment from the taxpayers and close. For fiscal year 1997-98, the 59 bank and corporation settlement cases required an average of 17 months to close. For the entire period from fiscal years 1993-94 through 1997-98, as shown in Figure 1, the 283 bank and corporation settlement cases required an average of 13.5 months to close. Yearly averages for closing cases ranged from 8.4 to 17 months.

FIGURE 1

Bank and Corporation Tax Disputes Are Resolved More Quickly Through Settlements (Fiscal Years 1993-94 Through 1997-98)



Further, the 165 personal income tax cases settled between fiscal years 1993-94 and 1997-98 required an average of 10.5 months to close and ranged from an average of 6.3 to 17.6 months

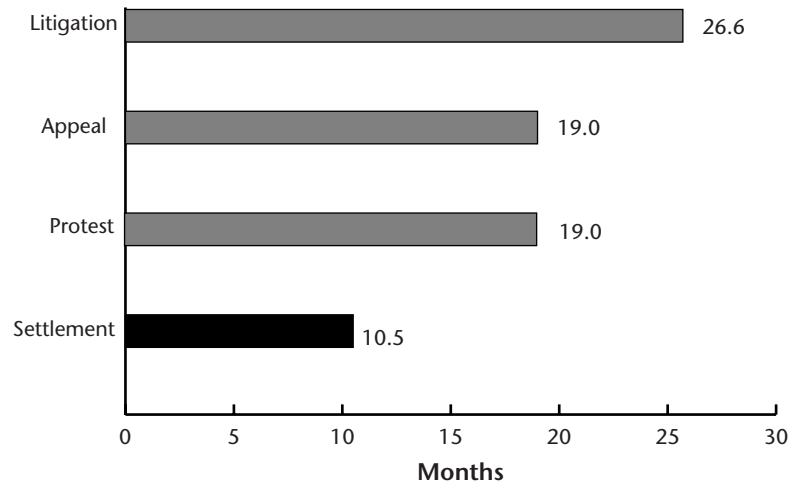
annually. This is significantly less time than the FTB has historically taken to resolve personal income tax cases in the protest, appeal, and litigation processes, as shown in Figure 2.

By settling 448 tax disputes, FTB avoided future, more lengthy, resolution processes.

Settling the 448 personal income tax and bank and corporation cases reduced the FTB’s current and future workload for resolving cases through the separate protest, appeal, or litigation processes. As noted earlier, we could not quantify the number of the FTB staff hours charged to specific cases in the settlement program or compare them with hours charged to cases being protested, appealed, or litigated. However, the settlement program accelerated resolution of cases by removing them from the potential unresolved inventory of up to three separate processes, including expensive litigation. Moreover, the settlement agreement is final and nonappealable unless fraud or misrepresentation of important facts is involved. Therefore, it appears that the settlement process is less expensive to the State. Businesses involved in tax disputes also benefit because of potential reduced costs for settling their disputes. Thus, this process may create a better working relationship between the FTB and taxpayers when tax disputes arise.

FIGURE 2

Personal Income Tax Disputes Are Resolved More Quickly Through Settlements (Fiscal Years 1993-94 Through 1997-98)



In our previous review of the FTB's settlement program, we reported the average resolution time for both bank and corporation and personal income tax cases as three months. Although this short period is significantly less than the average settlement times we determined for fiscal years 1993-94 through 1997-98, it was based on conditions that did not exist in years following the first year of the settlement program.

According to the settlement program director, the original short resolution period resulted from several factors affecting only fiscal year 1992-93 operations. Prior to the passage of settlement legislation, the FTB had a large backlog of unresolved tax dispute cases. With the passage of the settlement legislation, the FTB had a one-year window of opportunity to resolve these disputed tax cases through compromise with the taxpayer based on potential litigation risk to the State. The FTB used its new authority and resolved approximately \$1 billion of its dispute inventory during the first year. Because the original legislation only authorized the settlement program for one year, the FTB sought to resolve as many cases as possible during what it perceived to be a limited period. According to the director, resolving such a large volume of cases was possible since most cases had already been fully prepared and analyzed. This backlog of cases, and the perception that the settlement program presented a limited opportunity for resolving numerous large cases, contributed to the volume of resolutions. The director believes these factors caused the average resolution time for cases during the first year of the program to be unusually low and not representative of what the FTB expected during succeeding years.

The 448 cases resolved in the settlement program represent 43 percent of the 1,035 cases for which the settlement program made a determination during the five fiscal years we reviewed. Of the remaining 587 cases submitted, 404 did not qualify for the settlement. Dispute resolution was not attained through settlement in 183 cases.

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

The settlement program may resolve the disputed taxes for an amount that is different from what would have been eventually collected through protest, appeal, or litigation. However, the settlement program sustains taxes at a rate that falls within the range of rates sustained through protest, appeal, or litigation

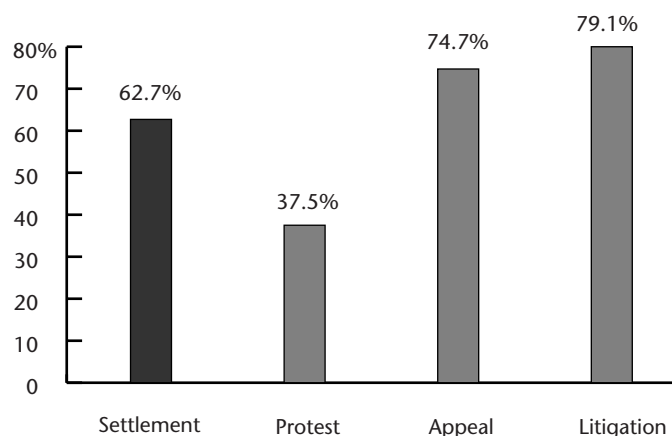
The FTB settled \$1.52 billion in tax disputes, recovering an average of 62.7 percent of the original assessment.

processes. The 59 bank and corporation cases settled during fiscal year 1997-98 achieved a tax-sustained rate of 68.6 percent. During the five-year period from fiscal years 1993-94 through 1997-98, the settlement program's yearly tax-sustained rate for bank and corporation tax disputes ranged from 59.4 percent to 68.6 percent and averaged 62.7 percent. These rates are comparable to the fiscal year 1992-93 tax-sustained rate for bank and corporation cases of 61 percent. As shown in Figure 3, the settlement program's rate falls within the range of the average rates from protest, appeal, and litigation for the same five-year period.

The tax-sustained rates for the settlement program are based on amounts received in dispute cases and in claims taxpayers submit for refunds. The benefits of the settlement program to the State include both tax dispute cases and claim cases. If these cases are sustained, the State collects additional cash from tax disputes or retains taxes paid that the taxpayer previously claimed as a refund. Therefore, recognizing the total amount sustained reflects the total benefit of the settlement program to the State. During fiscal years 1993-94 through 1997-98, the settlement program sustained \$1.52 billion resulting in additional cash collections of \$759 million. The remaining portion of the amount sustained had already been collected by the FTB as part of a disputed claim or as prepayments by the taxpayer against possible future liability.

FIGURE 3

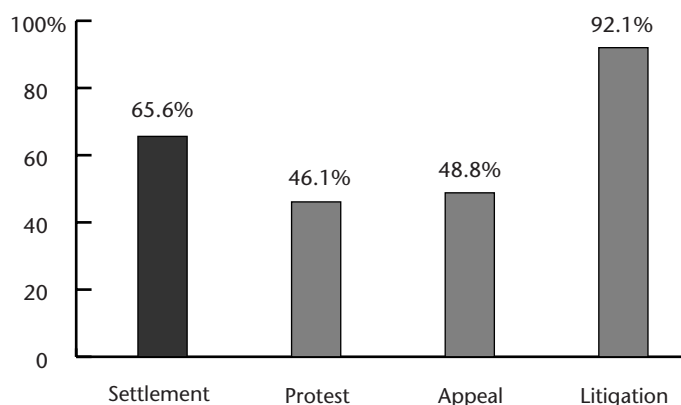
Bank and Corporation Tax-Sustained Rates for Cases in Each Phase of the Tax Dispute Process (Fiscal Years 1993-94 Through 1997-98)



During the five-year period from fiscal years 1993-94 through 1997-98, the yearly tax-sustained rate for settlements ranged from 56.2 percent to 76.5 percent and averaged 65.6 percent. This average compares very favorably with the settlement program's fiscal year 1992-93 tax-sustained rate of approximately 36 percent for personal income tax cases. As shown in Figure 4, the average falls within the range of tax-sustained rates of other resolution processes during fiscal years 1993-94 through 1997-98.

FIGURE 4

**Personal Income Tax Sustained Rates in Each Phase of the Tax Dispute Process
(Fiscal Years 1993-94 Through 1997-98)**



Generally, the tax-sustained rate in the settlement program should approximate the rate in protest, appeal, and litigation. An important distinction when comparing the settlement program's sustained rate with the rates achieved in protest and appeal is that the settlement program generally collects all the taxes due to the State prior to the final approval of the agreement. While cases entering litigation also result in cash collections, cases in protest and appeal may not result in any immediate cash collections since the law does not require taxpayers to pay disputed taxes until they have exhausted all administrative remedies. Cash collections may be delayed until taxpayers resolve cases with the FTB or begin litigation. In contrast, the resolution of disputes through settlements is final and nonappealable unless fraud or misrepresentation of material facts is involved. The settlement program also eliminates the

possibility that the State would not realize these collections because of a decision against the State in protest, appeal, or litigation, or because of a taxpayer's insolvency.

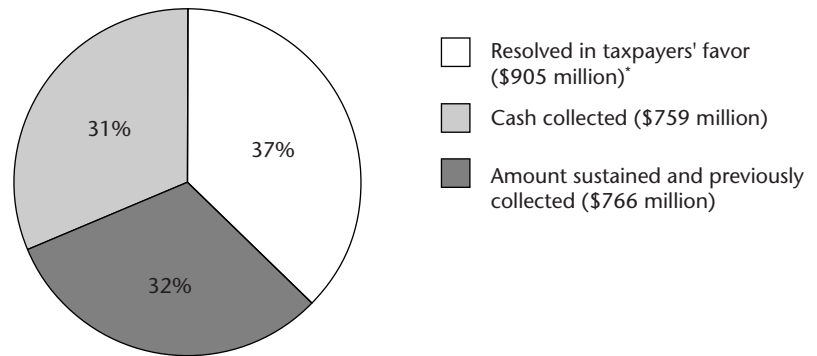
Another consideration is that most of the settled cases already went through the protest and appeal processes. Thus, the FTB and the taxpayers have already put effort into building their cases. Their previous efforts probably contribute to determining the amount of tax the two parties finally agree to 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 settlement program results. This will continue if the settlement program is maintained because some taxpayers will begin with protest or appeal and then transfer to the settlement program.

THE SETTLEMENT PROGRAM CONTINUES TO GENERATE CASH FOR THE STATE

During fiscal years 1993-94 through 1997-98, the FTB's settlement program collected approximately \$759 million in disputed taxes. Our previous report indicated the settlement program collected \$325 million during 1992-93, its first fiscal year. The cash collected through the settlement program needs to be put in perspective relative to the amount of taxes sustained. For fiscal years 1993-94 through 1997-98, the settlement program resolved tax disputes totaling \$2.43 billion. Of this amount, the settlement process sustained taxes totaling \$1.52 billion, or 62.7 percent, of the amounts in dispute. The remaining disputed amounts, \$905 million, were resolved in the taxpayers' favor. Of the \$1.52 billion, the FTB collected \$759 million upon settlement. The remainder was previously collected. Figure 5 displays how the FTB resolved the \$2.43 billion in tax disputes.

FIGURE 5

**Results of Settlement Agreements for
\$2.43 Billion in Disputed Tax Payments
(Fiscal Years 1993-94 Through 1997-98)**



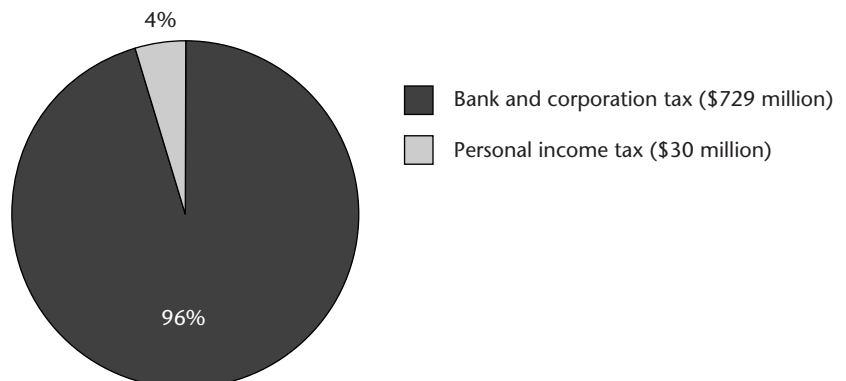
* Amount includes approximately \$162 million which was refunded to taxpayers during fiscal years 1993-94 through 1997-98.

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 6, most of the cash collected through the settlement program is from bank and corporation taxpayers. Of the \$759 million in cash collected from fiscal years 1993-94 through 1997-98 settlements, \$729 million related to bank and corporation settlements and \$30 million related to personal income tax settlements.

FIGURE 6

**Most Settlement Collections Are From
Bank and Corporation Tax Disputes
(Fiscal Years 1993-94 Through 1997-98)**



SETTLEMENT PROGRAM COSTS ARE RELATIVELY MINIMAL

The FTB spent \$3 million to operate the settlement program during fiscal years 1993-94 through 1995-96, or an average of \$1 million per year. Cost figures were not available for fiscal years 1996-97 through 1997-98. These operating costs exclude the FTB's overhead, most of which is incurred regardless of the settlement program's existence. Thus, the \$3 million represents the incremental cost to the FTB to avoid future protest, appeal, and litigation costs; to accelerate the collection of disputed taxes; and to reduce its inventory of unresolved cases. However, we could not quantify the cost for the FTB and taxpayers to develop these cases so that they could be considered for settlement.

Section 19442(b)(2) of the Revenue and Taxation Code requires that the attorney general review each proposed settlement above a designated amount. We feel this control is beneficial because it adds an independent verification of the facts involved in each proposed tax settlement. The attorney general reported spending approximately \$122,000 to review the FTB's tax settlement cases during fiscal years 1993-94 through 1997-98, for an average yearly cost during that period of \$24,400.

Other cost considerations include how long it takes to process cases through the settlement program as opposed to protest, appeal, and litigation. The longer tax disputes take to resolve, the greater the processing costs to the State and the greater the delay in collecting disputed taxes are likely to be. Another consideration is whether the settlement program sustains taxes at a rate comparable to protest, appeal, and litigation. However, as discussed earlier, the settlement program resolves tax disputes quickly and sustains taxes at a rate that falls within the range of rates for the other three phases of resolution.

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

THE SETTLEMENT PROGRAM PROVIDES LONG-TERM BENEFITS

Resolving tax disputes more quickly at rates generally comparable to protest, appeal, and litigation is the long-term benefit of the FTB's settlement program. As our analysis shows, the cases processed through the settlement program have taken, on average, significantly less time to process. Thus, the settlement program can be a mechanism to avoid costly and drawn-out tax

disputes. It also may create a better working relationship between the FTB and taxpayers when tax disputes arise. In addition, unless fraud or misrepresentation of important facts is involved, cases closed in settlement end the tax dispute at tax-sustained rates that generally approximate what would have been achieved through protest, appeal, or litigation.

RECOMMENDATIONS

The FTB settlement program has merit and should be continued. However, the FTB should perform annual reviews of the settlement program and compare it to the other administrative dispute resolution processes to ensure its continued viability. Further, the FTB should report to the Legislature biennially on the results of its review. This monitoring will ensure the settlement program continues to resolve tax disputes more efficiently than, and as effectively as, its other administrative appeal processes do.

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

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M E M O R A N D U M

To:
Kurt R. Sjoberg
State Auditor
Date: June 22, 1999

From:
Gerald H. Goldberg
Executive Officer

Subject:
Report on the Franchise Tax Board's Settlement Program
For the Period July 1, 1993 through June 30, 1998

Thank you for the opportunity to comment on the report referenced above. Your conclusion that the settlement program has merit is shared by my staff and the vast majority of taxpayers who have participated in it.

As your report points out, the settlement program sustained \$1.52 billion in disputed amounts, collecting \$759 million in cash and retaining \$766 million in potential refunds. The program continues to play an important part in the dispute resolution process. The savings of time and resources benefit both the state and the taxpayers.

With regards to your recommendation, we would be happy to report the results of the settlement program to the Legislature. We think a reporting period longer than two years may be appropriate to provide an accurate analysis of the program's trends and results. We suggest that using a five-year reporting cycle, similar to the current audit cycle, would provide the most relevant information in a timely manner.

We appreciate your recommendation that the settlement program has merit. Our experience indicates that it continues to promote solid tax administration and a better working environment between the state and its taxpaying citizenry.

(Signed by: Brian Toman for Gerald H. Goldberg)

Executive Officer