

Amend Section 7076.2 and repeal Sections 7076.6 and 7076.7 of, the Revenue and Taxation Code to delete the sunset date and restrictive criteria with respect to Section 6596 application, and the restrictive criteria to determine taxpayer eligibility for participation in the managed audit program, and to instead authorize the Board to establish the criteria which would determine taxpayer eligibility.

Source: Business Taxes Committee

Under existing law, as added by Board-sponsored SB 1104 (Ch. 686, Stats. 1997, effective January 1, 1998), the Board is authorized to determine which taxpayer accounts are eligible to participate in a Managed Audit Program (MAP) and to enter into MAP Participation Agreements with eligible taxpayers. This measure also requires the Board on or before February 1, 2001, to submit a report to the Legislature that evaluates the programmatic and fiscal benefits of the managed audit program. In 2000, the Board sponsored legislation (AB 2898, Ch. 1052) to extend the sunset date of the MAP by two years to January 1, 2003.

Managed audits are essentially self-audits. Accounts selected as part of the Board's routine audit program are reviewed to determine if the taxpayer is eligible for MAP. If the taxpayer is eligible, the auditor provides the taxpayer with written and oral instructions to enable the taxpayer to perform the audit verification and prepare the working paper schedules necessary to complete a particular portion of the audit.

Under the law, eligible taxpayers are those whose accounts meet all of the following criteria:

- The taxpayer has not received written notification pursuant to Section 6471 that he or she is required to make prepayments of tax (currently, those taxpayers with a measure of tax liability averaging \$17,000 or more per month);
- The taxpayer's business involves few or no exemptions;
- The taxpayer's business involves a single or small number of clearly defined taxability issues;
- The taxpayer agrees to participate in the MAP; and,
- The taxpayer has the resources to comply with the managed audit instructions provided by the Board.

The advantages of the MAP for the Board and for taxpayers can include:

- Resolution of questions about taxability during the audit process, thus reducing the number of audits requiring resolution through the administrative appeals process.

- More efficient allocation of audit resources to audits and other revenue-generating activities.
- Reduction in litigation of protested audits.
- Decreased disruption of a taxpayer's regular business activities since an auditor is likely to spend fewer hours at the taxpayer's place of business.
- Promotion of an ongoing cooperative relationship between the taxpayer and the Board.
- Increased understanding on the part of the taxpayer about the application of sales and use tax to his or her business.

As an added incentive to participate in the program, interest on a tax liability disclosed as a result of an approved MAP audit is computed at one-half the normal statutory interest rate for the total unreported tax liability. This is the case even if the entire audit is not performed under a MAP audit and even if the portion performed by the auditor results in a tax liability. In addition, MAP audits that result in a credit or refund compute interest using the standard running balance method. That is, if the audit has both debit and credit periods, the one-half interest rate would apply for debit periods and the full statutory credit interest rate applies for credit periods.

This proposal would: 1) delete the provisions that specify the criteria for taxpayers to participate in the MAP and would instead authorize the Board to establish regulations that maximize the effectiveness of the program; 2) delete the provision that specifies that Section 6596 (the statute that provides relief of tax, interest, and penalty in cases where the taxpayer relied on erroneous advice from the Board) shall not apply to any managed audit conducted; and 3) delete the January 1, 2003 sunset date of the managed audit program provisions.

An analysis of the first 18 months of the MAP showed the following:

Total audits initiated	20,607
Number of audits eligible for MAP	525
Percent eligible for MAP	2.5%
Number of MAP audits initiated	58
Percent participation of eligible accounts	11.0 %
Number of completed MAP audits	30
Tax liability for MAP audits	\$ 381,917
Amount of foregone interest	\$ 52,855
Number of audit hours for MAP audits	1,142
Estimated number of hours saved	719
Percent of total hours saved (719/(719+1142))	38.6%

If we project the amount of additional audit liability derived from the 719 hours saved on MAP audits at the average return per audit hour at the marginal rate for all in-state districts of \$160 per hour, the additional audit liability would be \$115,040. (719 hours x \$160 per hour = \$115,040.) The net revenue gain would be \$62,185. (\$115,040 - \$52,855.)

Removing the restrictions to participation will mean that more audits will eligible for the MAP. The Sales and Use Tax Department has estimated that the annual number of audits that would be available for MAP audits, if the current statutory restrictions on participation were repealed, would be 5,838. It is difficult to predict, however, what the participation rate would be. As an example of the revenue impact of the proposed legislation, the following table details the revenue gain if 10 percent of the eligible audits participate in managed audit program.

Average tax liability for all audits 1999-00	\$ 19,515
Estimated interest per audit 1999-00	\$ 4,879
Average hours per audit 1999-00	68
Estimated audits eligible for MAP	5,838
Estimated participation rate	10%
Estimated MAP audits	584
Estimated liability – MAP	\$11,396,888
Estimated total interest – MAP	\$ 2,849,222
Interest reduction (1/2)	\$ 1,424,611
Estimated total audit hours – MAP	39,451
Estimated hours saved (38.6%)	15,228
Tax change per hour – at margin	\$ 160
Estimated additional audit liability	\$ 2,436,499
Net revenue gain	\$ 1,011,888

In this example, the estimated net revenue gain would be just over \$1 million. The actual revenue gain would be higher or lower than this based on the participation rate. However, it does appear that the additional audit revenue from the time saved on MAP audits would more than offset the loss in interest on MAP audits.

In conclusion, although participation in the MAP has been limited, completed MAP audits have met the goals of the program. The survey indicates that limited participation has resulted primarily from the restrictions contained in current law with respect to taxpayer eligibility to participate in the program, as well as taxpayer reticence to participate in the program. Staff will continue to meet with interested parties to consider means by which taxpayers can participate more fully in the MAP process. By enabling the Board to establish regulations to determine who is eligible for participation in the MAP, and by deleting the sunset date, the maximum benefits of the program can be achieved for both the State and taxpayers. In addition, deleting the provision which prohibits the Board from granting relief of liability in cases where taxpayers who have participated in the managed audit program rely on erroneous advice from the Board and fail to pay amounts due would provide consistency with the relief provisions extended to those taxpayers who have been audited by the Board's under its normal audit selection process.

Section 7076.2 of the Revenue and Taxation Code is amended to read:

~~7076.2. Under regulations adopted by the board, The State the Board of Equalization shall determine, consistent with the efficient use of audit resources and to maximize the effectiveness of the program, which accounts are to be eligible for the managed audit program, provided that no person shall be required to participate in the managed audit program.~~

~~Persons whose accounts are eligible for the managed audit program shall include any person who meets all of the following criteria:~~

- ~~—(a) Any person who has not received written notification pursuant to Section 6471 that he or she is required to make prepayments of tax.~~
- ~~—(b) Any person whose business involves few or no statutory exemptions.~~
- ~~—(c) Any person whose business involves a single or small number of clearly defined taxability issues.~~
- ~~—(d) Any person who agrees to participate in the managed audit program.~~
- ~~—(e) Any person who has the resources to comply with the managed audit instructions provided by the board.~~

Section 7076.6 of the Revenue and Taxation Code is repealed:

~~7076.6. The provisions of Section 6596 shall not apply to a managed audit conducted pursuant to this article.~~

Section 7076.7 of the Revenue and Taxation Code is repealed:

~~7076.7. This article shall remain in effect only until January 1, 2001, and as of that date is repealed; however, any managed audit commenced pursuant to Section 7076.3 before January 1, 2001, may be completed by the board thereafter and the person whose account is audited shall remain eligible for the interest rate computation specified in Section 7076.5.~~