STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**04/01/03**	Bill No:	**AB 1043**
Tax:	**Sales and Use**	Author:	**Liu**
Board Position:	**Support** **Board-sponsored**	Related Bills:	

BILL SUMMARY

This Board-sponsored bill would grant the Board the authority to utilize a Managed Audit Program in which a taxpayer could perform an audit of their own books and records, with limited guidance from the Board, in order to determine any tax deficiencies. In return for performing the managed audit, the taxpayer would be liable for only one-half of the interest usually imposed under current law.

Summary of Amendments

The amendments added a January 1, 2009 sunset date and also added provisions requiring the Board to report to the Legislature on or before January 1, 2008 regarding various aspects of the managed audit program.

ANALYSIS

Current Law

Under existing law, the Board is authorized to examine the books, papers, records, and equipment of any person selling tangible personal property and any person liable for the use tax. The authority is granted in order to verify the accuracy of any return made, or, if no return is made by the person, to ascertain and determine the amount required to be paid.

Under various sections of the law, the payment of interest is required for failure to pay a sales or use tax liability within the time periods established by law. Generally, the only relief granted from the payment of interest is if a person's failure to pay the tax was due to an unreasonable error or delay by a Board employee, an error by the Department of Motor Vehicles in calculating the amount of use tax due, or due to a disaster.

Until January 1, 2003, the Board had the authority for a Managed Audit Program (MAP). Taxpayers who participated in the MAP were only assessed interest on audit deficiencies at one-half the normal interest rate. Since no further legislation was introduced to extend the sunset date of the MAP, as of January 1, 2003, the Board is no longer able to utilize the MAP.

Proposed Law

This bill would add Article 2.5 (commencing with Section 7076) to the Revenue and Taxation Code to grant the Board the authority to utilize a MAP. At the discretion of the Board, and consistent with the efficient use of audit resources, taxpayers who meet the following criteria could be considered candidates for a managed audit:

- Persons whose business involves few or no statutory exemptions;
- Persons whose business involves a single or small number of clearly defined taxability issues;
- Persons who agree to participate in the MAP; and
- Persons who have the resources to comply with the managed audit instructions provided by the Board.

Those taxpayers the Board selects and who agree to participate in a managed audit would be required to examine books, records, and equipment to determine unreported tax for the audit period, and make all computations and records available to Board staff for review and verification. Specifically, a managed audit agreement would include:

- the audit period;
- the types of transactions covered;
- the specific procedures the person is to follow in determining liability;
- the records to be reviewed by the person;
- the manner in which the types of transactions are to be scheduled for review;
- the time period for completion of the managed audit;
- the time period for the payment of the liability and interest; and
- such other criteria as the Board may require for completion of the managed audit.

As an incentive to participate in a managed audit, upon completion of the work and verification by the Board, Section 7076.4 would provide that any tax liability discovered would be subject to only one-half the rate of interest that would otherwise be due.

This bill would also require the Board, on or before January 1, 2008, to report to the Legislature regarding the MAP as of June 30, 2007. The report shall contain all of the following:

- The amount of taxes, penalties, and interest payments collected from taxpayers that participated in the MAP.
- The amount of interest that was forgiven as a result of the MAP.
- The amount of taxes, penalties, and interest payments that was collected as a result of redirecting the Board's audit resources away from taxpayer's participating in the MAP toward audits of other taxpayers with outstanding sales and use tax liabilities.
- Board recommendations for improving the success of the managed audit program.

This bill also contains a sunset provision that would repeal the Board's authority to utilize a MAP as of January 1, 2009.

The proposed MAP would differ from the previous MAP as follows:

- Would not exclude taxpayers on a prepayment reporting basis from participating in the MAP; and
- Would not include 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.

Background

Until January 1, 2003, the Board had the authority for a MAP for a five-year period. Managed audits are essentially self-audits. Accounts selected as part of the Board's routine audit program were reviewed to determine if the taxpayer was eligible for the MAP. If the taxpayer was eligible, the auditor provided 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.

The original MAP, as added by Board-sponsored SB 1104 (Ch. 686, Stats. 1997, effective January 1, 1998), contained a sunset provision of January 1, 2001. This measure also required the Board on or before February 1, 2001, to submit a report to the Legislature that evaluates the programmatic and fiscal benefits of the MAP. 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. Since no further legislation was introduced to extend the sunset date, as of January 1, 2003, the Board is no longer able to utilize the MAP.

Under the previous MAP, the Board was authorized to determine which taxpayer accounts were eligible to participate in a MAP and to enter into MAP Participation Agreements with eligible taxpayers. Under the law, eligible taxpayers were those whose accounts met all of the following criteria:

- The taxpayer had 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 involved few or no exemptions;
- The taxpayer's business involved a single or small number of clearly defined taxability issues;
- The taxpayer agreed to participate in the MAP; and
- The taxpayer had the resources to comply with the MAP instructions provided by the Board.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the Board of Equalization. The purpose of this bill is to reinstate the MAP that sunset as of January 1, 2003.
2. **Summary of April 1 amendments.** The amendments added the January 1, 2009 sunset date and also added provisions requiring the Board to report to the Legislature on or before January 1, 2008 regarding various aspects of the MAP.
3. **Advantages of the MAP.** 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.
4. **Interest reduction for taxpayers.** As an added incentive to participate in the program, interest on a tax liability disclosed as a result of an approved MAP audit was 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 resulted in a credit or refund computed 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 applied for credit periods.
5. **Success of the MAP.** Although participation in the previous MAP had been limited, completed MAP audits have met the goals of the program. Information gathered by the Board indicates that limited participation has resulted primarily from the restrictions contained in prior law with respect to taxpayer eligibility to participate in the program, as well as taxpayer reticence to participate in the program. Deleting the provision which prohibits the Board from granting relief of liability in cases where taxpayers who have participated in the MAP 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. Additionally, deleting the provision that prevents prepayment accounts from participating in the MAP could open up the program to

numerous taxpayers who may be willing to participate but were barred from doing so under the previous provisions.

COST ESTIMATE

Since the Board utilized the MAP until January 1, 2003, any costs associated with reinstating the MAP are expected to be absorbable.

REVENUE ESTIMATE

An analysis of the previous MAP utilized by the Board shows 142 managed audits were completed. Staff estimated that a total 4,292 audit hours were saved by taxpayers participating in the MAP. Staff also determined that foregone interest due to participation in the MAP totaled $532,096. If we project the amount of additional audit liability derived from the 4,292 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 $686,720 (4,292 hours x $160 per hour = $686,720). The net revenue gain was $154,624 ($686,720 - $532,096).

Reinstating the MAP without the restrictive criteria with respect to prepayment accounts will mean that more audits will be 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 previous statutory restrictions on participation were excluded, would be 5,838. It is difficult to predict, however, what the participation rate would be. As an example of the revenue impact of this proposal, the following details the revenue gain if 10 percent of the eligible audits participate in MAP.

1.	Average tax liability for all audits 1999-00	$ 19,515
2.	Estimated interest per audit 1999-00	$ 4,879
3.	Average hours per audit 1999-00	68
4.	Estimated audits eligible for MAP	5,838
5.	Estimated participation rate	10%
6.	Estimated MAP audits	584
7.	Estimated liability – MAP *(line 1 x line 6)*	$11,396,760
8.	Estimated total interest – MAP *(line 2 x line 6)*	$ 2,849,336
9.	Interest reduction *(line 8 x 1/2)*	$ 1,424,668
10.	Estimated total audit hours – MAP *(line 3 x line 6)*	39,712
11.	Estimated hours saved *(line 10 x 38.6%)*	15,329
12.	Tax change per hour – at margin	$ 160
13.	Estimated additional audit liability *(line 11 x line 12)*	$ 2,452,640
14.	Net revenue gain *(line 13 - line 9)*	$ 1,027,972

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

The revenue gain is the additional audit hours available to the Board based on the time savings generated by taxpayers who participate in the MAP, less the foregone interest. 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.

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