State of California

Board of Equalization

# Memorandum

To : Mr. L. Gene Mayer

Date : November 2, 1989

From : Eric F. Eisenlauer

Subject : Escape Assessments

Your staff and have raised an issue which is set forth in 's letter to me of September 22, 1989 (a copy of which is attached) as follows:

If the Board determines an escape assessment which is smaller than the total amount of those audit adjustments which increased the value of the taxpayer's property and which were due to taxpayer errors and "opinion of value" errors by the Board, is the assessment in lieu of interest to be imposed under section 864 computed with reference to: (1) only the amount of the escape assessment which is added to the roll; or (2) the total amount of such specified audit adjustments?

HYPOTHETICAL FACTS AND BACKGROUND

To help explain the specific point in issue, sets forth the following hypothetical facts (hereafter referred as "Hypothetical No. 1") relating to a state assessee by the name of SA and its property tax audit for the lien date March 1, 1985. For that year, the staff proposes that there be an escape assessment of approximately $11 million. Thus, the staff believes that SA's unitary property for such lien date was originally enrolled at a value which was $11 million less than it should have been.

In support of this escape assessment, the staff points to a number of adjustments which it determined after completing its audit of the March 1, 1985, lien date year. In essence, the staff found two adjustments which caused SA's unit value to go up, one in the amount of roughly $80 million, and a second which caused an increase of roughly $1 million. The smaller adjustment was due to "an error, other than an erroneous opinion of value, on the part of the board," but the larger adjustment was not. In addition, the staff found an adjustment in the amount of roughly $70 million which caused the unit value to go down. This adjustment was not due to "clerical errors or other errors by the board not involving exercise of judgment."

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Assume further that the Board adopts the escape assessment recommended by the staff and issues a Notice of Escape Assessment in the amount of $11 million. If the Board follows prior practice, the notice will contain no mention of specific audit adjustments (see, e.g., the copy of the Board's notice dated July 1, 1982, attached as Exhibit A to Mr. Hoenig's letter). Assuming the $11 million escape assessment is eventually enrolled by the state in 1990 and then allocated back to the respective county rolls, and assuming further a 1.08 percent aggregate county tax rate, SA would pay the counties about $119,000 in back tax for such March 1, 1985, lien date year.

The present dispute concerns how much interest SA should pay the counties, under the section 864(a) "assessment in lieu of interest" mechanism, to compensate the counties for the lost use of such $119,000 for the five-year period from 1985 to 1990.

The rate of interest and the time over which interest should accrue under section 864(a) are not in dispute, i.e., the statute provides for interest totalling roughly 40 percent to accrue on 1985 escape assessments enrolled in 1990. The question concerns the base amount against which such 40 percent interest factor should be applied. Pacific understands that the staff would calculate an assessment in lieu of interest against SA in Hypothetical No. 1 by multiplying the relevant section 864(a) percentage, i.e., 40 percent, times $80 million, i.e., the total amount of audit adjustments which increased the taxpayer's value and which were attributable to taxpayer errors or "opinion of value' errors by the Board. Using this $80 million base for the section 864(a) calculation produces an assessment in lieu of interest of $32 million. If the Board ultimately enrolled this $32 million assessment in lieu of interest, and allocated such assessment back to the counties, SA would eventually have to pay $346,000 or so to the counties on such assessment <u>to compensate them for the lost use of $119,000 for five years</u>.

believes that such an interpretation of section 864(a) as applied to the above hypothetical is clearly wrong. Instead, contends that the statute should be read as imposing an assessment in lieu of interest based on the actual escaped assessed value which is added to the tax roll, $11 million in Hypothetical No. 1. Using this base, the assessment in lieu of interest on the state roll would come out to roughly $4.4 million ($11 million times 40 percent) and, when allocated back to the counties, would require SA to pay roughly $48,000 of interest to the counties to compensate them for the lost use of the $119,000 of taxes from 1985.

believes that the only correct interpretation of section 864 is that an assessment in lieu of interest cannot be computed

with respect to any amount greater than the actual escape assessment found by the Board and added to the tax roll. believes this to be the case for primarily two reasons: (1) the plain wording of section 864(a) requires that the amount of the escape assessment which is added to the tax roll be used as the base amount against which the assessment in lieu of interest may be applied; and (2) because section 864 is intended to operate "in lieu of interest," i.e., to make the counties whole for the loss of the use of certain property taxes, it would be improper to read section 864 as imposing interest on an amount greater than the escape assessment which is added to the tax roll.

In support of its first reason, cites two additional Hypotheticals. In Hypothetical No. 2, it is assumed that the staff finds there was an "opinion of value" Board error causing the assessee's unit value to go up by $10 million and a second "opinion of value" Board error causing the unit value to go down by $15 million. In this case, the Board would find that there was an excessive assessment for the year in question in the amount of $5 million. Under the staff's interpretation of section 864, the counties would owe a tax refund to the taxpayer on the $5 million excessive assessment, but the taxpayer would owe interest to the counties on the $10 million "opinion of value" Board error.

In Hypothetical No. 3, the staff finds a clerical Board error causing the state assessee's unit value for a particular year to decrease by $80 million and a clerical Board error causing the unit value to increase by $81 million, resulting in a net escape assessment for the year in question in the amount of $1 million.

Pacific points out the absurd results in each of the foregoing hypotheticals if assessment in lieu of interest is computed before netting.

LAW AND ANALYSIS

Section 864 provides as follows:

> (a) Property which is found to have escaped assessment may either be added to the roll for the fiscal year in which it is discovered or included with the assessment for the succeeding fiscal year. To the escaped assessment, there shall be added, in lieu of interest, three-quarters of 1 percent of the escaped assessed value for each month or fraction thereof from December 10 of the year in which the escaped assessment should have been enrolled to the date the escaped assessment is added to the board roll; provided, however, that an assessment in lieu of interest shall not be added if the escape was due to an error, other than an erroneous opinion of value, on the part of the board. The property shall be taxed at the rates

applicable to assessments on the roll to which it is added. (Emphasis added.)

(b) If the escaped assessment is made as a result of an audit which discloses that property assessed to the party audited has been excessively assessed for any year covered by the audit which falls within the period provided for corrections under Section 4876, the excessive assessments together with any assessment in lieu of interest under subdivision (c) shall be an offset against proposed escaped assessments, including accumulated penalties and additional assessments in lieu of interest. If the excessive assessments exceed the escaped assessments, including penalties and assessments in lieu of interest, the excess may either be credited to the roll for the fiscal year in which it is discovered or deducted from the assessment for the succeeding fiscal year.

(c) Whenever the excessive assessments were due to clerical errors or other errors by the board not involving exercise of judgment, there shall be added, in lieu of interest, three-quarters of 1 percent of the excessive assessment for each month or fraction thereof, from December 10 of the year in which the excessive assessment was enrolled to the date the excessive assessment is credited to the board roll or to the date the excessive assessment is deducted from the assessment from the succeeding fiscal year, as provided in subdivision (b).

Section 864 is part of Article 4 (commencing with section 861) which was added to Chapter 4 of Part 2 of Division 1 of the Revenue and Taxation Code by Statutes of 1977, Chapter 147. Section 861 provided then as it does now that "[i]f any property subject to assessment by the board pursuant to Section 19 of Article XIII of the Constitution escapes assessment, the board shall assess it in accordance with Section 864 . . ." Section 864 then provided in relevant part:

Property which is found to have escaped assessment may either be added to the roll for the fiscal year in which it is discovered or included with the assessments for the succeeding fiscal year.

Section 864 was amended two years later by Statutes of 1979, Chapter 516 (SB 839) to add the following as the second sentence of section 864:

To <u>the assessment</u> which has escaped assessment, there shall be added, in lieu of interest, one-half of 1 percent of <u>the assessed value</u> for each month from December 10 of the year in

> which the assessment should have been enrolled to the date the additional assessment is added to the board roll; provided, however, that no such addition shall be made where the escape was due to an error, other than an erroneous opinion of value, on the part of the part of the board. (Emphasis added.)

The foregoing language is very clear that the assessment in lieu of interest is to be computed on the "additional assessment . . . added to the board roll," i.e., the netted amount which would be $11 million in Hypothetical No. 1 because there is a net underassessment. Gene Dupaul, the staff audit supervisor at the time section 864 as amended in 1979 was in effect, has advised me that that was the approach taken by the staff at that time.

However, even assuming for the sake of argument that section 864 as amended in 1979 could be characterized as ambiguous because of the proviso language added at that time, to interpret it to permit the computation of assessment in lieu of interest in the manner now used by the staff would be contrary to the purpose of section 864 which, as pointed out in Mr. Hoenig's letter, is to make the counties whole for the loss of the use of property taxes.

Support for that position can be found in the staff analysis of SB 839, a Board-sponsored bill which added the assessment in lieu of interest provisions to section 864 in 1979. That analysis states:

> Section 4 provides for the addition of interest to escape assessments on the Board roll. Currently, interest is charged when escapes are added to the local roll, but there is no provision for adding interest when escapes of State assessed property are enrolled. The proposed change would bring State and local assessment practices into closer conformity and would also compensate local government for the loss of use of revenues to which it was entitled. (Emphasis added.)

See also a memo from James M. Williams to Mr. Neilon M. Jennings dated February 20, 1981, to the same effect.

In 1982, section 864 was amended to its present form by the Statutes of 1982, Chapter 1465 (AB 3382) in effect January 1, 1983. The staff's current method of computing assessments in lieu of interest was apparently put into effect as a result of this amendment.

The question here is whether the Legislature intended by the 1982 amendment to change the method by which an assessment in lieu of interest is computed. In the context of Hypothetical No. 1 that would mean a change from a base of $11 million to a base of $80 million, in Hypothetical No. 2 a change from no assessment in lieu of interest at all (because there was no escape assessment) to an

assessment in lieu of interest on a base of $10 million and in Hypothetical No. 3 a change from no assessment in lieu of interest at all to an assessment in lieu of interest on $80 million in favor of the taxpayer.

Such an intent is not supported by the language of section 864(b) because changing the method of computing assessment in lieu of interest would require substituting the words "audit adjustment(s) increasing unit value" for the words "escaped assessment(s)" and the words "audit adjustment(s) decreasing unit value" for the words "excessive assessments" for each individual positive and negative audit adjustment within the same year without regard to whether there was a net escape assessment or a net excessive assessment for that year. Such an interpretation of section 864(b) is clearly contrary to the Board staff's analysis of the 1982 amendments to section 864 which the Board sponsored. That analysis, which was sent to the Legislature and Governor prior to the passage of AB 3382 states:

> Sections 11 and 17 would amend section 864 and 11317 of the Revenue and Taxation Code to provide for the netting of overassessments against underassessments discovered by an audit of state assessees and private railroad car companies.
>
> Section 864, for state assessees, and 11317, for private railroad car companies, presently provide for procedures for handling escapes discovered by audit but are silent on the handling of excessive assessments applicable to other years covered by the same audit. Section 533 of the Revenue and Taxation Code, which relates to the local roll, provides that taxes paid on assessments found to be excessive by an audit may offset proposed tax liabilities, including applicable penalties and interest, discovered during any year covered by the same audit. The proposed amendments would provide for similar treatment of overassessments and underassessments discovered through audit of state assessees and private railroad car companies. Such amendments would also reduce an assessee's need to file refund claims. (Emphasis on "other years" added.)

The foregoing analysis corroborates 's assertion on page 7 of his letter that section 864(b) is talking only about offsetting the escape assessment(s) proposed to be put on the roll for one or more year(s) against any excessive assessment(s) for one or more different year(s).

This is a clear indication that there was no intention by the Board or the Legislature to change the method of computing assessments in lieu of interest on escape assessments to the method the staff has been using.

Moreover, to interpret section 864(b) as changing the method of computing assessments in lieu of interest on escape assessments to the method now used by the staff would, as indicated above, be contrary to the purpose of section 864 which is to compensate the counties for the loss of the use of property taxes.

For the foregoing reasons and the additional reasons stated in 's letter, we are of the opinion that an assessment in lieu of interest under section 864 cannot be computed with respect to any amount greater than the actual escape assessment or excessive assessment found by the Board for a given year and added to the roll, i.e., the netted amount shown under the heading "Full Value" on the Board's Notice of Escape Assessment.

Because of the proviso language in section 864(a), however, it is still necessary to characterize the causes of the escape due to (a) taxpayer errors and Board errors involving an erroneous opinion of value; and (b) other errors. As pointed out in 's letter, the assessment in lieu of interest could be imposed on that part of the escape assessment which equalled the type (a) errors divided by the total of the type (a) and (b) errors. Under Hypothetical No. 1, this would result in an assessment in lieu of interest based on:

$$\$10.864 \text{ million} \quad \left(\frac{\$80 \text{ million}}{\$81 \text{ million}} \times \$11 \text{ million}\right)$$

A second approach would be to impose an assessment in lieu of interest on an amount equal to the total of the type (a) errors up to the amount of the escape assessment. This is what the staff does now when the audit adjustments increasing value due to type (a) errors are less than the netted escape assessment. Under Hypothetical No. 1, this amount would be $11 million.

A third approach would be to absorb errors in the opposite order, i.e., an assessment in lieu of interest would be imposed on the escape assessment only to the extent the escape exceeded the type (b) errors. In Hypothetical No. 1, the type (b) errors are $1 million. Thus, assessment in lieu of interest would be imposed on $10 million under this approach.

Since section 864(a) is silent on how to apply type (b) errors in a situation like Hypothetical No. 1, the Valuation Division, presumably, may select an approach which it finds is most appropriate under the circumstances. That is, it may select any one of the three approaches described above or perhaps some other approach not yet described. In making that selection, it should be recognized that the ultimate goal is not necessarily maximizing tax revenues. Further, since any approach adopted by the staff is subject to challenge because of the lack of specific guidance in

section 864(a), we recommended that the staff seek clarifying legislation which will expressly support whatever approach is finally adopted.

PENALTY UNDER SECTION 862

Although not raised as an issue in 's letter, your staff has also asked whether their method of computing penalties under section 862 is correct. It is my understanding that penalties have been computed in the same way as assessments in lieu of interest, i.e., before any netting.

Section 862 provides in relevant part:

> When an assessee, after a request by the board, fails to file a property statement or files with the board a property statement or report on a form prescribed by the board with respect to state-assessed property and the statement fails to report any taxable tangible property information accurately, regardless of whether or not this information is available to the assessee, to the extent that such failures cause the board not to assess the property or to assess it at a lower valuation than it would have had the property information been reported accurately, the property shall be assessed in accordance with Section 864, and a penalty of 10 percent shall be added to the additional assessment. (Emphasis added.)

Although the foregoing language is somewhat ambiguous and might be interpreted in more than one way, we do not believe that the foregoing language supports the method of computing penalties which we understand the staff now uses.

One possible interpretation of the quoted language is to apply the penalty to the net amount of all audit adjustments which were caused by the failure of the taxpayer to report accurately but only where there is an escape assessment to which a penalty can be added. Thus, in Hypothetical No. 1, if both the audit adjustment of $80 million which increased unit value and the audit adjustment of $70 million which decreased unit value were caused by taxpayer reporting error, the penalty would be based on $10 million. If only the $80 million adjustment were based on taxpayer reporting error, the penalty would be based on $80 million, i.e., a penalty of $8 million. If the audit adjustments in Hypothetical No. 1 were reversed so that the $80 million adjustment caused the unit value to go down and the $70 million adjustment caused the unit value to go up, there would be no penalty regardless of whose error caused the adjustments because in that case there would be no escape assessment to which a penalty could be added.

An alternative interpretation would be the same as the one discussed above except that in no event should the penalty be computed on an amount greater than the escape assessment adopted by the Board. In the context of Hypothetical No. 1, that would mean that in no event would the penalty be calculated on an amount greater than $11 million. The latter interpretation is the one found by Richard Ochsner to be consistent with the language of section 862, the Board's Strategic Plan, and the way penalties are applied on the local roll, and would therefore be our recommended method for calculating penalties on the Pacific Bell escape assessments.

In reviewing section 862, it immediately became apparent that the types of problems encountered in the audit concerning penalties were not foremost in the minds of those who drafted the language of the section. As a result, section 862 does not address such problems as clearly as it could. Accordingly, we also recommend that staff also seek clarifying legislation which will provide express guidance in the application of section 862 penalties.

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Attachment

cc: Mr. John W. Hagerty - w/att.
Mrs. Margaret S. Boatwright - w/att.

II. PERTINENT STATUTE.

The relevant statute is section 864, which reads in its entirety as follows:

"§ 864. Inclusion on assessment roll; Rate applicable; Offset.

"(a) Property which is found to have escaped assessment may either be added to the roll for the fiscal year in which it is discovered or included with the assessments for the succeeding fiscal year. To the escaped assessment, there shall be added, in lieu of interest, three-quarters of 1 percent of the escaped assessed value for each month or fraction thereof from December 10 of the year in which the escaped assessment should have been enrolled to the date the escaped assessment is added to the board roll; provided, however, that an assessment in lieu of interest shall not be added if the escape was due to an error, other than an erroneous opinion of value, on the part of the board. The property shall be taxed at the rates applicable to assessments on the roll to which it is added.

"(b) If the escaped assessment is made as a result of an audit which discloses that property assessed to the party audited has been excessively assessed for any year covered by the audit which falls within the period provided for corrections under Section 4876, the excessive assessments together with any assessment in lieu of interest under subdivision (c) shall be an offset against proposed escaped assessments, including accumulated penalties and additional assessments in lieu of interest. If the excessive assessments exceed the escaped assessments, including penalties and assessments in lieu of interest, the excess may either be credited to the roll for the fiscal year in which it is discovered or deducted from the assessment for the succeeding fiscal year.

"(c) Whenever the excessive assessments were due to clerical errors or other errors by the board not involving exercise of judgment, there shall be added, in lieu of interest, three-quarters of 1 percent of the excessive assessment for each month

> or fraction thereof, from December 10 of the year in which the excessive assessment was enrolled to the date the excessive assessment is credited to the board roll or to the date the excessive assessment is deducted from the assessment from the succeeding fiscal year, as provided in subdivision (b)."

III. QUESTION.

If the Board determines an escape assessment which is smaller than the total amount of those audit adjustments which increased the value of the taxpayer's property and which were due to taxpayer errors and "opinion of value" errors by the Board, is the assessment in lieu of interest to be imposed under section 864 computed with reference to: (1) only the amount of the escape assessment which is added to the roll; or (2) the total amount of such specified audit adjustments?

IV. HYPOTHETICAL SET OF FACTS.

To help explain the specific point is here disputing, let us pose a hypothetical situation (hereinafter referred to as "Hypothetical No. 1") relating to a state assessee by the name of SA and its property tax audit for the lien date March 1, 1985. For that year, the Staff proposes that there be an escape assessment of approximately $11 million. Thus, the Staff believes that SA's unitary property for such lien date was originally enrolled at a value which was $11 million less than it should have been.

In support of this escape assessment, the Staff points to a number of adjustments which it determined after completing its audit of the March 1, 1985 lien date year. In essence, the Staff found two adjustments which caused SA's unit value to go up, one in the amount of roughly $80 million, and a second which caused an increase of roughly $1 million. The smaller adjustment was due to "an error, other than an erroneous opinion of value, on the part of the board," but the larger adjustment was not. On the other side of the fence, the Staff found an adjustment in the amount of roughly $70 million which caused the unit value to go down. This adjustment was not due to "clerical errors or other errors by the board not involving exercise of judgment."

We should note parenthetically that believes that certain of the Staff's actual audit adjustments which caused 's unit value for any particular lien date to go down were indeed due to "clerical errors or other errors by the board not involving exercise of judgment." While this letter will not address that question (in part because has not seen the Staff's exact calculation of assessments in lieu of interest), this letter and the hypotheticals constructed herein should not be viewed in any way as an admission by that any or all of the audit adjustments actually being proposed by the Staff for any specific tax year were not due to clerical errors or other errors by the Board not involving exercise of judgment.

Returning to Hypothetical No. 1, assume further that the Board adopts the escape assessment recommended by the Staff and issues a Notice of Escape Assessment in the amount of $11 million. If the Board follows prior practice, the notice will contain no mention of specific audit adjustments (see, e.g., the copy of the Board's Notice dated July 1, 1982 attached as Exhibit A). Assuming the $11 million escape assessment is eventually enrolled by the state in 1990 and then allocated back to the respective county rolls, and assuming further a 1.08 percent aggregate county tax rate, SA would pay the counties about $119,000 in back tax for such March 1, 1985 lien date year.

The present dispute concerns how much interest SA should pay the counties, under the section 864(a) "assessment in lieu of interest" mechanism, to compensate the counties for the lost use of such $119,000 for the five-year period from 1985 to 1990.

The rate of interest and the time over which interest should accrue under section 864(a) are not in dispute, i.e., the statute provides for interest totalling roughly 40 percent to accrue on 1985 escape assessments enrolled in 1990. The question concerns the base amount against which such 40 percent interest factor should be applied. understands that the Staff would calculate an assessment in lieu of interest against SA in Hypothetical No. 1 by multiplying the relevant section 864(a) percentage, i.e., 40 percent, times $80 million, i.e., the total amount of audit adjustments which increased the taxpayer's value and which were attributable to taxpayer errors or "opinion of value" errors by the Board. Using this $80 million base for the section 864(a) calculation produces an assessment in lieu

of interest of $32 million. If the Board ultimately enrolled this $32 million assessment in lieu of interest, and allocated such assessment back to the counties, SA would eventually have to pay $346,000 or so of interest to the counties, to compensate them for the lost use of $119,000 for five years.

believes that such an interpretation of section 864(a) as applied to the above hypothetical is clearly wrong. Instead, the statute should be read as imposing an assessment in lieu of interest based on the actual escaped assessed value which is added to the tax roll, $11 million in Hypothetical No. 1. Using this base, the assessment in lieu of interest on the state roll would come out to roughly $4.4 million ($11 million times 40 percent) and, when allocated back to the counties, would require SA to pay roughly $48,000 of interest to the counties to compensate them for the lost use of the $119,000 of taxes from 1985.

## V. DISCUSSION.

believes that the only correct interpretation of section 864 as applied to the above-stated Hypothetical No. 1 is that an assessment in lieu of interest cannot be computed with respect to any amount greater than the actual escape assessment found by the Board and added to the tax roll. believes this to be the case for primarily two reasons: (1) the plain wording of section 864(a) requires that the amount of the escape assessment which is added to the tax roll be used as the base amount against which the assessment in lieu of interest may be applied; and (2) because section 864 is intended to operate "in lieu of interest," i.e., to make the counties whole for the loss of the use of certain property taxes, it would be improper to read section 864 as imposing interest on an amount greater than the escape assessment which is added to the tax roll. These arguments will be discussed in order below.

### A. Statutory Language Is Clear.

believes that the pertinent language of section 864(a) could not be any more clear in saying that the amount of the escape assessment which is added to the tax roll represents the maximum amount on which the assessment in lieu of interest may be computed. The pertinent language reads as follows:

> "Property which is found to have escaped assessment may * * * be added to the roll * * *. To the escaped assessment, there shall be added, in lieu of interest, three-quarters of 1 percent of the escaped assessed value for each month or fraction thereof from December 10 of the year in which the escaped assessment should have been enrolled to the date the escaped assessment is added to the board roll * * *" (emphasis added).

Thus, the base on which an assessment in lieu of interest is to be computed is the amount of the escape assessment which is added to the tax roll. The obvious purpose is to impose interest on the particular assessed value amount--which can easily be converted into a tax amount--needed to make sure the counties are made whole, both for the lost taxes and the loss of the use of such funds.

The "escape assessment" or "escaped assessed value" referred to in section 864 is the amount by which the Board increases the total unitary value of the state assessee for the particular year in question, i.e., the amount "added to the [tax] roll." The Board's notice of escape assessment will contain no mention of particular audit adjustments, but rather will specify the single amount by which the property of the state assessee, being valued as a unit, was undervalued for each year in question.

The Staff's interpretation necessarily requires the replacement of the term "escape assessment" whenever it appears in section 864 with the words "audit adjustment increasing the unit value," and likewise requires replacement of the term "excessive assessment" whenever it appears in the statute with the words "audit adjustment decreasing the unit value." However, that is simply not the way the statute reads.

The distortion evident in the Staff's interpretation also can be seen by examining a Hypothetical No. 2. Assume here that the Staff finds there was an "opinion of value" Board error causing the assessee's unit value to go up by $10 million and a second "opinion of value" Board error causing the unit value to go down by $15 million. In this case the Board would find that there was an excessive assessment for the year in question in the amount of $5 million. Under the Staff's interpretation of section 864,

the counties would owe a tax refund to the taxpayer on the $5 million excessive assessment, but the taxpayer would owe interest to the counties on the $10 million "opinion of value" Board error.

Such result would be absurd. Of course, that result is never reached if one applies section 864(a) and (c) as they are plainly worded. Thus, the proper reading in this Hypothetical No. 2 is that: (1) there is an excessive assessment of $5 million; (2) subsection 864(a) never comes into play; and (3) the only question left to resolve is whether or not the taxpayer should receive interest under section 864(c).

In Hypothetical No. 3, the parties' positions in Hypothetical No. 1 will be, in large part, reversed. In Hypothetical No. 3, the Staff finds a clerical Board error causing the state assessee's unit value for a particular year to decrease by $80 million and a clerical Board error causing the unit value to increase by $81 million, resulting in a net escape assessment for the year in question in the amount of $1 million. Surely the Staff would not take the position that the taxpayer owed the counties tax on the $1 million net escape assessment while the counties owed the taxpayer interest on the $80 million audit adjustment!

As support for its interpretation of section 864(a) in computing assessments in lieu of interest in all the above hypotheticals, the Staff may point out that the three subsections of section 864 utilize a "compute the interest, then do the offsets" approach to figure out the net amount to be enrolled where there are escape assessments in one or more years of an audit and excessive assessments in another year(s) of the same audit. However, the statute is clearly talking only about offsetting the escape assessment(s) determined for one year(s) against the excessive assessment(s) for a different year(s). In this connection, it must be noted that interest calculations would have to be run before offsetting is performed in this multi-year situation, because the pertinent interest percentage will vary for each year in the audit. However, there is nothing in the way these three subsections operate which shows that the legislature thereby intended to permit or authorize what the Staff is now proposing, i.e., that interest be computed on each positive and negative audit adjustment within one particular tax year completely without regard to whether there was an escape assessment or an excessive assessment for that particular year.

The Staff may also point to the proviso language of section 864(a)--to the effect that an assessment in lieu of interest shall not be added if the escape was due to a Board error other than an erroneous opinion of value--as indicating that the legislature intended assessments in lieu of interest to be imposed on an audit-adjustment-by-audit-adjustment basis. It is true that the proviso requires categorizing all the audit adjustments as either of two types: (a) taxpayer errors and Board errors involving an erroneous opinion of value; or (b) other errors. However, the proviso does not specify that there is to be an assessment in lieu of interest on each audit adjustment which increased the unit value and which fell into the type (a) category. Instead it appears to be saying, more logically, that the assessment in lieu of interest--computed as required in the opening sentence of section 864(a) (i.e., using the escape assessment as the base or measure)--may be forgiven, entirely or in part, to the extent that the escape assessment can be attributed to type (b) audit adjustments.

Obviously, the proviso language is not very clear about how the forgiveness works when there are numerous audit adjustments, some of which may be increasing the unit value and some decreasing it and/or where the adjustments are attributable to both type (a) and type (b) errors. The assessment in lieu of interest could be imposed on that part of the escape assessment which equalled the type (a) errors divided by the total of the type (a) and (b) errors. Another approach might be to say that an assessment in lieu of interest would be imposed on an amount equal to the total of the type (a) errors <u>up to</u> the amount of the escape assessment. A third approach would be to absorb errors in the opposite order, i.e., that there would be an assessment in lieu of interest imposed on the escape assessment only to the extent the escape exceeded the type (b) errors.

will not here state a preference for how this allocation or absorption process should work. The key point is that no matter which way one computes the assessment in lieu of interest, it may not be computed on a base in excess of the escape assessment. This is what the language of the statute requires.

B. Purpose and Policy of Code Section 864.

In determining the reasonable interpretation of section 864, it is important to keep in mind that this statute is intended to impose an assessment "in lieu of interest." Thus, the dominant purpose of the statute is to provide a mechanism by which the counties may be made whole for the loss of the use of the property taxes which would have been received had the correct amount of assessment value been put on the roll in the first place.

In Hypothetical No. 1 the counties were without the use of $119,000 for five years. Section 864 should be read in a way which will make the counties whole for such loss of the use of this amount. The Staff's interpretation of 864(a) would require that the assessment in lieu of interest in Hypothetical No. 1 be computed with respect to the $80 million positive audit adjustment. In essence, this means that the Staff would require the counties to be reimbursed for the loss of $864,000 in property taxes, even though the only amount of property tax which they actually lost the use of was $119,000. Under the Staff's reading, the interest statute has been changed into a draconian penalty statute.

In fact there is a separate statute which imposes reporting penalties on state assesses, namely section 862. However, the operative language of section 862 is quite different from the operative language of section 864. Thus, a penalty is imposed under section 862:

> "[T]o the extent that [the taxpayer's reporting failure(s)] cause[d] the board [in the original annual valuation] not to assess the property or to assess it at a lower valuation than it would have had the property information been reported accurately * * *."

It may well be that penalties are imposed on an audit-adjustment-by-audit-adjustment basis under section 862, without regard to the existence of an escape vs. an excessive assessment in the year in question, or the size of the same. Indeed, this would accord with the dominant purpose for imposing penalties, which is punitive. As noted above, however, the dominant purpose for imposing interest is to make the payee whole for the lost use of funds. Section 864 should be interpreted to accomplish this latter purpose; it

should not be read in a way which turns it into another penalty provision.

VI. CONCLUSION.

As set forth above, the very clear language of section 864 states that an assessment in lieu of interest is to be imposed not on particular audit adjustments but rather on the amount of the escape assessment which is added to the roll. To read the statute as the Staff proposes requires one to rewrite the words and to distort the plain meaning of the statute in a way the legislature never expressly or impliedly intended. Moreover, the purpose and policy which underlie interest, as opposed to penalties, reinforce the conclusion that the amount of the escape assessment added to the tax roll should be read as a ceiling for purposes of the assessment in lieu of interest calculation under section 864(a).

* * * * *

If you have any further questions on this matter, please do not hesitate to give
or me (at ) a call.

Thank you for your cooperation.

Sincerely,

Enc.

cc:

STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 1799, SACRAMENTO, CALIFORNIA 95808)

(916) 322-2323

GEORGE R. REILLY
First District, San Francisco

ERNEST J. DRONENBURG, JR.
Second District, San Diego

WILLIAM M. BENNETT
Third District, Kentfield

RICHARD NEVINS
Fourth District, Pasadena

KENNETH CORY
Controller, Sacramento

DOUGLAS D. BELL
Executive Secretary

July 1, 1982

Dear Mr. :

IN REPLY REFER TO:

NOTICE OF ESCAPE ASSESSMENT
(Sections 758 and 864 Revenue and Taxation Code)

This is to inform you that on June 30, 1982, the Board adopted escape assessments for the years and in the amounts shown below. These assessments will be entered on the 1982 Board Roll in accordance with Section 864.

| Year | Full Value | Penalty Per Section 862 | Assessment in Lieu of Interest Per Section 864 | Total |
|---|---|---|---|---|
| 1980 | $175,000,000 | $14,437,500 | $14,654,062 | $204,091,562 |
| 1979 | 85,000,000 | 5,525,000 | 8,922,875 | 99,447,875 |
| 1978 | 103,000,000 | 5,665,000 | 12,547,975 | 121,212,975 |
| 1977 | 70,000,000 | 3,500,000 | 9,852,500 | 83,352,500 |

Assessment in lieu of interest was computed on the escapes that were caused by the assessee at the rate of one-half percent per month from December 10 of the years the escapes occurred through August 19, 1982, as required by Section 864. Also, a penalty of 10 percent was added under Section 862 on the escapes caused by the assessee.

Section 758, Revenue and Taxation Code, provides that a petition for reassessment must be filed, i.e., received by this Board within TEN (10) CALENDAR DAYS from the date of mailing of this notice. Petition for reassessment should be filed with Mr. Douglas D. Bell, Executive Secretary, 1020 N Street, Sacramento, California 95814, and must state the specific grounds upon which it is claimed a correction or adjustment of the assessment is founded. Upon receipt of a timely petition for reassessment, you will be notified of the time and place for the hearing on the petition.

Section 862, Revenue and Taxation Code, provides that the Board shall abate the penalty on showing of good cause, provided a written application for abatement is received within the 10-day period for filing applications for assessment reductions.

July 1, 1982

If you have any questions concerning these years or amounts, please contact the Valuation Division IMMEDIATELY at (916) 322-2323.

Sincerely,

Louis E Mayer

Louis E. Mayer, Chief
VALUATION DIVISION

LEM:cam
VL-06-1396A

cc: Mr. J. E. Horner

State of California

cc: Jerry Del Agostino

Board of Equalization

# Memorandum

Mr. Gene Mayer

Date : February 7, 1991

RECEIVED
FEB 7 1991
Valuation Division
Board of Equalization

From : Jim Williams

Subject : Section 722.5

In your memo of January 31, 1991 to Richard H. Ochsner, Assistant Chief Counsel, you presented five situations of property transfers and asked us to determine whether the Board or the local assessor is responsible for assessment for the current lien date.

1. Pacific Bell leases a property from John Doe on which the lease terminated on January 15.

Response: The Board assesses the property for the remainder of the local assessment year pursuant to Revenue and Taxation Code section 722.5(a). The local assessor may issue a supplemental assessment for the January 15 change in ownership, if appropriate, treating it for section 75.11 purposes as though the change in ownership occurred on March 1.

2. Pg&E sells one acre out of a 10 acre parcel to John Doe on February 10.

Response: Essentially the same as 1. with a one acre supplemental assessment for the February 10 change in ownership.

3. Pacific Bell sells an entire piece of property to John Doe on January 15.

Response: Same as 1.

4. PG&E purchases a property from John Doe on February 1.

Response: The Board assesses the property as of January 1 pursuant to section 722.5(b).

5. Pacific Bell leases a property from John Doe on February 28.

Response: Same as 4.

In all cases we have assumed that the property is owned or used within the meaning of California Constitution Article XIII, Section 19.

JW:jd
3674H

cc: Mr. Jerry Del Agostino