

Add Article 2.5 (commencing with Section 7076.1) to the Sales and Use Tax Law to reauthorize the Board to implement a managed audit program.

Source: Honorable John Chiang

Until January 1, 2003, the Board had the authority for a Managed Audit Program (MAP) for a five year period. 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.

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.

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 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.

This proposal would again grant the Board the authority to utilize a MAP. The proposed MAP would differ from the previous MAP as follows:

- Would delete the provision that specifies that any taxpayer that is on a prepayment reporting basis does not qualify for the MAP; and
- Would 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.

An analysis of the previous MAP showed the following:

Total audits initiated	42,972
Percent eligible for MAP based on previous MAP analysis for the period 1/1/99 to 6/30/00	2.5%
Estimated number of audits eligible for MAP (42972 x 2.5%) *	1,074
Number of MAP audits initiated	151
Percent participation of eligible accounts (151/1074)	14.1%
Number of completed MAP audits	142
Tax liability for MAP audits	\$3,439,877
Amount of foregone interest	\$532,096
Number of audit hours for MAP audits	6,827
Percent of total hours saved based on previous MAP analysis for the period 1/1/99 to 6/30/00	38.6%
Estimated number of audit hours saved (38.6% x (6827/61.4%)) *	4,292

* The analysis of the Managed Audit Program for the first 18 months (1/1/99 to 6/30/00) was used to estimate the number of audits eligible for Map and the number of audit hours saved, for the period 1/1/99 to 6/30/02.

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 would be \$154,624. (\$686,720 - \$532,096.)

Reinstating the MAP without the restrictive criteria with respect to prepayment accounts 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 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.

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 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.

Article 2.5, commencing with Section 7076.1 of the Revenue and Taxation Code is added to read:

Article 2.5 Managed Audit Program

7076.1. The State 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 whose business involves few or no statutory exemptions.
- (b) Any person whose business involves a single or small number of clearly defined taxability issues.
- (c) Any person who agrees to participate in the managed audit program.
- (d) Any person who has the resources to comply with the managed audit instructions provided by the board.

7076.2. (a) If a person's account is selected for a managed audit, the person shall review and examine the books, records, and equipment to determine any unreported liability for the audit period, and make available all computations and records reviewed for verification by the board. The board shall identify for the person all of the following:

- (1) The audit period covered by the managed audit.
- (2) The types of transactions covered by the managed audit.
- (3) The specific procedures the person is to follow in determining any liability.
- (4) The records to be reviewed by the person.
- (5) The manner in which the types of transactions are to be scheduled for review.
- (6) The time period for completion of the managed audit.
- (7) The time period for the payment of the liability and interest.
- (8) Any other criteria as the board may require for completion of the managed audit.

(b) The information provided by the person shall be the same information that is required for the completion of any other audit that the board may conduct.

7076.3. Nothing in this article shall limit the board's authority to examine the books, papers, records, and equipment of a person under Section 7054.

7076.4. Upon completion of the managed audit and verification by the board, interest shall be computed at one-half the rate that would otherwise be imposed for liabilities covered by the audit period. Payment of the liabilities and interest shall be made within the time period specified by the board. If the requirements for the managed audit are not satisfied, the board may proceed to examine the records of the person in a manner to be determined by the board.