

**California Commission on Tax
Policy in the New Economy**

Los Angeles
September 9, 2003

Proceedings

SEPTEMBER 9, 2003: LOS ANGELES

Steve Peace - Director, California Department of Finance

Budget Structural Reform Panel

Commissioner Sean Burton

Moderator:

Charlene Wear Simmons, Ph.D. - California Research Bureau

Panelists:

George Passantino - Reason Public Policy Institute

Steve Levy - Center for the Continuing Study of the California Economy

Professor Craig Stubblebine - Claremont McKenna College

Jean Ross - California Budget Project

California State Tax Court Panel

Commissioner Bill Weintraub

Moderator:

Marcy Jo Mandel, State Controller's Office

Panelists:

John Warren - Loeb & Loeb, LLC

Steve Kamp - State Board of Equalization

Professor Daniel Simmons - UC Davis School of Law

Eric Miethke - Nielsen & Merksamer

State Net Articles on Tax Court

Letters to the Commission: State Tax Courts

Professor Daniel Simmons, Letter Dated September 23, 2003

Professor Daniel Simmons, E-mail Dated November 14, 2003

Bruce Brusavich, Letter Dated November 12, 2003

Michael Delote, California Advocates, Inc., Letter Dated November 14, 2003

William Vickrey, Judicial Council, Letter Dated November 6, 2003

Model State Administrative Tax Court Act - American Bar Association (ABA)

**MEETING OF THE
CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY**

www.caneweconomy.ca.gov

Los Angeles City Council Chambers
200 North Spring Street, Room 340
Los Angeles, CA 90012
September 9, 2003
AGENDA

Note: This meeting is being simultaneously webcast. To view the proceedings online please go to: www.lacity.org/cdvideo.htm and choose the link for the Council Chambers. Or you can listen to the audio portion only by calling 213.621.2489 and selecting Council Chambers from the automated directory.

9:45 AM Chairman Bill Rosendahl
Meeting called to order
Announcements
Roll Call and Introductions

10:00 AM Steve Peace, Director, California Department of Finance

10:15 AM Commissioner Sean Burton
Budget Structural Reform Panel

Moderator:

Dr. Charlene Wear Simmons, California Research Bureau

Panelists:

George Passantino, Reason Public Policy Institute

Steve Levy, Center for the Continuing Study of the California
Economy

Professor Craig Stubblebine, Claremont McKenna College

Jean Ross, California Budget Project

11:15 AM Break

Agendas for public bodies supported by the California Technology, Trade and Commerce Agency are available at <http://commerce.ca.gov>. For additional information regarding this notice, please contact Marshall Graves, California Technology, Trade and Commerce Agency, 1102 Q Street, Suite 6000, Sacramento, CA, 95814, (916) 445-7654, or email, mgraves@commerce.ca.gov

(continued)

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11:30 AM Budget Structural Reform Panel (continued)

12:30 PM Break for Lunch

1:30 PM Commissioner Bill Weintraub
California State Tax Court Panel

Moderator:

Marcy Jo Mandel, State Controller's Office

Panelists:

John Warren, Loeb & Loeb, LLC

Steve Kamp, State Board of Equalization

Professor Daniel Simmons, UC Davis School of Law

Eric Miethke, Nielsen & Merksamer

2:30 PM Break

2:45 PM California Tax Court Panel (continued)

TBD At the discretion of Chairman Rosendahl

Public commentary

Adjournment

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September 9, 2003

In attendance: Bill Rosendahl, Sean Burton, Bill Dombrowski, Glen Rossman, Larry Carr, Bill Weintraub, Marcy Jo Mandel, Steve Kamp, Bob Affleck

Bill Rosendahl: Introduced the commission and welcomed those in attendance. He also reviewed the schedule for the coming meetings.

Steve Peace: Regarding the governor's proposal and the new commission with Leon Pannetta.

3 issues:

Budget: There is a large misconception that the state is under budget. The budget is actually balanced and will have an overage of about 2.2 million. If the legislature does not change something we will have 7.9 million deficit by 6/30/05.

Governor has suggested a spending limit and a reserve. The car tax and the sales tax were put in place to counter the spending limit. When there is an economic downturn they will increase.

Multiyear budget: Does not recommend a two year budget. He is not as confident now as he was that it is that great of an idea. But we should be care about locking ourself into a budget.

Accountability: Re-election. There has to be a good relationship between the people and the government because the people are the producers of the state's capital.

Panetta Commission: He will select his commission members over the next few weeks. The commission will be very independent and bipartisan.

Rosendahl: Warren Buffet thought prop 13 needed to be revisited. Should prop 13 be looked at? **Peace:** The Governor is clear that he is not interested in looking at it. We are a very low property tax state. We need to make sure that we sustain the property value within the state.

Rosendahl: Prop 53 is on the ballot for October 7th. How does that impact where we are as a commission and what are your thoughts on that proposition? **Peace:** It is an important piece of work but it does have some drafting flaws and as a result of the upcoming election it got to the ballot before we got to tweak it. But I would guess that after the election there

will be a constitutional amendment which will allow the ability to tweak it then?

Rosendahl: How can we protect our investments and the money that we have borrowed under these turbulent times? **Peace:** There are inadequate incentives provided to the cities, therefore less housing is built and therefore the housing costs go up. There is tremendous growth of population and Therefore California has not grown it's economy in proportion to its growth.

Rossmann: When and how do you address the other side of the budget which is the expenditure side? **Peace:** Now that the adjustments have been made in the budget. The spending in the state is now flat. We have a 5 billion dollars state operation budget. 3.3 billion dollars are police officers and caregivers. The only place you can go to see program expansion is health care and that is carried by case load and the cost of delivery.

Budget Structural Reform Panel:

Passantino: Achieving greater value for the tax payers at lower cost is the key to addressing the budget crisis as well as the state's competitiveness crisis. The deficit is the result of spending more than we are bringing in. He supports moving to a two year budget plan because it increases oversight and transparency.

California Tax Court:

Simmons: Conformity in dispute resolution makes sense. It will make the system more functional for tax payers if the system worked the same as the federal system.

Kamp: The Board of Equalization sees 2000 cases and 26 were referred to the Superior Court.

Warren: The present system that we have in California just happened by a series of historical mistakes. It is not the way it was designed to be.

Miethke: Currently the system is very flexible. Tax payers are able to come in and represent themselves. There is not enough evidence to create a

California Tax Court. The Board of Equalization has tremendous board support. Having a court is not necessarily going to solve our tax expertise problem.

Warren: The majority of cases have gone to superior court instead of the Board of Equalization.

Miethke: People bypass the Board if their case arises under some constitutional issue. Then they must go to court. Each system has its own level of flexibility.

Kamp: I think it is inaccurate to say that the BOE is a rubber stamp for the franchise tax board.

Kanter: This all comes down to whether or not we are going to require people to come before a legal judge before they have to pay the tax. The hearings at the BOE are very abbreviated hearings. Perhaps we can do something to lengthen the hearings. It does not offer a full and fair opportunity to present their case.

Kamp: It is predicted that the Tax Court would replace the BOE. The BOE is open to the public and the cases that want them, get the publicity that they deserve.

Weintraub: We are proposing to give tax payers additional rights and opportunities than they have right now, to have enough time to present the case, to be able to have it heard by judges who are not elected and effected by politics and to be represented by good and educated council.

Miethke: Perhaps we do not need a Tax Court but we need to just make changes to the current system that we have.

9 September 2003

TESTIMONY

by

Wm. Craig Stubblebine
Emeritus Professor of Political Economy
Claremont McKenna College

before the

California Commission on Tax Policy in the New Economy

Chairman Rosendahl, I thank you for your kind invitation to speak today before this Commission.

I am Wm. Craig Stubblebine. As of July 1, I am emeritus professor of political economy at Claremont McKenna College. Over the years, I have had the opportunity to participate in various attempts to provide a more constructive budgetary environment in California, including then Governor Reagan's Proposition 13 and, subsequently, what came to be known as the Gann (tax and spending) limits.

In discussing my appearance here today, I was told to be creative on the one hand and reflective of my experiences on the other. I propose to address four topics in the short time allotted: Prop 13, tax reform, the Gann limits, and budget process reform.

However, before I take up these topics, I would take a moment to set the fiscal environment within which current discussion takes place. Although some, such as advocates of the Henry George single tax on land values, would argue for concentrating on a single tax base, experience has been otherwise. State and local government revenues are derived from a wide variety of sources: income, sales (of all sorts), property, estate, and many others, in addition to various charges and miscellaneous sources. Partly this reflects historical accident, partly it reflects notions of efficacy in tax administration, and partly it reflects a notion that the heavier the reliance on one tax source, the greater the payoff for avoidance and evasion. Diversity seems likely to be a continuing feature of the fiscal landscape.

Considered as a share of California Personal Incomes (SPI), California state and local government tax revenues rose from 11% in fiscal 57-58 to a high of 14% in fiscal 77-78. Thereafter, in the face of Prop 13, tax revenues fell to a low of 9.6% in fiscal 82-83 and then recovered gradually to 11% by fiscal 99-00, essentially returning to the level of fiscal 57-58. Meanwhile, over this long period from fiscal 57-58 to 99-00, current charges and miscellaneous general revenues rose gradually from 1.8% to 4.6% of SPI. Own Source state and local government Revenues in fiscal 98-99 were not far below those of fiscal 77-78: 16.2% versus 16.6%. By these measures, the overall California fiscal situation for 1999-2000 should have been little different from what it was at its previous high in fiscal 1977-78.

This is not to say that the California fiscal landscape did not change dramatically over that period. Following Prop 13, Own Source Revenues, after falling to a low of 13% in fiscal 82-83, did not return to the 16% range until fiscal 89-90. Property tax revenues, which topped out at 6.4% of SPI in fiscal 71-72, now hover in the 2.7% range. By contrast, income tax revenues have risen relentlessly from less than 1% of SPI in fiscal 57-58 to over 4% in fiscal 99-00. These data reflect the major shift in California fiscal arrangements: away from local property taxes toward state income taxes. With this has come a major shift in fiscal responsibility: away from substantial local government autonomy to state fiscal control of all levels of California government.

With this in mind, perhaps the obvious place to begin is with Proposition 13. Although I was not a supporter at the time, subsequent events led me to become a student of Prop 13. I now would argue that Prop 13, itself, is not broke and does not need fixing. It brought and continues to bring to California property owners a semblance of security with respect to their property tax burden during the period property is held. For practical purposes, it provides the same security as a fixed-rate mortgage: at the time of purchase, the new owner can predict with substantial accuracy his property tax payments during his period of ownership. At the same time, Prop 13 prevents the capturing of this certainty by owners of record at its time of passage. Moreover, for any given holding period, the burden of the property tax, measured as a percentage of owner=s income, substantially is the same whether a property was purchased in 1980, in 1990, or in 2000. At most, one might argue for repeal of various post-Prop 13 amendments which have distorted this aspect.

Of course Prop 13 also had a second aspect, one which changed dramatically the distribution of fiscal responsibility in California. One might argue that the current one-percent limitation should be raised to, say, 1.5% of assessed value B in exchange for a corresponding reduction in personal income tax rates. Whatever importance one attributes to Warren Buffett=s assertion that Californians pay too little in property taxes, his statement clearly is defective in not also asserting that Californians are paying too much in personal income or sales taxes. Such a two-sided assertion would have the effect of focusing on the core issue here: what is the appropriate distribution of the California tax burden among California tax sources?

In an Aop-ed@ piece in Sunday=s Los Angeles Time [p. M2, September 7, 2003], Kotkin and Hertzberg argue cogently for a return of fiscal responsibility to California local governments. If their proposed remedy is incompetent, their point is not. Local government fiscal responsibility can be restored by the straightforward and simple expedient of the State taking over all property tax revenues and yielding to local governments a flat-rate tax on personal incomes. During fiscal 1999-2000, the essentially flat-rate property tax generated revenues of \$26.2 billion and the progressive individual income tax generated revenues of \$39.6 billion.

In this exchange, the State would gain control of a relatively stable revenue source and local governments would have the autonomy to determine their revenues from the income tax. It was the practicality of local governments administering a local property tax in an

era when notions of taxable income were unknown that has left us with the legacy of the local property tax. With our ability to administer income taxes, we now have the opportunity to inaugurate a local income tax. The local income tax base would be allocated among local governments according to the primary residency of the taxpayer. Each local government would decide the rate appropriate for its citizens. The total tax rate to which an individual would be subjected would be the sum of the rates imposed by the various local governments in which the taxpayer resides: county, city, school district, and special districts in the same way that property owners were taxed prior to Prop 13. Just as there were property tax rate limits prior to Prop 13, there could be local income tax rate limits.

The important point here is restitution of a substantial measure of local fiscal autonomy. Taxpayers, state government, and local governments all would benefit from this tax base swap.

I turn now to the inoperative Gann tax-spending limits. The goal of Gann was to constrain the growth of state and local government taxing and spending, to smooth year-to-year variations in spending, and to initiate a dialogue between citizen-taxpayers and their governments. The first part was to be achieved by limiting the year-to-year growth in dollar spending. The second part was to be achieved by establishing various bond, emergency, and fiscal stabilization funds. The third part was to be achieved by providing for voter-approved changes in spending limits.

While I now might support some clarifying changes in the Gann provisions, for the most part I would argue that Gann was well-conceived, well-drafted, and well-implemented. To be sure, the first part imposed some calculation burden on state and local governments, the second part imposed some burden on state and local governments to behave in a fiscally responsible manner, and the third part imposed substantial new burdens on citizens to participate in a dialogue with their fiscal representatives. However, to my mind, these burdens would not be excessive.

What I had not anticipated during the conceptualization and drafting of the Gann limits was the depth of the antipathy by those who perceived that cherished spending programs would not be realized within the limits. The success of Proposition 111 of 1990 is the most illustrative and the most damaging. Unlike Prop 13, Gann has not generated majority constituencies to maintain its integrity. The current amount of dialogue between the governors and the governed appears to be negligible. I have no insights as to how to enact and to maintain over time constructive tax-spending limits except, perhaps, to understand that effective government demands the continuing attention of its citizens.

Let me end with what I hope will be viewed as a creative note with respect to reform of the budgetary process. Though the essential notion did not originate with me, I accept responsibility for continuing to think about it. It began with the observation that, after the Magna Carta, the Parliament had responsibility for raising revenues and the Crown responsibility for spending those revenues. The modern manifestation would be for the

legislature to enact revenue bills and for the governor to determine how those revenues would be used. Alternatively, and more provocatively, the Senate could have the (sole) responsibility for generating revenues and the Assembly could have the (sole) responsibility for spending the revenues generated under Senate aegis.

I have come to no conclusions as to whether such a reform of the budgeting process would improve or worsen the conduct of California fiscal affairs relative to the current situation. Perhaps serious discussion would clarify its implications.

The fundamental issues remain: how much to tax and spend, what to tax and on what to spend. With a distribution of citizen preferences, some will find the level of spending woefully inadequate, others will find the burden of taxation excessive. In a well-functioning democracy, almost no one will like the results of the budgeting process. But those results will represent a balancing of competing interests and pressures. Can the process of reaching that balance be improved? Perhaps, perhaps not.

Thank you.

A Summary of Recommendations for Reforms to the State Budget Process

By Charlene Wear Simmons, Ph.D., Assistant Director, California Research Bureau

This CRB Note summarizes recommendations made by commissions and study groups over the last decade as to how to improve the state's budget process. The recommendations vary, but there is considerable consensus as to the major issues confronting the state. Some recommendations were introduced in bill form, as with the California Constitution Revision Commission, while others are conceptual; some may be unrealistic. This note was prepared at the request of Assembly member Joe Canciamilla.

Problem Statement:

The California Constitution Revision Commission concluded after a lengthy review that "...the legislature's budget process is not designed to make the critical decisions that are necessary to meet the needs of the state within available resources. It is widely agreed that the result of this process is not satisfactory to any of the participants or to the people of California."¹

Issue: Promote Better Public and Legislative Understanding

Problem Summary: California's incremental budget document is highly technical, is based on sometimes erroneous economic forecasting, does not promote "...public scrutiny of spending decisions or program performance",² and discourages public participation.

Recommendations^{*}

*The Senate Cost Control Commission*³: "The Legislature should develop a simple, easy-to-read, and understand budget document for public dissemination."

California Citizens Budget Commission:⁴ Insert a new "Statement of Fiscal Condition" in the first section of the Budget Act, providing a simple comprehensive picture of the state's overall fiscal condition and spending priorities. It would summarize state and related local budget decisions, special funds, and short and long-term borrowing, and discuss goals and objectives in a simplified and standardized terminology. In addition, the Legislative Analyst should distribute an annual, short and easy-to-read budget primer summarizing the budget to all taxpayers. The Department of Finance should issue a final narrative

budget report within 90 days after the budget's adoption.

*

The quality and quantity of California budget information has improved considerably since these recommendations were made: see the Legislative Analyst's Office's website (www.lao.ca.gov) and the Department of Finance's website (www.dof.ca.gov). In addition, the California Budget Project, whose mission is "...to improve the economic and social well-being of low and middle income Californians..." provides California budget analysis on its website (www.cbp.org).

*The Government Accounting Office:*⁵ A budget process should provide information about the long-term impact of decisions, the trade-offs between missions, goals and different policy tools (such as tax provisions, grants, and credit programs), and use clear and consistent definitions in order to enhance control and accountability.

*Ellwood and Sprague:*⁶ Increase the analytic capability that supports the budget decision-making process (Legislative Analyst Office, Legislative Fiscal Committee staff, Department of Finance).

*The California Budget Project:*⁷ Improve the quality of budget information, much of which is extremely detailed and intimidating to the lay reader, by: providing a simple overview; implementing a functional (policy area vs. program) reporting system, and; producing a user-friendly summary of the adopted budget.

*California Business-Higher Education Forum:*⁸ "The state should consider improving its collection of economic and fiscal data at all levels of government and the economy." Establish a nonpartisan long-term economic and fiscal forecasting unit, like the former Commission on State Finance.

Problem Summary: The Legislature does not regularly hold state departments accountable, due in part to its incremental, fragmented approach to budgeting.

Recommendations

*The Senate Cost Control Commission:*⁹ "The Legislature should hold information hearings on departmental activities prior to the introduction of the Governor's proposed budget."

*The California Citizens Budget Commission:*¹⁰ Create a Joint Fiscal Oversight Committee to monitor the budget's implementation during the year, including during the legislative interim, and recommend needed changes to keep it in balance. Hold Joint Assembly-Senate Fiscal Subcommittee hearings on the budget. Add a section to the Budget Act that accurately portrays the state's

accumulated deficit so that legislators may make informed spending decisions. Include sufficient information about long-range demographic and fiscal trends. Once a decade, create an independent commission to review California fiscal policy and present recommendations for modifications.

Issue: Fiscal Discipline

Problem Summary: California's Constitution does not require a balanced budget, except as introduced by the Governor. The state's budget as enacted is not always balanced within the budget year, and actual deficits can be carried over into the next fiscal year.

Recommendations

*California Citizens Budget Commission:*¹¹ Require the Governor and the Legislature to balance California's annual budget when presented *and adopted* each year. Clearly identify the state's entire accumulated debt in a section of the budget. Authorize the Auditor General to review and summarize existing revenues, spending and borrowing. Stop "off-budget" loans (borrowing for operating expenses). Amend the state constitution to prohibit all short-term borrowing unless repaid within the same fiscal year. Explicitly authorize all loans by enacted law. Annually review all special fund financed activities in the budget process, and effectively eliminate continuous appropriations for special funds (by closing the loophole of "Notwithstanding Section 13340 of the Government Code"). Develop a plan to retire the accumulated deficit within five years, with a goal of repaying at least 20 percent each year.

*California Governance Consensus Project:*¹² Require the state to adopt a balanced and timely budget.

*California Constitution Revision Commission:*¹³ Adopt and maintain a balanced budget for General Fund expenditures, and prohibit external borrowing to finance deficits. Require the governor to provide an update midway through the fiscal period, recommending any necessary budgetary adjustments in a budget-rebalancing bill requiring a majority vote of the legislature. Prohibit borrowing to finance a deficit.

*California Business Roundtable:*¹⁴ Require the budget to be in balance through the fiscal period. Do not permit legislation increasing net costs or reducing net revenues after enactment of the budget. Prohibit cross-fiscal period borrowing.

Problem Summary: The state budget does not clearly reflect all state spending.

Recommendations

*California Citizens Budget Commission*¹⁵: The Budget Act "...should describe and enumerate all spending and revenue decisions, detail their impact on local

[†] California is one of thirteen states that allow year-end deficits to be carried over into the next year and financed by debt arrangements; only the budget *submitted* by the Governor must be in balance. governments and establish clear priorities..." Include all special funds and tax breaks in separate schedules in the Governor's budget.

The California Budget Project:¹⁶ Require tax expenditures to be evaluated next to spending through budget expenditures as part of the budget process.

Problem Summary: A considerable amount of the budget is "locked up" by revenue and spending restrictions[‡], many enacted through the ballot initiative process ("ballot-box budgeting")[§], severely limiting budget choices.

Recommendations

*The Speaker's Commission on the California Initiative Process*¹⁷ considered whether to allow the legislature to amend initiatives after three to five years, as many other states do, to take into consideration unanticipated changes.

California Governance Consensus Project:¹⁸ Require any future initiative containing a super-majority vote requirement to be approved by an equal super-majority vote.

California Policy Choices:¹⁹ "New programs should have an identifiable source of funding before being implemented."

Ellwood and Sprague:²⁰ "...modify the initiative so that its results can be modified by the normal political process and so that it cannot be used to create mandated spending."

California Constitution Revision Commission:²¹ "Allow amendment of statutory initiatives after six years."

California Business Roundtable:²² Eliminate earmarking of general tax revenues for general fund programs and automatic cost of living adjustments for programs. Allow legislative amendment of an initiative to further its purposes by a two-thirds vote after five years.

*California Business-Higher Education Forum:*²³ Remove statutory and constitutional provision earmarking state general funds for specific purposes, including the K-14 earmark created by Proposition 98 (while maintaining increased investment in education).

[†] These include earmarked and mandated expenditures, cost-of-living allowances, federal tax conformity, and criminal justice policies, among others.

[§] Examples of initiatives earmarking state funds on the November 2002, ballot include Proposition 49, *After School Programs. State Grants* and Proposition 51, *Transportation. Allocation of Sales and Use Taxes...* See www.ss.ca.gov for full text of current initiative propositions.

Problem Summary: The state's tax structure relies heavily on highly cyclical revenues (sales and a very progressive income tax), which exacerbates revenue shortfalls in recessions. At the same time, demands for higher levels of public services and investment place pressure on resources.

Recommendations

Although a detailed discussion of this issue is beyond the scope of this memo, a number of changes in the state's tax structure have been recommended to increase revenue stability. These include, among others: increase the number of income tax brackets in the middle to decrease reliance on a few wealthy taxpayers and capital gains; increase reliance on the more stable property tax; broaden the sales tax to include some services; put triggers on tax cuts so they automatically kick back in when revenues decrease substantially, cut levels of services, provide local government with greater fiscal independence, and either eliminate the protected status of K-14 schools or change the Proposition 98 funding formula so that funding can decrease during periods of state revenue shortfall.

Issue: Budget Reserve Account (Rainy Day Fund)

Problem Summary: Downturns in the economic cycle have a considerable impact on California's budget due to decreased revenues and caseload-driven increases in expenditures, and the state periodically experiences natural disasters and other fiscal emergencies. The state's Constitution requires a "reasonable and necessary" prudent reserve (Article XXIII B, Section 5.5), but its role in state finance is unclear.

Recommendations

*California Citizens Budget Commission:*²⁴ Create a budget reserve account for

emergencies, unexpected expenses and revenue shortfalls. Include provisions to maintain specified levels of funding and methods for replenishing funds.

*California Constitution Revision Commission:*²⁵ Require a three percent reserve within each two-year budgetary period, phased in at a rate of one percent each year. Specify the rules governing the reserve and its use in statute, and require a two-thirds legislative vote to spend reserve funds. Replenish the reserve within two fiscal periods.

*California Business Roundtable:*²⁶ “The state budget should include a three percent reserve for contingencies.”

*League of Women Voters of California:*²⁷ Supports a statutory provision for a three percent reserve in the state budget.

Issue: Legislative Voting Requirements for Budget and Taxes

Problem Summary: California’s requirement of a two-thirds vote of both houses for the budget, and for all revenue and appropriation bills, is the highest vote requirement of all

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states, yet it has not restrained increased state spending. “Instead, it places the power to control, block or veto the state budget into the hands of a small minority...(and) allows legislative parties to avoid responsibility.”²⁸

Recommendations

*The California Citizens Budget Commission:*²⁹ The Legislature should be allowed to adopt a budget bill and “trailer bills” by a simple majority vote.

*California Governance Consensus Project:*³⁰ Change the legislative vote requirement for tax expenditures (exemptions, credits, deductions, etc.) to two-thirds, unless revenue-neutral.

*Ellwood and Sprague*³¹ : Eliminate super majorities and limitations of all sorts. Place expenditure and revenue limitations on special funds as well as on the general fund.

*California Budget Project:*³² Allow passage of the budget and revenue increases by a majority vote.

*California Constitution Revision Commission:*³³ Provide for a majority vote for the adoption of the state budget, the budget implementation bills, and bills enacted to

“rebalance” the budget. Change the Constitution to allow the legislature to pass a single budget implementation bill (as an exception to the single subject rule).

Nebraska: A three-fifths vote is required in order for the Nebraska Legislature to increase the governor’s recommendation, while a majority vote is required to reject or decrease them.

*California Business Roundtable:*³⁴ Approve the budget by a simple majority of the Legislature. State tax increases or new taxes should continue to require approval by two-thirds of the Legislature.

*League of Women Voters of California:*³⁵ Strongly supports reducing the required legislative vote from two-thirds to a majority on the budget bill, the budget implementation bill, and the budget-balancing bill.

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Nine states have some type of supermajority requirement, but none apply the two-thirds legislative vote requirement as broadly as California, according to the National Council on State Legislatures.

***Problem Summary:* The Legislature can reduce taxes by a simple majority vote but cannot increase revenues without a two-thirds supermajority vote, creating pressure to give tax breaks but not ensure sufficient revenue**

Recommendations

*The California Citizens Budget Commission:*³⁶ Tax increases and tax breaks should both be enacted by a simple legislative majority vote.

*California Constitution Revision Commission:*³⁷ Retain the two-thirds vote for any tax increases.

*League of Women Voters of California:*³⁸ Instituting a tax expenditure or break, and reducing or eliminating one (a tax increase), should both have the same legislative majority vote requirement.

Issue: Local Government

Problem Summary: Local government’s dependence on state revenues has limited its ability to address local needs and has jeopardized home rule. There is a confusion of responsibility and thus little accountability.

Recommendations

*California Citizens Budget Commission:*³⁹ “A clearer picture of intergovernmental resources is an essential missing ingredient in the state budget process.” The budget should include information about the financial status of local government and the effect state decisions might have on local governments. Further, the state should give local governments greater fiscal independence.

*California Governance Consensus Project:*⁴⁰ “Restore accountability and financial stability to local government and ensure that revenue streams provide incentives for balanced growth... [and give] local voters more control over taxes.” Realign state/county responsibilities.

*The California Budget Project:*⁴¹ The “financial relationship between California’s state and local governments is in need of major reforms.” Actions might include restoring local control over local revenues, providing certainty to facilitate long-term planning, and aligning program and financial responsibilities.

*California Constitution Revision Commission:*⁴² “The governor and the legislature must develop and adopt a state-local realignment plan.” The plan would become part of a state Strategic Plan (see Section VIII below) and would be reviewed and updated at least every four years.

*California Business Roundtable:*⁴³ “The state should initiate a process to realign state and local programs to achieve efficiency and accountability...” and reexamine the operation of realignment every five years.

*California Business-Higher Education Forum:*⁴⁴ Make fundamental changes to insure long-term local government financial stability.

*Speaker’s Commission on Regionalism:*⁴⁵ Encourage regional tax sharing, protect local revenues (including amending the Constitution to protect locally levied taxes, such as property taxes, from being relocated for state purposes), and authorize regional compacts through the constitution.

Issue: Multi-Year Budgets

Problem Summary: The State undertakes only limited long-term planning, a problem exacerbated by the yearly baseline budget.^{††}

Recommendations

*California Citizens Budget Commission:*⁴⁶ Implement long range or multi-year

budgets for major programs. The costs of all legislation should be analyzed from a three-year perspective, with sources of funding identified.

*Little Hoover Commission:*⁴⁷ Explore the potential for adopting budgets that span more than one year.

*Ellwood and Sprague:*⁴⁸ Move to a multi-year budget process, to increase flexibility, as budget changes can become part of a multi-year agenda.

*California Constitution Revision Commission:*⁴⁹ Adopt a two-year budget: “...the legislature will be able to spend more time evaluating program outcomes and effectiveness...and to adjust to economic and caseload changes in a more organized manner.”

*California Business Roundtable:*⁵⁰ The state should adopt a two-year budget cycle and enact a five-year capital improvement plan.

*League of Women Voters of California:*⁵¹ Urges consideration of a two-year budget and four-year capital outlay plan.

††

According to the National Council on State Legislatures (NCSL), three states (Oregon, North Dakota and Wyoming), enact a consolidated two-year budget. Most of the 15 biennial budgeting states enact separate budgets for two fiscal years at once, allowing for yearly revisions. Two studies have found “little evidence of clear advantages of either annual or biennial state budgeting practices.” The success of either approach depends on good implementation. See Ronald K. Snell, *Annual and Biennial Budgeting*, National Council on State Legislatures, November 2000, page 4.

Issue: Conform the State Fiscal Year with the Federal Fiscal Year

The federal fiscal year was changed to October 1 in 1974 to allow more time for deliberation after the April collection of tax receipt, and to encourage utilization of federal grant funding. Two states—Alabama and Michigan—have adopted the federal practice.

Issue: Long-Term Vision or Strategic Direction

Problem Summary: Budget planning is not driven by an “integrated statewide vision and strategy that sets priorities for the state and departments;”⁵² this makes it impossible to review departmental budgets against a clear set of goals. Short-term incremental budget decisions inhibit change and favor the status quo.

*The Senate Cost Control Commission:*⁵³ Establish a Task Force to develop priorities to guide strategic planning activities; hold informational hearings to examine how long term strategic plans fit into departmental budget requests; and

enact a Strategic Program Area Review based on the Arizona or Texas models. This process would require better information, and more operational flexibility and training at the departmental level.

*California Governance Consensus Project:*⁵⁴ Require the state to adopt a strategic budget planning process.

*Little Hoover Commission:*⁵⁵ The Governor and the Legislature should commit to long-term budgetary reform, building on the performance-based budget piloting project.

*California Constitution Revision Commission:*⁵⁶ Adopt a long-term strategic plan to guide the state: “The state needs a strategic plan to have a better sense of where it is going and how resources should be spent.” The strategic plan would include policy and fiscal priorities, performance standards, a capital facilities and financing plan, and a description of the programmatic relationship between the state and local governments.

*California Business Roundtable:*⁵⁷ The state should enact a four-year strategic plan, proposed by the Governor and adopted by the Legislature. State operation and capital budgets should be consistent with the strategic plan.

*Bay Area Economic Forum:*⁵⁸ Strongly endorses a State Strategic Plan with measurable performance outcomes.

Problem Summary: “California has not adopted modern elements of public administration for the vast majority of its programs: clear mission statements for individual programs, or definitions of priority populations to be served and measurements of budgetary success (“performance outcomes”)...⁵⁹ The “current services” approach in use merely allots the same funding as the prior year, plus increases for inflation and caseload growth, focusing entirely on inputs instead of performance.

Background:^{††} Performance-based budgeting focuses on outputs rather than assuming a given baseline of inputs, and allocates resources based on expected agency performance levels. A performance-based budget contains information about program mission, goals, performance measure and funding.^{§§} Implementation is a long-term process, and may be more appropriate in some policy areas than others.^{***} For example, the California Department of Finance has released California’s first five-year infrastructure plan, pursuant to AB 1473, Hertzberg (Chapter 606, Statutes of 1999).

Recommendations

*The California Citizens Budget Commission:*⁶⁰ Adopt a three-year approach to fiscal and budgetary planning by requiring programs to review their primary mission, identify top priorities, and predict future costs. The budget should contain specific measures of program performance and effectiveness for each department.

*California Governance Consensus Project:*⁶¹ Review all state taxes and tax expenditures every four years. Require annual performance indicators and outcomes for all state services and integrate it into the budget process.

*The Finance Project:*⁶² Implementing a results-based budget can be hampered by confusion over basic terms, the difficulty of identifying appropriate results and performance measures, and the challenges over overhauling existing planning, budgeting and management systems. A results-based budget incorporates broad-cross agency strategies to address system-wide goals (for example, improve the well-being of children) and the detailed budgets and performance measures for individual agencies.

^{††} NCSL reported in 1999 that Texas, Tennessee and Louisiana have performance-based budgets. ⁸⁸ Arizona requires information on program missions, goals, performance measures, funding and personnel to be compiled in a Master List of State Government Programs printed every even-numbered year. The state's Strategic Program Area Review process links program performance to budget recommendations.

The Performance and Results Act of 1993 established a pilot program in four state departments: the California Conservation Corps and the Departments of Consumer Affairs, General Services, and Parks and Recreation. The State Government Strategic Planning and Performance Review Act of 1994 required the Department of Finance to identify state agencies needing to develop or update a strategic plan, and required annual reports to the Legislature on development of performance measures.

*California Constitution Revision Commission:*⁶³ Adopt a formal performance-based budgeting system: "...performance measures should be established to allow the legislature to determine if state programs are effective...and redefine priorities and funding as necessary."

*Cal-Tax:*⁶⁴ Implementation of performance budgeting should include establishment of benchmarks to measure changes in outcomes, ongoing measurement of program results tied to future funding, monetary incentives for program performance, and flexibility in program implementation.

*California Business Roundtable:*⁶⁵ Enact performance-based budgeting through state government agencies, including clear mission statements and performance standards.

*Bay Area Economic Forum:*⁶⁶ Require the state and all political subdivisions to prepare budgets with measurable goals and objectives.

*California Business-Higher Education Forum:*⁶⁷ "State and Local governments

should expand their use of ‘performance’ budgeting, working to establish goals and benchmarks consistent with an evaluation of the ‘outputs’ of government rather than the traditional focus on inputs.”

An Alternative View: Nothing is Wrong with the Budget Process

*Ellwood and Sprague:*⁶⁸ “...the supposed failures of the process have more to do with the poor performance of the California economy and with the particular partisan divisions of the State than with the specific provisions and political institutions set out in the California Constitution.”

*Leroy Graymer:*⁶⁹ “Given the scarcity of resources and highly fragmented interests in our state, the system may be functioning about as well as can be expected.”

Endnotes

¹ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, “Improving the State Budget and Fiscal Process: Developing a Long-term Vision with Increased Fiscal Discipline” (Sacramento: the Commission, 1996), pp. 35-36. ² Senate Advisory Commission on Cost Control in State Government, “Summary of Findings and Recommendations,” *California’s Budget Process: Improving Quality, Cost-Efficiency, Effectiveness and Accountability in State Government* (Sacramento: the Commission, 1999), p. iv. ³ Senate Advisory Commission on Cost Control in State Government, “Summary of Findings and Recommendations,” *California’s Budget Process: Improving Quality, Cost-Efficiency, Effectiveness and Accountability in State Government* (Sacramento: the Commission, 1999), pp. ii-iv. ⁴ California Citizens Budget Commission, *Reforming California’s Budget Process, Preliminary Report and Recommendations* (Los Angeles, Center for Governmental Studies, 1995), pp. 1, 2, 4, 41, 48, 50. ⁵ U.S. Government Accounting Office, *Budget Process: Extending Budget Controls*, GAO-01-682T (Washington, D.C.: the Office, April 25, 2002), pp. 2-3. ⁶ John W. Ellwood and Mary Sprague, *Options for Reforming the California State Budget Process*, (Berkeley, Calif.: Conference on California Constitutional Reform, June 8-10, 1995), p. 27. ⁷ California Budget Project, *Dollars and Democracy: An Advocate’s Guide to the California State Budget Process* (Sacramento: the Project, March 1999), pp. 38-39. ⁸ California Business-Higher Education Forum, *California Fiscal Reform: A Plan for Action, Recommendations and Summary*, June 1994, p. 11. ⁹ Senate Advisory Commission on Cost Control in State Government, “Summary of Findings and Recommendations,” *California’s Budget Process: Improving Quality, Cost-Efficiency, Effectiveness and Accountability in State Government* (Sacramento: the Commission, 1999), pp. ii-iv. ¹⁰ California Citizens Budget Commission, *Reforming California’s Budget Process, Preliminary Report and Recommendations* (Los Angeles: Center for Governmental Studies, 1995) pp. 30-31, 40, 50. ¹¹ California Citizens Budget Commission, *Reforming California’s Budget Process, Preliminary Report and Recommendations* (Los Angeles: Center for Governmental Studies, 1995) pp. 2, 27-29. ¹² California Governance Consensus Project, *Conceptual Plan as Modified at the March 2, 1999 Plenary Meeting*, accessed July 21, 2002, at www.csus.edu/calst/cgcp/page2a.htm ¹³ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, “Improving the State Budget and Fiscal Process: Developing a Long-term Vision with Increased Fiscal Discipline” (Sacramento: the Commission, 1996) pp. 38, 40. ¹⁴ California Business Roundtable, *Revenue and Taxation Task Force Agenda for Governance and Fiscal Reform*, Approved November 30, 1995, p. 5. ¹⁵ California Citizens Budget Commission, *Reforming California’s Budget Process, Preliminary Report and Recommendations* (Los Angeles, Center for Governmental Studies, 1995), pp. 2, 38-40. ¹⁶ California Budget

Project, *Dollars and Democracy: An Advocate's Guide to the California State Budget Process*, (Sacramento, March 1999), p. 38.¹⁷ The Speaker's Commission on the California Initiative Process, *Final Report* (Los Angeles: the Commission, January 2002).¹⁸ California Governance Consensus Project, *Conceptual Plan as Modified at the March 2, 1999 Plenary Meeting*, accessed July 21, 2002, at www.csus.edu/calst/cgcp/page2a.htm¹⁹ Jeffrey Chapman, "Fiscal Context," *California Policy Choices*, V. 7, University of Southern California, 1991, p. 33.²⁰ John W. Ellwood and Mary Sprague, *Options for Reforming the California State Budget Process* (Berkeley, Calif.: Conference on California Constitutional Reform, June 8-10, 1995), p. 27.²¹ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, "Improving the State Budget and Fiscal Process: Developing a Long-term Vision with Increased Fiscal Discipline" (Sacramento: the Commission, 1996), p. 32.²² California Business Roundtable, *Revenue and Taxation Task Force Agenda for Governance and Fiscal Reform*, Approved November 30, 1995, pp. 5,7.²³ California Business-Higher Education Forum, *California Fiscal Reform: A Plan for Action, Recommendations and Summary*, June 1994, p. 9.²⁴ California Citizens Budget Commission, *Reforming California's Budget Process, Preliminary Report and Recommendations* (Los Angeles: Center for Governmental Studies, 1995), p. 30.²⁵ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, "Improving the State Budget and Fiscal Process: Developing a Long-term Vision with Increased Fiscal Discipline" (Sacramento: the Commission, 1996), pp. 38,42.²⁶ California Business Roundtable, *Revenue and Taxation Task Force Agenda for Governance and Fiscal Reform*, Approved November 30, 1995, p. 5.²⁷ Allyson Washburn, Ph.D., "Testimony Given Before the California Constitution Revision Commission," October 24, 1995.²⁸ California Citizens Budget Commission, *Reforming California's Budget Process, Preliminary Report and Recommendations* (Los Angeles: Center for Governmental Studies, 1995), p. 3.²⁹ California Citizens Budget Commission, *Reforming California's Budget Process, Preliminary Report and Recommendations* (Los Angeles, Center for Governmental Studies, 1995), pp. 1, 43-46.³⁰ California Governance Consensus Project, *Conceptual Plan as Modified at the March 2, 1999 Plenary Meeting*, accessed July 21, 2002, at www.csus.edu/calst/cgcp/page2a.htm³¹ John W. Ellwood and Mary Sprague, *Options for Reforming the California State Budget Process*, , (Berkeley, Calif.: Conference on California Constitutional Reform, June 8-10, 1995), pages 23, 27.³² California Budget Project, *Dollars and Democracy: An Advocate's Guide to the California State Budget Process* (Sacramento: the Project, March 1999), pp. 36-37.³³ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, "Improving the State Budget and Fiscal Process: Developing a Long-term Vision with Increased Fiscal Discipline" (Sacramento, 1996), pp. 38, 43.³⁴ California Business Roundtable, *Revenue and Taxation Task Force Agenda for Governance and Fiscal Reform*, Approved November 30, 1995, pp. 4-5.³⁵ Allyson Washburn, Ph.D., "Testimony Given Before the California Constitution Revision Commission," October 24, 1995.³⁶ California Citizens Budget Commission, *Reforming California's Budget Process, Preliminary Report and Recommendations* (Center for Governmental Studies, 1995), pp. 3, 4.³⁷ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, "Improving the State Budget and Fiscal Process: Developing a Long-term Vision with Increased Fiscal Discipline" (Sacramento, 1996), p. 44.³⁸ Allyson Washburn, Ph.D., "Testimony Given Before the California Constitution Revision Commission," October 24, 1995.³⁹ California Citizens Budget Commission, *Reforming California's Budget Process, Preliminary Report and Recommendations* (Center for Governmental Studies, 1995), pp. 48-51.⁴⁰ California Governance Consensus Project, *Conceptual Plan as Modified at the March 2, 1999 Plenary Meeting*, accessed July 21, 2002, at www.csus.edu/calst/cgcp/page2a.htm⁴¹ California Budget Project, *Dollars and Democracy: An Advocate's Guide to the California State Budget*

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⁴³ California Business Roundtable, *Revenue and Taxation Task Force Agenda for Governance and Fiscal Reform*, Approved November 30, 1995, p. 2.

⁴⁴ California Business-Higher Education Forum, *California Fiscal Reform: A Plan for Action, Recommendations and Summary* (June 1994), p. 12.

⁴⁵ Speaker's Commission on Regionalism, *Final Report*, January 13, 2002, p. 9; accessed July 25, 2002 at <http://news.statesmanjournal.com/article.cfm?i=45604>.

⁴⁶ California Citizens Budget Commission, *Reforming California's Budget Process, Preliminary Report and Recommendations* (Los Angeles: Center for Governmental Studies, 1995), pp. 3, 42.

⁴⁷ Little Hoover Commission, *Budget Reform: Putting Performance First*, Report #135 (Sacramento: the Commission, October 1995), p. 7.

⁴⁸ John W. Ellwood and Mary Sprague, *Options for Reforming the California State Budget Process*, (Berkeley, Calif.: Conference on California Constitutional Reform, June 8-10, 1995), pp.5-26. ⁴⁹ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, "Improving the State Budget and Fiscal Process: Developing a Long-term Vision with Increased Fiscal Discipline" (Sacramento: the Commission, 1996), pp. 37, 40.

⁵⁰ California Business Roundtable, *Revenue and Taxation Task Force Agenda for Governance and Fiscal Reform*, Approved November 30, 1995, pp. 5-6.

⁵¹ Allyson Washburn, Ph.D., "Testimony Given Before the California Constitution Revision Commission," October 24, 1995.

⁵² Senate Advisory Commission on Cost Control in State Government, "Summary of Findings and Recommendations," *California's Budget Process: Improving Quality, Cost-Efficiency, Effectiveness and Accountability in State Government* (Sacramento, the Commission, 1999), p. ii.

⁵³ Senate Advisory Commission on Cost Control in State Government, "Summary of Findings and Recommendations," *California's Budget Process: Improving Quality, Cost-Efficiency, Effectiveness and Accountability in State Government* (Sacramento, the Commission, 1999), pp. ii-iv.

⁵⁴ California Governance Consensus Project, *Conceptual Plan as Modified at the March 2, 1999 Plenary Meeting*, accessed July 21, 2002, at www.csus.edu/calst/cgcp/page2a.htm ⁵⁵ Little Hoover Commission, *Budget Reform: Putting Performance First*, Report #135 (Sacramento: the Commission, October 1995), pp. 4-6.

⁵⁶ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, "Improving the State Budget and Fiscal Process: Developing a Long-term Vision with Increased Fiscal Discipline" (Sacramento: the Commission, 1996), pp. 37-39.

⁵⁷ California Business Roundtable, *Revenue and Taxation Task Force Agenda for Governance and Fiscal Reform*, Approved November 30, 1995, p. 5.

⁵⁸ Bay Area Economic Forum, *California Constitution Revision and Economic Competitiveness for the Bay Area*, December 1995.

⁵⁹ California Citizens Budget Commission, *Reforming California's Budget Process, Preliminary Report and Recommendations* (Los Angeles: Center for Governmental Studies, 1995), pp. 36-37.

⁶⁰ California Citizens Budget Commission, *Reforming California's Budget Process, Preliminary Report and Recommendations* (Los Angeles, Center for Governmental Studies, 1995), pp. 30-31, 42.

⁶¹ California Governance Consensus Project, *Conceptual Plan as Modified at the March 2, 1999 Plenary Meeting*, accessed July 21, 2002, at www.csus.edu/calst/cgcp/page2a.htm ⁶² Mark Friedman, *A Guide to Developing and Using Performance Measures in Results-Based Budgeting* (Washington, D.C.: The Finance Project, May 1997), p. i.

⁶³ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, "Improving the State Budget and Fiscal Process: Developing a Long-term Vision with Increased Fiscal Discipline" (Sacramento: the Commission, 1996), pp. 37-38.

⁶⁴ Cal-Tax, "Plan for Stabilizing California Public Finance," *Policy Brief*, March 1995, pp. 3-4, accessed July 22, 2002, at www.caltax.org/RESEARCH/plan.htm ⁶⁵ California Business Roundtable, *Revenue and Taxation Task Force Agenda for Governance and Fiscal Reform*, Approved November 30, 1995, p. 5.

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⁶⁷ California Business-Higher Education Forum, *California Fiscal Reform: A Plan for Action, Recommendations and Summary* (June 1994), p. 10.

⁶⁸ John W. Ellwood and Mary Sprague, *Options for Reforming the California State Budget Process* (Berkeley, Calif.: Conference on California Constitutional Reform, June 8-10, 1995), p. 20.

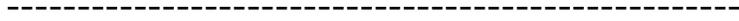
⁶⁹ LeRoy Graymer, *Report on a Study of California Governance Reform, based on Interviews and Discussions with Non-Elected Leaders in California Public Policy* (UCLA Extension, March 1994), p. 6.

Institute of Regional and Urban Studies

MEMORANDUMS ON THE CALIFORNIA BUDGET

by

Steve Levy



Three Major Tax Bases

Education Enrollment Trends

Census Migration Findings

State Government and Economic Growth

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DATE: July 8, 2003

TO: Budget Project Friends

FROM: Stephen Levy

SUBJECT: Analysis of California's Three Major Tax Bases

1. In June 2003, the Institute of Regional and Urban Studies (IRUS) was awarded a grant from The James Irvine Foundation to provide information and analysis on both short and long-term budget issues in California. The IRUS focus is on understanding the relationship between budget choices and the California economy.

IRUS is the non-profit affiliate of the Center for Continuing Study of the California economy (CCSCE).

2. This memo is the first in a series of brief reports on issues related to the state budget and economy.

California depends on three major taxes for the majority of state and local tax revenue. The personal income tax and sales tax are the largest sources of tax revenue for the state budget and property taxes and sales taxes are the largest source of tax revenues for most local jurisdictions including school districts.

The Commission on Tax Policy in the New Economy and many others have called attention to the question of whether the state's existing tax structure needs to be reformed. One part of that discussion focuses on the volatility and long-term growth of the state's three major tax bases—1) personal income, 2) taxable sales and 3) the assessed value of property.

This memo provides some data and analysis of the growth and volatility of these three tax bases.

3. I tabulated data for the period 1980-2002 for total personal income from the United States Department of Commerce and for taxable sales and assessed valuation from the California Board of Equalization. I looked at two major time periods—1980 through 1990 and 1990 through 2002. All of the data and original graphs are in the accompanying file Tax Bases.xls.

4. Summary

Taxable sales is the slowest-growing and most volatile of California's three major tax bases. These characteristics will continue unless the taxable sales base is broadened to

include spending on selected fast-growing service sectors. Broadening the sales tax base will also reduce volatility by a small amount.

Assessed valuation had the highest growth rate in the 1980s and the second highest since 1990. Volatility was similar to that for personal income. Future growth rates will depend on the level of private sector building and the rate of turnover. The two major reforms currently under consideration, sales/property tax “swaps” and periodic reassessment of commercial property, are being advanced primarily to address inequities and disincentive effects stemming from the unintended consequences of Proposition 13.

Personal income is expected to be the fastest growing and most progressive of the state’s three major tax bases. Recent volatility in the portion of the income tax base related to the stock market has gained attention as a concern for the future. Consideration should be given to treating this as an **expenditure reform** issue through 1) the creation of a reserve account funded with “extra” stock market related revenues and/or 2) using the “extra” revenues exclusively for one-time investment purposes.

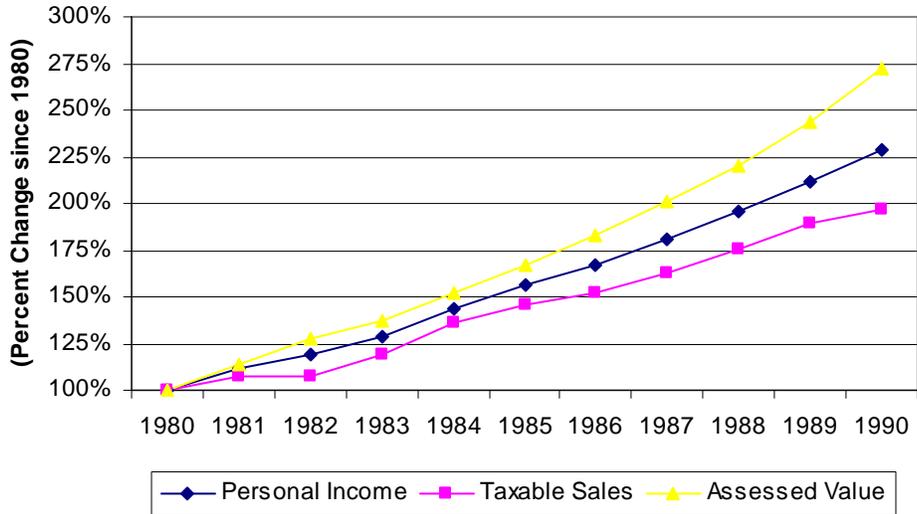
5. Tax Base Growth

In the 1980s, assessed valuation grew faster than both personal income and taxable sales. Between 1980 and 1990, assessed valuation in California grew by 172.5% or 10.5% per year. Personal income increased by 129% or 8.6% per year and taxable sales rose by 96.6% or 7.0% per year. The California Consumer Price Index increased by 5.1% per annually.

California							
Personal Income, Taxable Sales and Assessed Valuation							
(Billions)							
	1980	1990	2000	2002	Average Annual Growth Rate		
					1988-1990	1990-2000	1990-2002
Personal Income	\$286.3	\$655.6	\$1,100.7	\$1,158.7	8.6%	5.3%	4.9%
Taxable Sales	142.8	280.6	441.9	436.1	7.0%	4.6%	3.7%
Assessed Valuation	579.0	1,577.9	2,355.4	2,755.8	10.5%	4.1%	4.8%

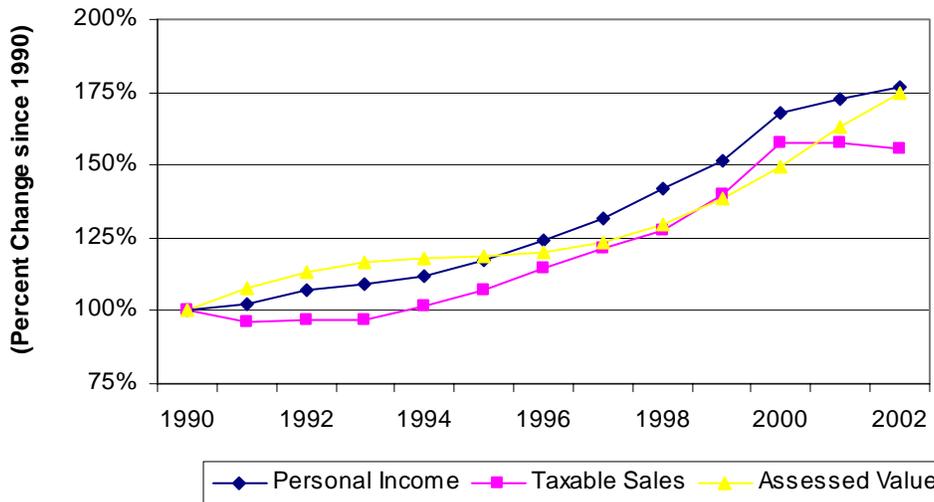
The growth rate for inflation and population combined in the 1980s was 7.5% per year.

Tax Base Growth in the 1980s



Since 1990, personal income and assessed valuation have grown at roughly the same rate while taxable sales grew more slowly. Between 1990 and 2002, personal income increased by 76.7% or 4.9% per year while assessed valuation rose by 74.6% or 4.8% per year. Taxable sales increased by 55.4% or 3.7% per year while the California Consumer Price Index rose by 2.7% annually.

Tax Base Growth since 1990



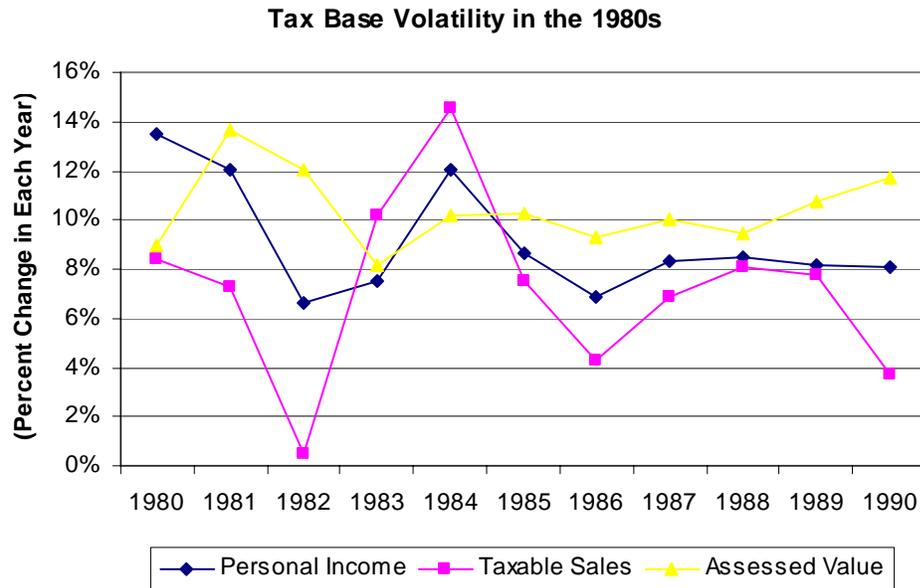
The growth rate for inflation and population combined between 1990 and 2002 was 4.2% per year.

6. Tax Base Volatility

Volatility refers to how much the growth rates of the tax base vary from year to year. For example, if the ten year average growth rate is 4.9% and the growth rate for each year within the ten year period is also 4.9%, then that particular tax base would be consider very stable. If, on the other hand, the 4.9% average growth rate for the ten-year period

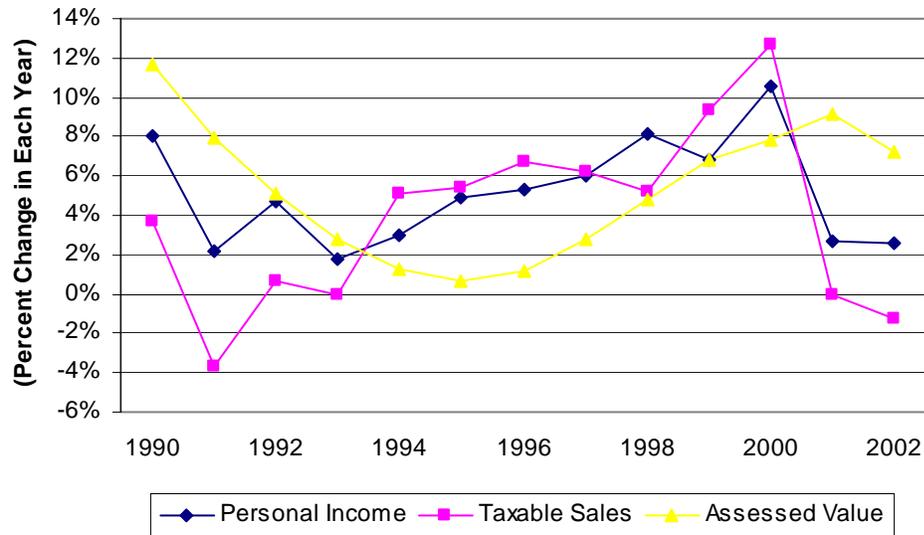
included two years of negative growth and three years of growth above 10%, then that tax base would be considered volatile.

In the 1980s, as shown below, the taxable sales series was quite volatile having both the highest and lowest single year growth rates among the three tax bases being analyzed. Both personal income and assessed valuation growth rates rose and fell during the early 80s recessions and then have relatively stable annual growth rates starting in 1985.



Between 1990 and 2002, the taxable sales series had the highest volatility; once again having both the highest and lowest single year growth rate as well as five years where taxable sales growth was less than 1%. The personal income series was the most stable through 2000 and then had two years of low growth. The assessed value series had the sharpest drop in the early 90s and had five years in the middle 90s with the lowest growth rate among the three series.

Tax Base Volatility since 1990



Personal income tax **receipts** were quite volatile after 1998 as stock option income and capital gains rose rapidly and then fell rapidly, even though the underlying personal income series did not vary as much. The implications of differing growth rates in personal income and personal income tax receipts are discussed below.

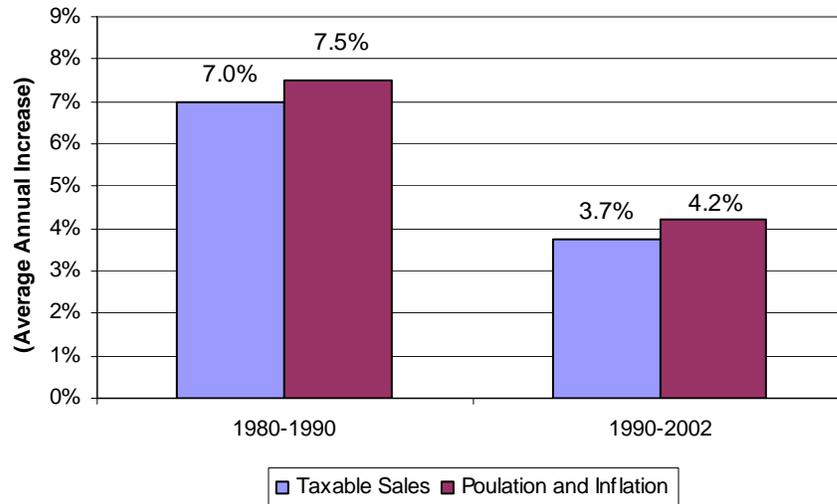
7. Interpretation and Implications

What are some of the implications of this data for discussions about the adequacy of California's tax structure for the current and future economy?

Taxable Sales/Sales Tax Revenues

Taxable sales have been the slowest growing and most volatile of California's three major tax bases. As shown below, taxable sales growth did not keep pace with population and inflation growth in either the 1980s or the period since 1990. In the 1980s, taxable sales rose by 7.0% per year, while population and inflation increased by 7.5% annually. Between 1990 and 2002, taxable sales rose by 3.7% per year while population and inflation increased by 4.2% annually.

Taxable Sales Versus Population and Inflation Growth



The charts above show that taxable sales have been the most volatile of the state's three major tax bases.

The slow growth of taxable sales is explained by the absence of fast growing expenditure items such as services and housing from the taxable sales base. These past trends are expected to continue as services represent a rising share of consumer spending.

The volatility of taxable sales is explained by the close link between business and consumer spending and the business cycle. In all recent recessions, spending has fallen by more than income. It is reasonable to expect that taxable sales will continue to be the most volatile of the three major tax bases.

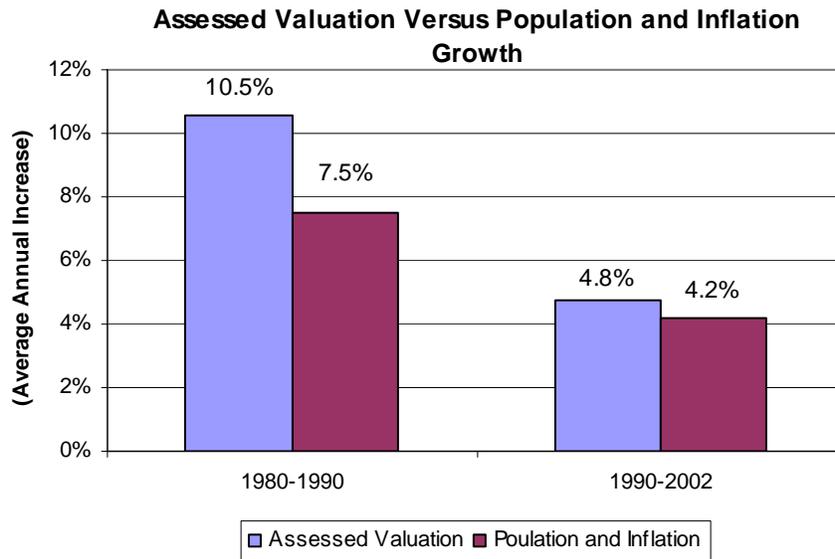
The principal sales tax reforms being discussed address both the slow growth and volatility of the sales tax base. The major sales tax reforms involve broadening the sales tax base to include services. These reforms range from the narrower goal of including all Internet transactions in the state sales tax base to broader efforts that involve extending the coverage of taxable sales to various expenditures on services such as legal, consulting, repair and, possibly, medical services.

Broadening the sales tax base would be effective, in my opinion, in raising the sales tax growth rate and in slightly reducing the volatility of sales tax revenues.

Whether broadening the sales tax base should be accompanied by tax rate reductions depends on overall budget and revenue considerations.

Assessed Valuation/Property Taxes

Assessed valuation grew faster than population and inflation combined in both the 1980s and the period since 1990. As shown below, assessed valuation grew by 10.5% per year between 1980 and 1990 compared with the 7.5% annual increase for population and inflation. Since 1990 assessed valuation growth (4.8% per year) has been slightly faster than the 4.2% annual growth rate for population and inflation.



Assessed valuation grew rapidly in the 1980s driven by record residential and nonresidential construction, and rising home prices and high turnover rates at the end of the decade. Assessed valuation growth slowed significantly in the 1990s as construction levels fell during the early 90s and, except for public construction, which does not affect the tax base, have not since approached previous record levels.

In the short term, AV growth is expected to slow. Nonresidential construction levels will remain low until existing vacancies are worked off. New housing construction is rising, but the volume of re-sales will level off and fall soon as interest rates rise. It is important to understand how much of recent housing market activity has been driven by record low mortgage rates.

In the longer term AV growth will probably keep pace with population and inflation increases as in the 1990-2002 period.

The AV reform issues deal with equity and land use incentive considerations more than the overall level of AV growth.

One set of reform suggestions deals with increasing the share of property tax revenues allocated to local governments with an offsetting decrease in sales tax revenues. This proposal is “revenue neutral” meaning that it will not raise or lower the amount of taxes collected.

Reforms that provide stronger fiscal incentives for local governments to approve housing developments **will directly address regional equity and economic goals as housing, particularly housing for lower and middle-income families is critical to maintain regional economic competitiveness.**

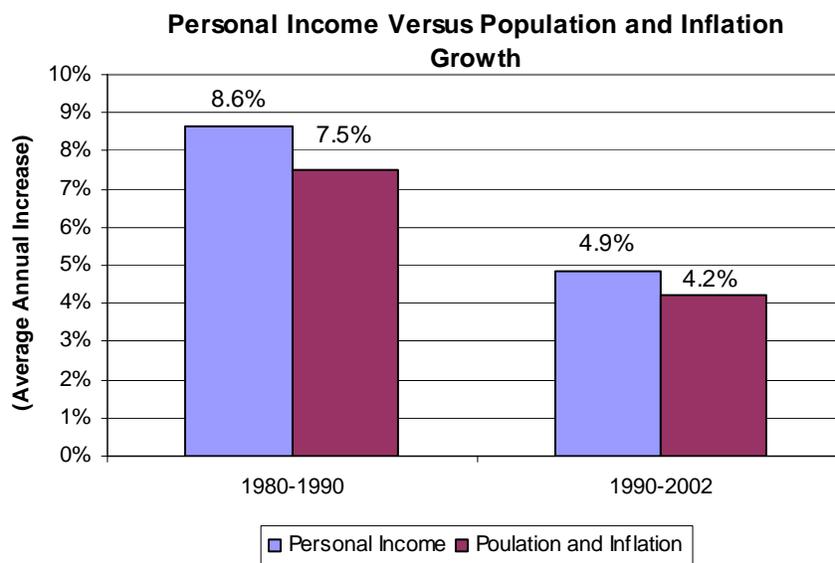
Another proposed reform, increasing the assessed valuation of nonresidential properties, potentially addresses revenue growth, equity and incentive considerations. The increased revenues from changing the rules on commercial property assessment could go either to raising overall local government revenues or, if offset by reductions elsewhere, go more

to correcting inequities between comparable group of property owners and improving the incentives for new developments.

Personal Income/Income Tax Revenues

In discussing the future of the income tax, it is important to distinguish trends in personal income and trends in stock option income and capital gains. Capital gains is **not** counted in personal income but **is** counted in income for tax purposes.

Personal income grew faster than population and inflation combined in both the 1980s and the period since 1990. As shown below, personal income grew by 8.6% per year between 1980 and 1990 compared with the 7.5% annual increase for population and inflation. Since 1990 personal income growth (4.9% per year) has been slightly faster than the 4.2% annual growth rate for population and inflation.

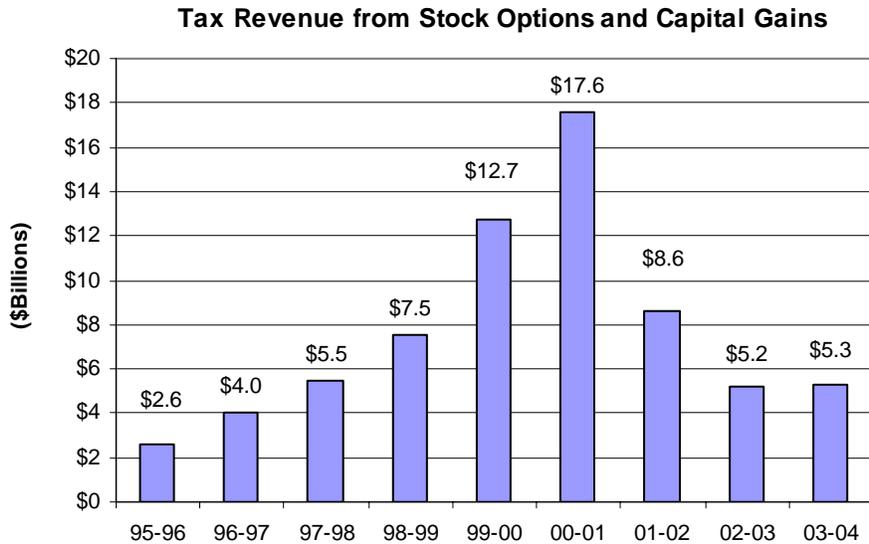


Personal income growth rises and falls with the business cycle, but personal income volatility is no greater than for assessed value and is less than the volatility in taxable sales.

Over the long-term, personal income is expected to **grow faster than** taxable sales and assessed valuation, at least as these tax bases are currently structured.

Personal income tax **revenues** have been volatile since 1998 because the personal income tax base is affected by variations in stock option income (which is included in personal income) and variations in capital gains, which are not included in personal income as compiled by the United State Department of Commerce and the California Department of Finance. Thus, there is a distinction between the personal income series and the personal income tax base.

As shown below, tax revenues from stock option income and capital gains rose and then fell by approximately \$12 billion between 1997-98 and 2002-03. Similar fluctuations in stock option income and/or capital gains could occur in the future if the stock market and tech economy surge again.



The policy question is what to do about these revenue fluctuations. I offer two ideas from an economic policy perspective. One, it does not make sense to de-emphasize the income tax. Personal income is expected to be the fastest growing of the state's three major revenue bases and the personal income tax is the most progressive component of California's tax structure

Two, it does make sense to take account of these fluctuations. While fluctuations in stock option income and capital gains cannot always be predicted ahead of when they occur, they **are** identifiable after the fact. Legislators **did** know in 2001 and 2002 that stock option and capital gains revenue had risen and was currently falling.

This ability to identify fluctuations in revenue caused by stock options and capital gains suggests the policy approach, already widely discussed, of treating these revenues **differently from the point of view of the spending side of the budget.** Indeed, there was an early attempt by Governor Davis and the Legislature to use these revenues for one-time expenditures.

Appropriate policy can insulate the state's spending from revenue fluctuations in stock option income and capital gains. Technically (politically may be a different story) one-time surges in revenues can be matched with one-time expenditures and/or put into a reserve fund.

Thus, it is possible to reform the way we treat income tax revenues without diminishing the importance of the personal income tax in California's tax structure.

DATE: July 24, 2003

TO: Budget Project Friends

FROM: Stephen Levy

SUBJECT: K-12 and Higher Education Enrollment Trends

1. California is beginning to experience a dramatic reversal in education enrollment trends. The rate of growth in K-12 enrollment will drop to near 0% in the next ten years, while higher education enrollments are projected to surge.

This memo summarizes enrollment projections prepared last year by the California Department of Finance (DOF) and briefly discusses the implications of changing enrollment trends for the budget and other public policy issues.

2. K-12 Enrollment

K-12 enrollment in California increased from 4.8 million in 1990 (the 1990-1991 school year) to 6.1 million in 2001 and is projected to reach 6.3 million in 2011. The latest DOF projections show K-12 enrollment peaking in the 2007-2008 school year and then falling slightly by 2011.

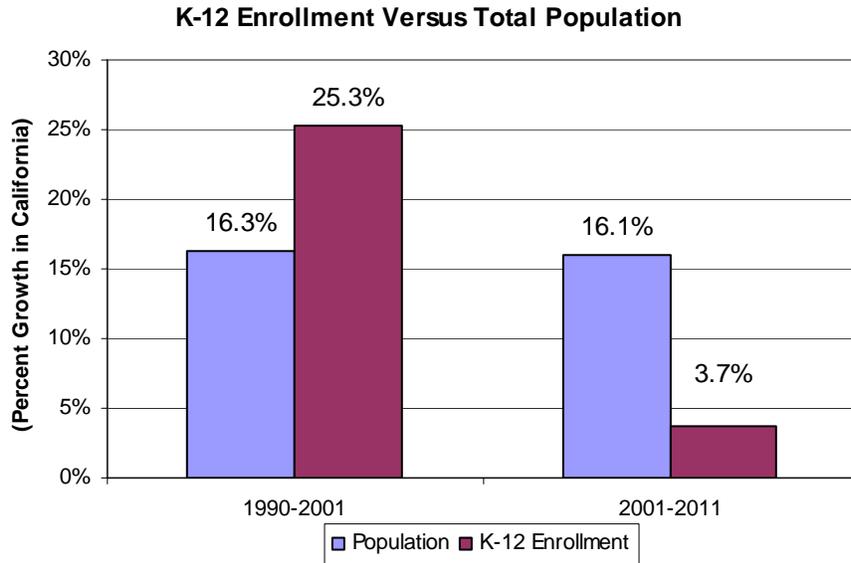
California Enrollment Trends 1990 – 2011 (Thousands)					
	1990	2001	2011	Percent Change	
				1990-2001	2001-2011
K-12	4,842.2	6,068.9	6,295.3	25.3%	3.7%
Higher Education	2,035.7	2,254.2	2,841.5	10.7%	26.0%
UC, CSU	522.7	567.6	751.4	8.6%	32.4%
Community Colleges	1,513.0	1,686.6	2,090.1	11.5%	23.9%

Source: California Department of Finance

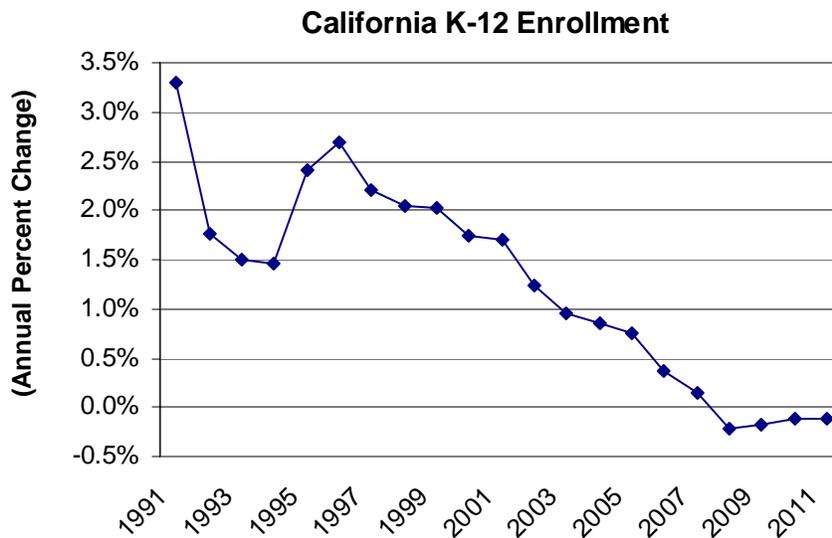
The K-12 enrollment projections are driven by the level of births and trends in migration to and from the state. The number of births and the number of children coming as immigrants reached record levels in the late 1980s and early 1990s. The number of births has fallen slightly since then and the number of immigrants has remained steady.

As a result, the number of children reaching school age surged in the late 1980s and early 1990s and has now begun to slow.

K-12 enrollment increased by 25.3% between 1990 and 2001, faster than the total population growth of 16.3%. Between 2001 and 2011, these trends will be reversed. K-12 enrollment is projected to grow by just 3.7%, while total population is projected to increase by 16.1%.



The annual growth rate for K-12 enrollment declines steadily between 1995 and 2008 and then levels off at close to 0%.



DOF will update these K-12 enrollment projections in late October 2003 and will publish them on the DOF Demographic Research Unit website shortly thereafter.

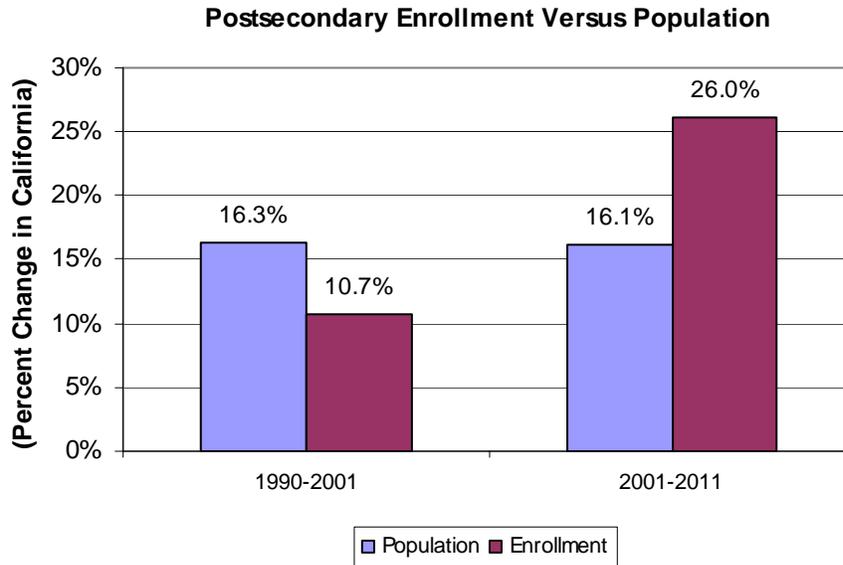
3. Higher Education Enrollment

The higher education enrollment projections are for the three segments of California's public higher education system — the University of California (UC), California State University (CSU) and the Community College system.

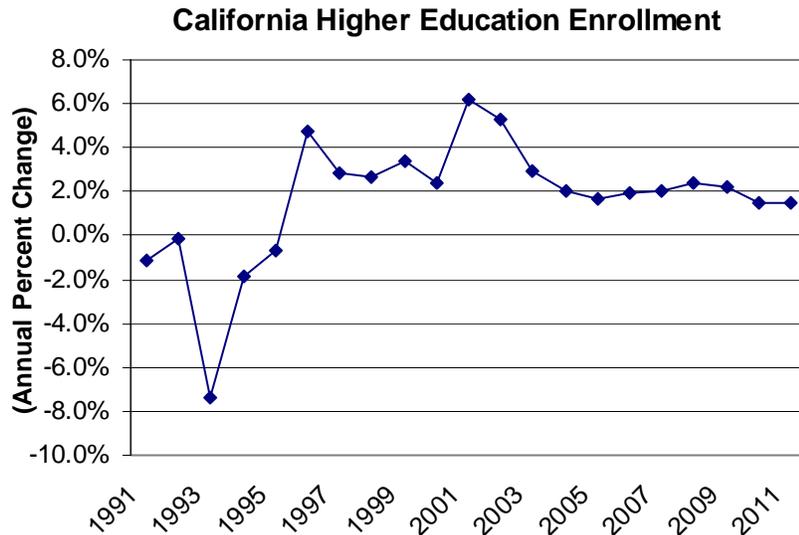
Higher education enrollment increased from 2.0 million in 1990 to nearly 2.3 million in 2001 and is projected to reach more than 2.8 million in 2011. The latest DOF projections show public postsecondary enrollment rising each year between now and 2011.

The postsecondary enrollment projections are driven by the projections of high school graduates and assumptions about the share of high school graduates who will attend California's public postsecondary schools.

Enrollments increased by 10.7% between 1990 and 2001, slower than the 16.3% gain in total population. Between 2001 and 2011, these trends will be reversed. Postsecondary enrollments are projected to increase by 26.0%, faster than the state's overall projected population growth of 16.1%.



The growth in public postsecondary enrollments in California is projected to be near 2% each year until 2011.



Community college enrollment accounted for 75% of total postsecondary enrollments in the 2001-2002 school year. As a result, community colleges are projected to see the largest numerical gain in enrollments. On a percentage basis, UC and CSU projected enrollment gains are slightly higher.

4. Potential Policy Implications

Implications for K-12 Education Funding

As I understand the current budget rules (Proposition 98) for education, K-12 funding grows according to changes in per capita income and enrollment. The legislature can add additional funds if they wish, but per capita income and enrollment growth provide the current floor for K-12 funding.

Two things will happen as the rate of enrollment growth falls. First, the overall formula-mandated spending growth for K-12 will fall for any given increase in per capita income because the enrollment growth factor will be less. K-12 spending growth will fall unless the state uses this opportunity to increase per pupil spending by more than the formula mandates.

For example, per capita income grew by 3.6% per year between 1990 and 2001. K-12 enrollment grew by 2.1% annually during the same period. The combination of these trends (other factors being equal) would produce a 5.8% annual growth in K-12 funding. Projected K-12 enrollment growth for 2001 - 2011 is 0.3% per year. As a result, if per capita income again grew by 3.6% annually, total K-12 funding growth would fall from 5.8% per year to 4.0% per year.

Second, the state share of K-12 funding is likely to fall because the local share depends on the growth in assessed valuation and property taxes, which will not fall as enrollment falls. Thus, the local share of K-12 funding will increase for most districts unless the state decides to raise per pupil spending more than the mandated minimum.

For example, assessed valuation grew by 4.5% per year between 1990 and 2001 and by 5.6% per year between 1995 and 2002. Either of these growth rates is higher than the projected 4.0% annual growth in per capita income and enrollment described above. If these trends actually happen, then the local share of K-12 funding will rise slightly and the state share will decline.

It is important for the state Department of Finance and Legislative Analyst's Office to begin discussing the budgetary implications and choices related to the upcoming slowing of K-12 enrollment growth. The projected trends are one potential bright spot in examining long-term state budget trends.

Implications for Higher Education Funding

Funding for the UC and CSU systems are one of the few discretionary items in the state budget. Funding for community colleges is part of the complicated funding arrangements mandated under Proposition 98.

The projected high rates of growth for postsecondary enrollment raise two budget policy issues for California. One issue is planning for the steady enrollment increases projected for the UC and CSU systems. California's public university systems are a major plus for the state's economic competitiveness as well as providing comparatively affordable access to top quality higher education for residents. There will be strong pressures to fund the projected enrollment gains and options for funding these enrollment gains should be part of any long-term budget planning in California.

A second issue is making sure that the projected community college enrollment increases are funded given the complicated funding rules under Proposition 98.

Implications for Land Use Planning

As overall K-12 enrollment growth slows, there will be more districts with level or declining enrollment. There will still be districts with growing enrollment and there will still be communities with new housing developments that require new school construction, but the balance between new construction and renovation will shift toward renovation as enrollment growth slows.

The relationship between school construction and renovation and local housing and land use policies is now the subject of concentrated focus in California. For example, see the work of the New Schools, Better Neighborhoods organization at www.nsbno.org.

The basic idea is to view schools as potential centers of community and to use the opportunities afforded by school construction and renovation to maximize collaborative master planning opportunities for combining school and community facilities. Since the K-12 enrollment surge of the past two decades is coming to an end, more and more of the state's school construction dollars will be spent on upgrading or replacing facilities in existing neighborhoods. Both new and modernized school facilities could, therefore, be multi-tasked community resource

and learning centers designed at the outset to be modified as demographics change and enrollments slow or accelerate.

DATE: August 15, 2003
TO: Budget Project Friends
FROM: Stephen Levy
SUBJECT: Recent Census Migration Findings

1. This is the third in an ongoing series of memos on California budget-related issues. This series is supported by a grant from The James Irvine Foundation. Previous memos are posted at www.ccsce.com.
2. The goal of this series of memos is to focus attention on three major questions:
 - a) What is the appropriate way to balance California's state budget? Should there be additional tax and fee increases, additional public service cuts or is there a third way? Does the answer differ in the long term versus the short term? What is the role of reform?
 - b) What makes a state economy competitive/attractive? How do budget choices relate to the state economy?
 - c) How do the economy and budget relate to reducing poverty and improving economic prosperity for low and middle-income Californians?
3. Each of these questions has proved difficult in terms of reaching any consensus. These questions will be directly addressed in later memos.

These beginning memos address key building blocks for the later discussion of policy choices. The first memo examined California's three major tax bases — personal income, taxable sales and assessed value. The second memo described changing trends in K-12 and higher education enrollment — areas where more than half of the state budget is spent.

This memo examines the Census findings released this week that net domestic migration was negative between 1995 and 2000, i.e., more residents **left California** for other states than **came to** California from other states.

By addressing this topic, the memo will also begin the ongoing discussion of assessing the California economy. The migration findings, and economy and budget analyses are linked. The stories accompanying the migration release had a strong flavor of "they're leaving because something is wrong with the California economy". An accurate assessment of the state's economy and likely future trends is essential to developing and discussing budget alternatives. That is why it is important to see

whether the migration findings tell us anything about the current state of the California economy.

4. Census Bureau Findings Released August 6, 2003

On August 6, 2003, the United States Census Bureau released data about the pattern of migration between states and metropolitan areas for the period 1995-2000. The finding for California was that 1,448,964 people moved **to California** from other states and 2,204,500 people moved **from California** to other states for a net outflow of 755,536.

As shown on the table below, the net outflow was accounted for by domestic out-migration from the Los Angeles Basin and San Francisco Bay Area regions.

Domestic Migration 1995 - 2000	
California	
Moved from other states	1,448,964
Moved to other states	2,204,500
Net domestic migration	-755,536
Los Angeles Basin	-549,951
San Francisco Bay Area	-206,670

The full set of Census Bureau releases can be accessed at www.census.gov/newonsite under August 2003.

There were several front-page stories about the Census findings and these stories made the following points: 1) migration trends usually reflect job and unemployment trends — people go where job prospects are good, 2) housing costs less in other states and 3) people move to improve their quality of life, for example, to where congestion is less.

The general tenor of these stories was that something was going on in California between 1995 and 2000 that led to this exodus.

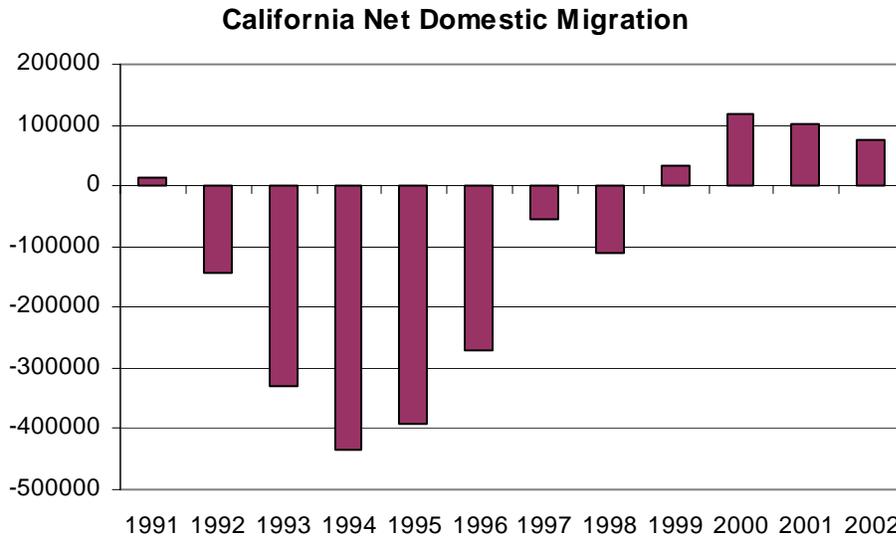
It is an interesting story and a tantalizing headline but the facts don't fit the story. Let's see what actually happened.

5. Explaining the Census Bureau Findings

Many people **did** leave California when the economy was worse than in other areas, but this is an **old** story, not a new story. It is about what happened during and immediately after the long early 90s recession.

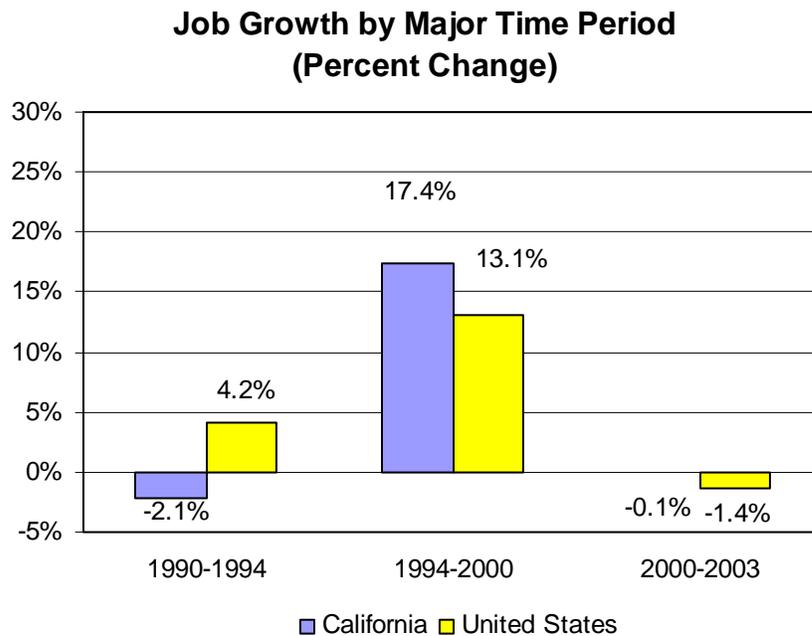
The graph below shows the annual estimates of domestic migration compiled by the California Department of Finance. Three findings are clear from the graph:

- 1) Domestic out-migration exceeded 1.4 million between July 1, 1992 and July 1, 1996
- 2) Domestic migration was close to zero between July 1, 1997 and July 1, 2000.
- 3) Domestic migration has been **positive** in each of the past four years.



Domestic migration trends do follow job trends. The out-migration flows described in the Census findings were a direct result of California's **below-average** job growth in the 1990-1994 period. The turnaround in migration trends beginning in 1997 and lasting through the middle of 2002 was the direct result of California's **above-average** job growth in the 1994-2000 period.

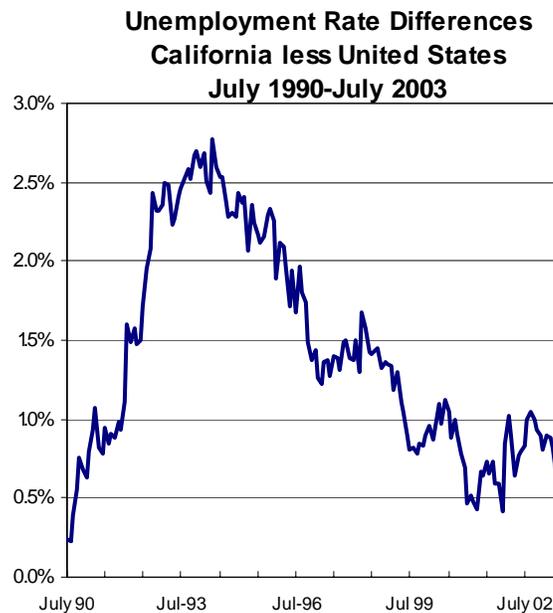
The graph on the next page, reprinted from **California Economic Growth-2003 Edition**, shows the difference in comparative job growth rates between the state and nation for each time period.



California lost jobs in the early 90s (-2.1%) while the nation added jobs (+4.2%). The nation recovered from the early 90s recession while job losses continued in the state. As a result, out-migration surged in the mid 90s.

California outpaced the nation in job growth (+17.4% versus +13.1%) between 1994 and 2000. As a result, out-migration was replaced by net domestic in-migration beginning in 1999.

The unemployment rate **difference** between the state and nation is the best single indicator of future trends in domestic migration. In the early 90s, California's unemployment rate was more than 2% higher than the national rate. In late 1993 and early 1994, the gap was as high as 2.7%. In part, these persisting unemployment rate differentials triggered the large out-migration of the mid 1990s.



Between 1994 and 2000, the unemployment gap dropped steadily and the pattern of out-migration was reversed.

6. Current Outlook for the California Economy

Some of the news stories surrounding the Census Bureau's recent release of the migration data implied that the state economy is doing poorly relative to other parts of the country and that out-migration was still continuing. These stories combined with similar statements associated with the recall election campaigns suggest the benefit of an up-to-date "status" report on the current outlook for the state economy.

There are two broad ways to look at the California outlook — 1) in absolute terms and 2) in relative or comparative terms. One way of looking focuses on changes in job levels and unemployment rates and the second way focuses on these trends in relation to trends in other states or in earlier time periods.

Trends in Job Growth and Unemployment

Job levels in California are approximately 50,000 below the level of three years ago. Job levels rose by 250,000 in the final months of the venture capital boom in late 2000 and have fallen by nearly 300,000 since then.

Unemployment rates statewide have risen from a low of 4.7% in December 2000 to 6.6% in July 2003. Income growth has fallen and real per capita income is below 2000 levels.

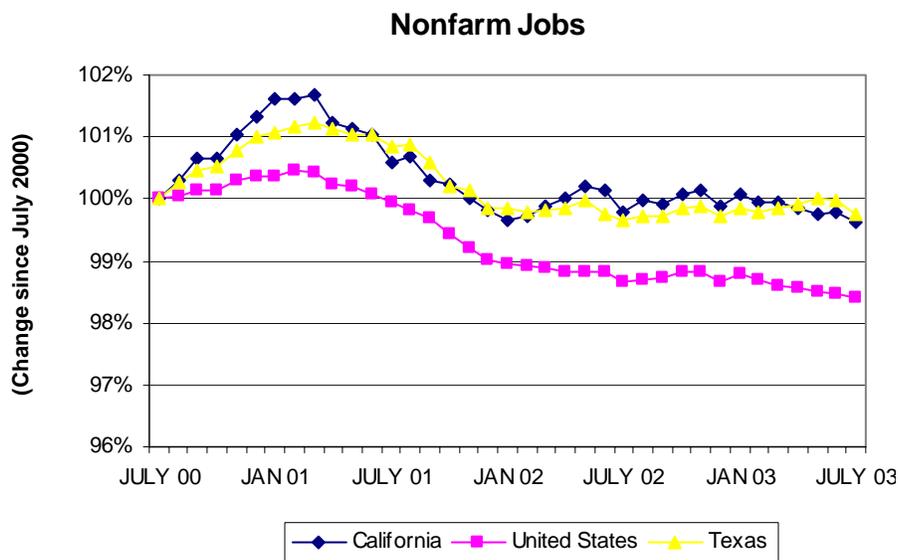
Relative Trends in Job Growth and Unemployment

In contrast to the economy of a decade ago, California is **not doing worse than the nation in the current downturn.**

The graph on page 4 shows that California job levels are down 0.1% between 2000 and the first seven months of 2003. During the same time period, job levels in the nation fell by 1.4%. The California jobs data released for July show that during the past twelve months job levels fell by 0.2% in the state and 0.3% in the nation.

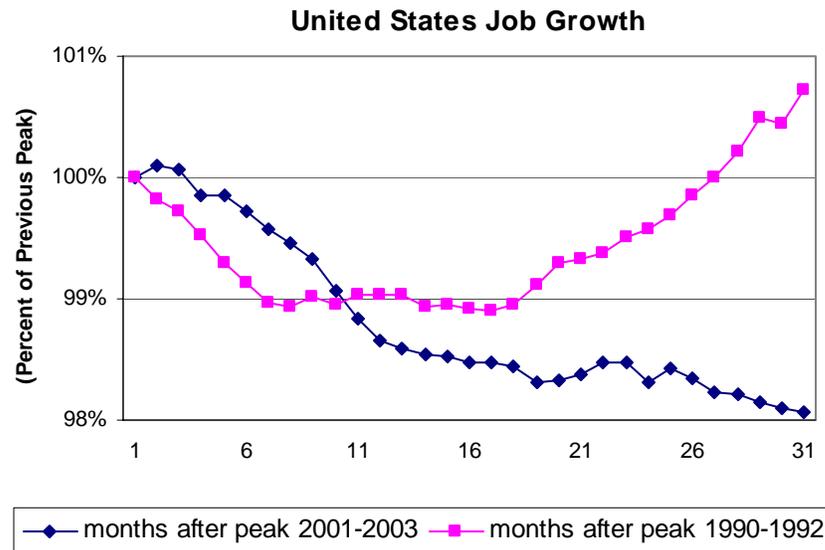
The graph on page 5 shows that the unemployment rate gap between the state and nation has **fallen** since the middle of 2000. In fact, the California's unemployment rate in July 2003 was 0.4% higher than the national average, which is the **smallest gap** since early in 1990. California's unemployment rate has risen 1.9% since the lows while the national unemployment rate has risen by 2.3%.

The graph below compares non-farm wage and salary job growth in California, Texas and the nation between July 2000 and July 2003.



California, Texas and the nation all added jobs in the last months of 2000. Since then, California and Texas have each given back all of their job gains. But the nation has given back all job gains **plus** has lost an additional 2 million jobs — for a total of 2.6 million jobs lost in the nation since the peak in early 2001.

The lack of any national recovery in job levels is hurting most states, including California. This is the slowest national economic recovery in more than fifty years and is far weaker than the recovery from the last recession in the early 90s as shown below.



Future Discussion—Key Questions

California has a great set of industries and serious economic challenges. I don't think there is much dispute about either claim.

State and local governments provide “public foundations” that affect how attractive California regions are for future private investment. There are three major areas of “public foundations”:

- The amount and quality of our public investments in areas like education, transportation, water supply and ports.

- The quality of life in our communities. Are they places where people are drawn to live and work?

- The business cost and regulatory environment, e.g., workers' compensation.

There are distinct differences of opinion on the importance, priority and specific steps to address each of these “public foundations”.

Future memos will look at each challenge in more depth and explore how each relates to budget choices.

DATE: September 2, 2003
TO: Budget Project Friends
FROM: Stephen Levy
SUBJECT: The Role of State Government in California Economic Growth

1. This is the fourth in a series of memos related to the California economy and budget, supported by a grant from The James Irvine Foundation. The previous memos are posted at www.ccsce.com.
2. The recall campaign has brought increased attention to the role of state government in promoting economic growth in California. Candidates are putting forth their plans to increase the rate of job growth in the state. Today's "sound-bite debate" about whether businesses are leaving California in record numbers can begin a serious discussion of the potential and limitations for state government policies about the California economy and how these economic policies relate to state budget choices.

The goal of this memo is to provide some background for the ongoing discussion of the role of state government in promoting a "good business climate".

3. Short-Term versus Long-Term

Governors and legislatures do not create recessions nor do they have the tools to end recessions. Moreover, state governments do not have tools to affect short-term industry trends or the stock market. The desire of state elected officials to help residents overcome layoffs and unemployment is not matched by any effective means of doing so.

Governor Wilson did not create the national recession of the early 90s, did not cause the simultaneous aerospace downturn and did not make the recession last longer in California than in the nation. Similarly, Governor Davis did not create the national recession of 2001, did not create the international tech downturn, did not cause the stock market drop, did not cause the current national job level to be nearly 3 million below the previous peak and cannot cause any of these to end.

Governors and legislatures do have a role in creating the conditions for long-term private sector job growth and can be held responsible for these policies as discussed in the next section. The role of state government in supporting long-term economic growth has budget implications but also is affected by policy choices outside the budget process.

4. Long-Term Growth — Governors and Legislatures Have a Role

Some businesses serve state, national and, even, world markets. These businesses export goods and services to people and businesses located outside of their immediate location. California firms export motion pictures, apparel, software, consulting services and a range of high-tech and other manufacturing products.

Firms that export a high percentage of their products and services **have a choice of where to locate facilities**. States and localities can and do “compete” for the location of businesses in export industries.

The current California recall campaign has called attention to the process whereby firms make location decisions for new and existing facilities. The debate about whether businesses are “leaving California” provides an opportunity to discuss the serious issues surrounding the question of what makes a state or local area “business friendly” and who has the responsibility and power to affect California’s “business climate”.

Public policy creates the foundations for attracting private-sector investments.

While state policies cannot affect the long-term growth in demand for technology products and services, public policy does play a role in determining, for example, what share of new technology start-ups choose to locate in California. There are three broad areas where state public policy can affect the location decisions of firms:

- 1) Public investment and public policies play a critical role in a state’s infrastructure — roads, public transportation, school and university facilities, energy and water systems, ports, and airports.
- 2) Public funding and policies play a critical role in helping local governments create **great places to live and work**.
- 3) Public policies play a critical role in defining the regulations and tax system that affect both businesses and residents. In the current debate about California’s economy, the workers’ compensation system has received a lot of attention as a factor in raising business costs in California compared to in other states.

All three of the above areas of public policy affect business decisions and there is great debate about the priority that should be given to each area. At times, the attention given to workers’ compensation makes it seem as if business groups care only about regulations and tax rates, but business groups have also been great supporters of investments in California’s education and infrastructure systems.

Public Investment in Education and Infrastructure

Businesses that can locate anywhere will certainly require California to maintain a competitive public investment program for education and infrastructure. This is especially true for companies whose main asset is creative people who can find employment anywhere in the world.

There is not really any disagreement about the importance of investment in education and infrastructure. Nor is there any disagreement that California is still well below where we

should be — California is 30th in per pupil funding for K-12 and in the bottom 20% of states on most measures of infrastructure investment.

The Governor and Legislature have a significant role re education and infrastructure investment. Investment monies are directly allocated in the state budget. The legislature approves bonds that go to the voters for approval. The state economy and budget play a role in determining the level of bonds that can be invested and the interest rate that will be charged.

The voting rules for passing the budget (a 2/3 majority is now required) and for passing infrastructure bonds (local education bonds require a 55% majority) are another way that public policy affects the level of investment. There will be initiatives next year to lower the voting majority to 55% for both the state budget approval and for other types of local infrastructure bonds

Great Places to Live and Work

For decades, California communities were recognized as great places to live and work. A great climate, excellent recreational facilities, access to both mountains and oceans, good local parks and public facilities and steady improvements in air and water quality helped California rank at or near the top in polls asking “where would you like to live”.

These attributes, together with good schools and infrastructure, constitute the main elements of “a high quality of life”. And a high quality of life is one of California’s major “competitive” forces in attracting new entrepreneurs and innovations. When you can locate a business anywhere, why would you locate in a place that was not attractive for living as well as working?

The Governor and Legislature have a significant role in developing public policies that affect the quality of life in California communities. Both the state budget and Proposition 13 heavily influence local government funding and land use choices.

During the past decade, state budget difficulties have resulted in the Legislature transferring money from local government programs to help balance the state budget. State policies to raise pension benefits for public employees have created pressures for local governments to follow along. The loss of property tax revenues for local governments after Proposition 13 led to the imposition of increasing fee levels on new homes and new businesses by local governments.

The end result has been continuing fiscal pressures and uncertainty for many of California’s local governments and a set of fees that discourage new housing and new economic activity. The fiscal rules surrounding local government finance have influenced land use choices in a way that restricts the ability of cities to create great places to live and work.

There is general agreement on these points but little consensus yet on how the state should change the rules to restore more power and funding to local governments.

Business Regulations and Taxes

By now most Californians have heard an ongoing series of complaints about the costs and rules of the state's current workers' compensation system. The case against the current workers' compensation system has often been combined with complaints that a much broader set of tax and regulatory policies are "job killers" and that the state's business climate is terrible.

There is no disagreement that regulations and taxes are a consideration in business location decisions and no disagreement that the current workers' compensation system has high costs compared to other states and inadequate controls on medical costs and usage. Beyond the issue of workers' compensation, there is little agreement, either on the contention that businesses are leaving California in record numbers or that the regulations and taxes being criticized are "job killers".

The arguments can, in theory, be separated. For example, there is probably agreement that the workers' compensation system will be a negative competitive force in the future even if today's rising costs did not create the tech downturn and even if today's California economy is not performing below the national average.

As a result, it is possible to support extensive reform of the workers' compensation system without accepting the argument that California's economy is in terrible shape.

There can, however, be no doubt that these regulations and tax policies are the direct responsibility of state government.

Two Dilemmas in Creating a Great Business Climate

The first dilemma is that not all businesses are attracted by the same factors. For example, high-tech startups may care more about the educational system, infrastructure and quality of life, while paint manufacturers may care more about energy costs and taxes.

So, in part, what makes a good business climate and what the state should do depends on what kind of industry you want to attract.

The second dilemma is that the three major roles for the state in supporting and attracting private investment **sometimes point in different directions**. Investing more in education and infrastructure and creating great places to live and work may require more public funding than is currently being spent, while lowering tax rates or granting tax incentives for business will reduce the funds available for public services and public investment.

The search for public policies that support the creation of new private investment and associated jobs is caught in the same set of choices that have paralyzed the state's budget process. Do Californians think the way to attract business is to support spending for education, infrastructure and local governments, which will require at least a temporary increase in public revenues? Or, is the best approach for increasing private investment to reduce the level of public services in an effort to balance the budget and fund additional tax cuts?

4.Short-Term Growth—Governors and Legislators Have No Role

The “sound-bite” debate has raised two questions—1) is the California economy underperforming? and 2) what can a governor do to stimulate immediate job growth? The second question is addressed first below.

The federal government and the Federal Reserve Bank have the tools and the legislative mandate to stimulate the economy when it is weak. Governors and legislatures, whether Republican or Democrat, whether in California or Colorado, have almost no influence over short-term economic trends. This is a point of agreement among economists.

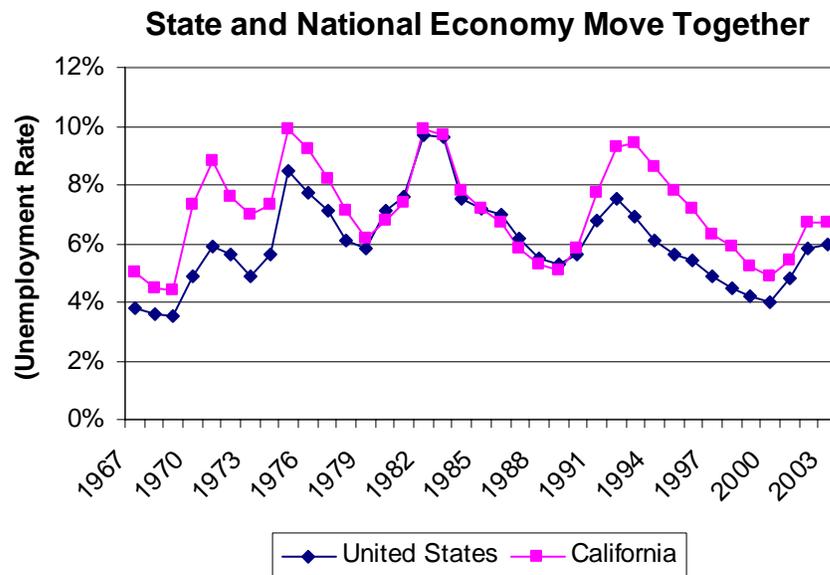
If a person (or candidate) is unhappy with the immediate state of the national or California economy, they should complain to Congress and the President, not to the Governor and Legislature.

The role of the national economy in dictating the major trends of state economy activity is clear from the data. The role of the federal government in fighting recessions is clear from an analysis of what causes recessions and from observation of the tools available to the federal versus state governments.

National Economic Cycles Drive State Cycles

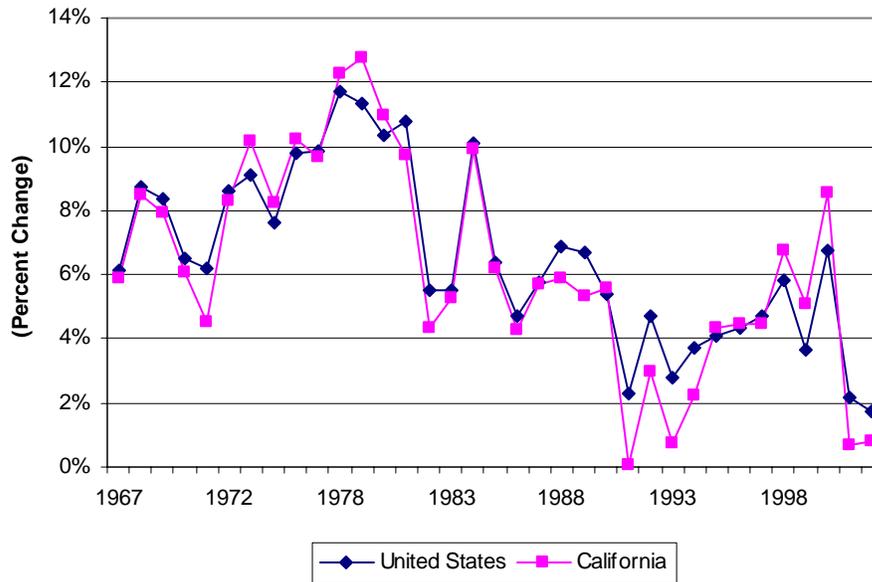
The graphs below look at two measures of economic conditions — the unemployment rate and the growth in per capita income. The graphs show the close similarity of national economic cycles to cycles in California. The graphs show clearly that there has never been an economic upturn in California that was started independently of a national economic recovery.

The unemployment rate trends for the state and nation are virtually identical. The rates move up and down together. In two instances, in the early 1970s and early 1990s, the state downturn was steeper and longer than the national downturn as a result of the impact of defense spending cuts.



The per capita income trends for the state and nation are also virtually identical. Per capita income in the state rises and falls in sync with the national trends.

Per Capita Personal Income



The Federal Government Has the Tools

Recessions are caused by a decline in the demand for goods and services. Usually some sectors of the economy experience a sharp decline and the declines in these sectors spread to other sectors. The current national downturn was initiated by a sharp decline in business capital investment and a sharp decline in stock market prices and new venture capital funding. The decline in business investment was compounded by a decline in economic growth in the nation's major trading partners including Japan and Europe, and, as a result, a decline in export demand.

The recession did not start in California and spread to the United States. It started in the national and world economies and spread to California and other states.

A recession in California would not have the power to create a recession in the nation, while a recession in the nation would certainly have the power to create a recession in California.

Why States Can't Fight Recessions

Recessions are caused by a drop in total spending. The federal government has three primary tools to stimulate total spending and help lower unemployment:

- 1) The Federal Reserve Bank lowers interest rates to make borrowing and spending less expensive. Consumers benefit from lower interest payments. For example, in the current downturn, interest rate cuts have allowed many homeowners to refinance and

reduce their monthly payments. In addition, interest rates cuts are supposed to provide an incentive to businesses to invest.

- 2) Congress reduces tax rates temporarily to increase the cash available to consumers to spend.
- 3) Congress can increase the level of government spending, for example, through spending on defense and non-defense purchases or by increased grants to state and local governments that act to prevent cuts and layoffs at the state and local level.

The reason that temporary tax cuts and increased federal spending work in fighting recessions is that **the federal government can spend more than it takes in as a tool in fighting recessions.** That is, the federal government can run a deficit and **it is this deficit that provides the extra stimulus to total spending.**

There are two major reasons why state governments are ineffective at fighting recessions:

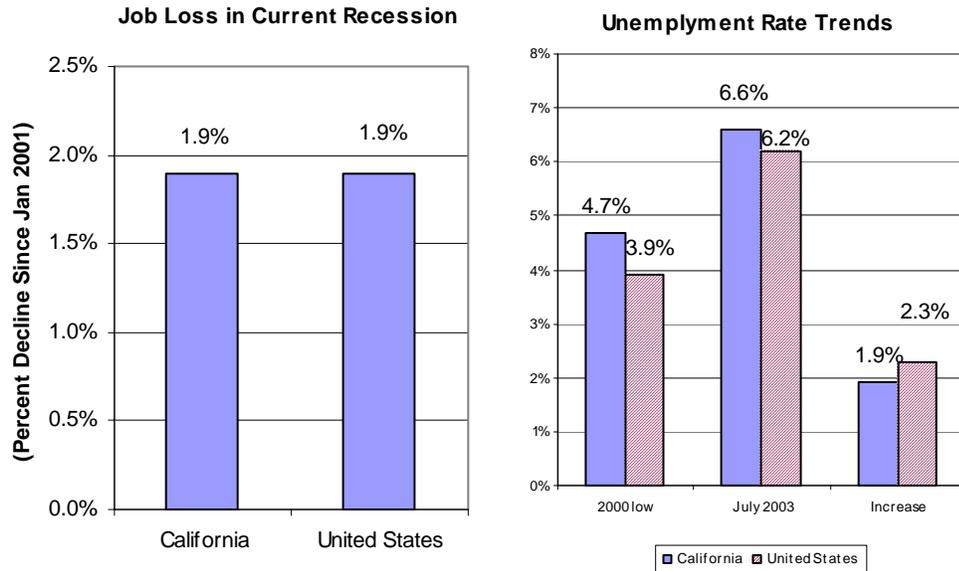
- 1) State budgets must be balanced. If states were to increase spending as the federal government is doing, they would be required to raise revenues, **which would negate the stimulus effect. Similarly, tax cuts would need to be balanced with spending cuts, again providing no net boost to spending.**
- 2) State governments do not possess broad economy-wide powers. States do not control interest rates, nor do state budgets (even if deficits were allowed) have enough scope to boost **national spending levels.**

As much as Governors or candidates want to help residents caught up in job loss and tough times, the tools available to Governors give them **a significant economic role, but it is in building long-term foundations to attract private sector investment, not in fighting today's recession.**

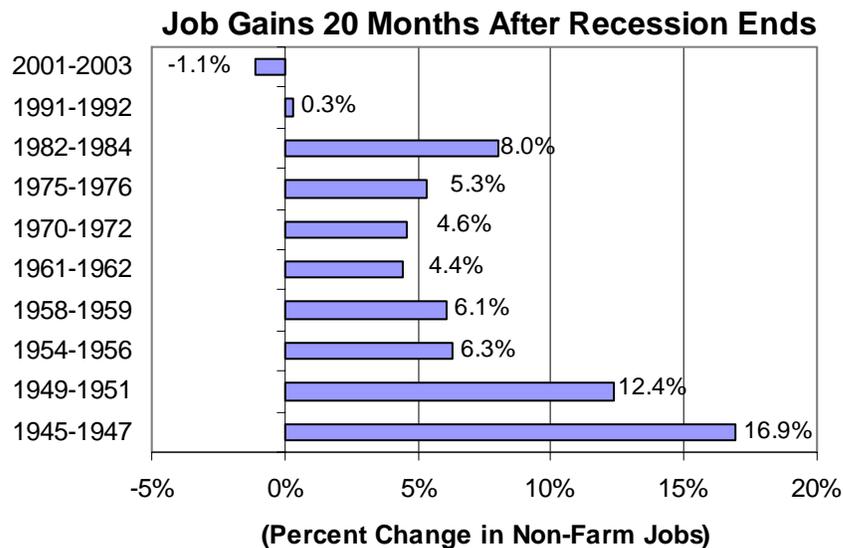
Current State of the California Economy

The state economy is in the midst of a lingering recession as measured by job levels and unemployment rates. Since January 2001, California has lost nearly 300,000 jobs for a decline of 1.9%. Unemployment rates have risen from a low of 4.7% to 6.6% in July 2003.

However, California's job and unemployment situation is right in line with the national average. The 1.9% job loss exactly matches the national job loss and the state's rise in unemployment rates is actually slightly smaller than the national rise.



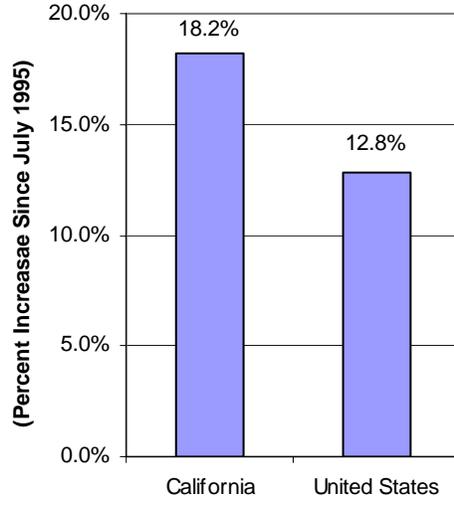
What **is** different about this post-recession period is that it is the weakest national recovery since World War II. In every other post-war recovery, job levels were **higher** 20 months after the recession ended, but in this post-recession period job levels are still **lower**.



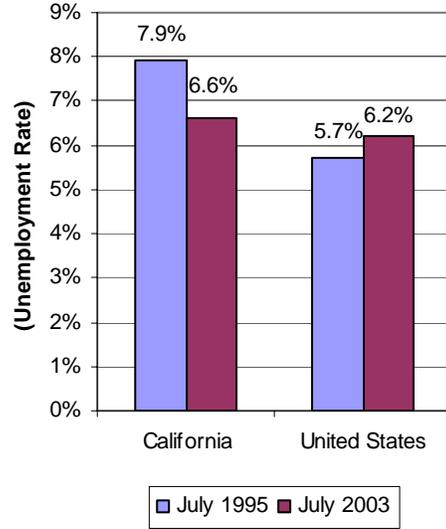
Finally, today's (September 2, 2003) Wall Street Journal editorial contained the statement "No wonder employment in California has lagged the rest of the country in recent years". The chart accompanying the editorial covered the period beginning in 1995. Since the editorial may become a part of the current debate in California, I am including comparative job and unemployment data below for the 1995-2003 period.

Non-farm job levels increased by 18.2% in California between July 1995 and July 2003, while national job levels grew by 12.8%. The state unemployment rate **fell** from 7.9% in July 1995 to 6.6% in July 2003, while the national unemployment rate **rose** from 5.7% in July 1995 to 6.2% in July 2003.

Job Gains Since 1995



Unemployment Rate Trends



INSTITUTE OF REGIONAL AND URBAN STUDIES

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DATE: July 10,2003

TO: Bill Rosendahl

FROM: Stephen Levy

SUBJECT: Comments on Options Report

1. I realize that the Commission's original mandate was to stay "above" current budget debates and focus on longer-term structural tax policy issues. Now it looks likely that the 2003-2004 budget agreement will **not** solve the state's budget deficits and that the issue of long-term structural budget deficits will remain for future years' debate.

The Legislative Analyst's Office (LAO) contends that California will face continuing budget deficits unless permanent changes are made to the path of expenditures or revenues or both.

I believe that the LAO's findings deserve immediate consideration and I am writing to encourage the Commission to provide a forum for discussing the question of long-term revenue adequacy. The question of long-term revenue adequacy is a central part of the ongoing budget debate in California today and the answer about revenue adequacy could affect other Commission recommendations, for example, whether broadening the sales tax base should or should not be offset by a rate reduction.

I am hopeful, also, that the Commission can be extended through at least June of 2004 as the questions before the Commission today could be a central part of next year's budget and reform discussions.

2. The Commission is considering two proposals that are presented as revenue neutral, meaning that they supposedly raise the same amount of money as the tax policy they replace. These are the property tax/sales tax swap and the flat tax proposal. Also, there have been a number of state/local restructuring proposals that are presented as revenue neutral.

I encourage the Commission to investigate how this revenue neutrality does or does not continue over time. Many proposals that I have analyzed in the past are revenue neutral only in the first year but then afterwards

have distinct biases. In the case of state/local restructuring of expenditures and revenues, the state wants to make sure that the expenditures and revenues being restructure grow at the same rate over time and that local governments do not get fast-growing expenditure responsibilities matched with slow-growing revenue sources.

In the case of the sales/property tax swap and the flat tax, the state would want to know whether the revenue neutrality looked the same, say, in the fifth and tenth years after the change.

3. Appendix A speaks to the subject of state budget structural reform, which will be the subject of your September 9th meeting. As explained above, I encourage the Commission to add the question of long-term revenue adequacy to this ongoing discussion.

With regard to revising the current state spending limit, I believe that the impact of the proposed change **depends significantly on the base year chosen**. For example, in the 2007-2008 budget year the spending limit will depend significantly on whether 2000-2001 is chosen as the base year or, say, 2003-2004. The issue is whether to start the new limits from a “high” spending year, a “low” spending year or a “normal” year if these terms can be defined.

Clearly a new spending limit that started from a low spending year, for example, one with many temporary budget cuts, would impose lower future spending limits than the new limit had a “high” spending base year.

I do not see how the Commission can make a meaningful recommendation that does not address the base year issue.

4. Speaking solely as an individual, I support some of the Commission’s options from the viewpoint of improving the climate for economic prosperity. The property tax/sales tax swap has the potential to improve land use planning and improve the fiscal incentives for housing, which would be a great help to many California regions where job growth is hindered by the lack and high price of housing.

The reserve requirement would add to the state’s fiscal stability and provides a solution to the problem posed by volatility in stock market related income. I wrote about this idea in an earlier memo.

I support the periodic reassessment of non-residential property on equity and incentive grounds. But the Commission needs to be clear in its evaluation that one primary purpose of the proposal is to **raise the amount of revenue collected**. That is another reason I encourage the Commission to address this question squarely.

I also support the lowered approval threshold for local tax and bond measures. Here, it is even more transparent that the objective is to allow local citizens to

raise more money, primarily for infrastructure investment. Since I generally favor more infrastructure investment to maintain both economic competitiveness and quality of life, I support this option while being completely clear that the intent is to raise more money.

TAX COURTS – OTHER STATES

Resources:

Arizona: Tax Court established in 1988. Jurisdiction over disputes anywhere in the state that involve imposition, assessment, or collection of taxes. The court adjudicates cases involving state taxes, municipal sales taxes, property taxes, and appeals from the Property Oversight Commission. This is a court of general jurisdiction.

<<http://www.superiorcourt.maricopa.gov/tax/index.asp>>

Cook County (Chicago), Illinois: In 1995, a Tax Division was proposed for the Cook County courts.

Indiana: Tax Court established in 1986. Exclusive jurisdiction over any case arising under Indiana tax laws that is an initial appeal of a final determination made by the Indiana Department of State Revenue or Indiana Board of Tax Review. Also has jurisdiction over certain appeals from Department of Local Government Finance, and appeals of inheritance tax determinations from probate courts (original tax appeals). This is an intermediate appellate court. We have a file with enacting legislation (House Enrolled Act No. 1861, 1985) if you are interested.

<http://www.in.gov/judiciary/tax/>

Maryland: The Tax Court is an independent unit of state government. It was created in 1959 to perform quasi-judicial functions related to tax issues. The court was formerly the State Tax Commission. It is a court of record; hearings are de novo, and held statewide. Judges travel to various counties to hear real property valuation appeals.

<http://www.txcrt.state.md.us>

Minnesota also has a tax court. This is a specialized executive branch court established by the legislature to hear tax-related cases (Min.. Stat. ch. 271). Jurisdiction is over appeals of orders issued by the Commissioner of Revenue and local property tax valuations, classification, equalization and/or other exemptions. Judges have expertise in tax laws, and travel throughout the state to conduct trials.

<http://www.taxcourt.state.mn.us/>

New Jersey: The Tax Court is a court of limited jurisdiction. Judges hear appeals of tax decisions by County Boards of Taxation, and appeals on decisions made by the Direct Division of Taxation on matters such as state income, sales and business taxes, and homestead rebates. Appeals from Tax Court decisions are heard in the Appellate Division of Superior Court. The twelve judges are appointed by the governor and serve terms of seven years.

<<http://www.judiciary.state.nj.us/taxcourt/index.htm>>

Oklahoma: Court of Tax Review is ad hoc, consisting of general district court judges. The court hears appeals of administrative agency decisions and appeals from the lower court. This is a court of limited jurisdiction.

Oregon: Tax Court has exclusive jurisdiction over tax appeals under state laws, including personal income tax, property tax, corporate excise tax, timber tax, local budget law and property tax limitations. The court has two divisions: Magistrate Division and Regular

Division. Generally, appeals to the court are filed and heard by the Magistrate Division. The decision may be appealed to the Regular Division, unless it is a small claims matter. www.ojd.state.or.us/courts/tax/index.htm

Note also that Maine once had an Administrative Court, in which two judges heard appeals of administrative agencies and lower courts, plus status offenses. The court was one of limited jurisdiction. It is no longer in operation.

From: Jones, Martha [mjones@library.ca.gov]

Sent: Thursday, June 12, 2003 7:16 PM

To: Marshall Graves-Commerce; 'Bill Dombrowski'; 'Bill Rosendahl'; 'Bill Weintraub'; 'Christine Rodriguez (for Scott Peters)'; 'Clif Williams (for Scott Peters)'; 'Denise Christensen (for Glen Rossman)'; 'Glen Rossman'; 'Glenda Winfield (for Sean Burton)'; 'Katrina Doerfler (for Glen Rossman)'; 'Larry Carr'; 'Lenny Goldberg'; 'Margaret Hasheminejad (for Bill Rosendahl)'; 'Marilyn Brewer'; 'Santee Libby (for Bill Weintraub)'; 'Scott Peters'; 'Sean Burton'; 'Betty Yee (for Carole Midgen)'; 'Brian Putler (for Gerald Goldberg)'; 'Carol Frost (for Michael Bernick)'; 'Cathy Mattias (for Michael Peevey)'; 'Connie Squires (for Steve Peace)'; 'Dan Savage (for Senator Gilbert Cedillo)'; 'Kimberly Bott (for Assemblymember Ed Chavez)'; 'Marcy Jo Mandel (for Steve Westly)'; 'Martin Helmke (for Senator Gilbert Cedillo)'; 'Nick Vucinich (for Senator Gilbert Cedillo)'; 'Patricia Landingham (for Steve Peace)'

Cc: 'Dean, Joan'; 'Doug Brown'; Eric Wiesenthal; 'Fred Silva'; 'Howard Roth'; 'Jason Weiner'; 'Joel Fox'; 'Kawahara, Ed'; Jones, Martha; 'Nick Bollman'; 'Ogaz, Angie'; 'Pete Montgomery'; 'Ray Sardo'; 'Seth Miller'; 'Szeto, Jesse'; Simmons, Charlene
Subject: Tax court proposal

All:

I have received a few requests for more information on the tax court proposal. I asked the librarians here to do a search on analyses from bills concerning tax court issues between 1991 and 1999. I've also attached a word document that lists other states that have state tax courts. Let me know if I can provide more information.

I'll be sending out the revised Options Report as soon as possible, hopefully in a few days.

Regards,
Martha Jones

Research Information:

CA Legislative Committee Analysis of Pending Bills tax court

Note:

Lengthy analysis of Tax Court Proposal in previous CA bills. We can provide text if requested

CALIFORNIA COMMITTEE ANALYSIS

STATENET

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srev Bill No. AB 1392

Date of Hearing: July 07, 1999

COMMITTEE: srev

BODY:
BILL ANALYSIS

SENATE REVENUE & TAXATION COMMITTEE AB1392 - Hertzberg

Senator Wesley Chesbro,
Amended: 6-30-99|

Chair

Hearing: July 7, 1999 Fiscal: Yes

SUBJECT: Income and Sales Taxes: Permits taxpayers to challenge tax assessments in superior court without prior payment of tax

DIGEST

EXISTING LAW generally requires a sales or income taxpayer to pay a disputed tax prior to taking action in court.

In the case of the sales tax, administered by the Board of Equalization, a taxpayer who disputes the validity of a tax assessment and loses an administrative protest or appeal with the staff of the Board then has the opportunity of a quasi-judicial appeal with the five-member Board of Equalization (including the State Controller). The same appeal opportunity is available to personal income taxpayers and bank and corporation taxpayers who lose administrative protests or appeals with their tax collecting agency, the Franchise Tax Board.

This quasi-judicial appeal to the Board of Equalization has been compared by many (including members of the Board of Equalization and business representatives) to a trial before a tax court (available in many states and at the federal level). An important aspect of this appeal is that it is available to the taxpayer without a requirement that the tax be paid before the appeal is filed with the BOE.

Should the taxpayer lose her/his appeal before the five-member BOE, the taxpayer may pay the tax in dispute and file a suit for refund with the Superior Court within 60 days of a final decision by the BOE. (The only exception to paying the tax before filing suit is in

residency cases, where the facts of residency, rather than the amount of tax due, are in dispute.)

THIS BILL would permit taxpayers to initiate a new cause of action in superior court: within one year after an assessment becomes final, the taxpayer would be permitted to bring an action to determine whether the assessment is void. The taxpayer could bring this court action if, instead of pre-paying the tax, he/she files a "good and sufficient bond to guarantee the payment of the amount due and any additional amount, including interest and penalties, that may reasonably be expected to become due during the pendency of the action."

The amount and terms of the bond, and sureties on the bond, would have to be approved by the trial court judge, following specified provisions of the Code of Civil Procedure. If the bond is so approved, the BOE or FTB would be prevented from taking actions to collect the tax during the period of the court action.

The bill provides that the filing of a bond would not suspend the accrual of interest. However no penalty for late payment could be assessed. During the period of the court action, the court may determine that the bond is insufficient to provide the necessary guarantee and require that the bond amount be increased. Also, the BOE or FTB may require that the bond be increased, or that an amount be paid, to cover accrual of interest.

The bill's provisions would apply to (1) assessments made on or after the effective date of the bill (presumably, January 1, 2000), and (2) assessments prior to 2000, provided that the statute of limitations remains open on the assessment. Also, the bill provides that no action under the bill's provisions may be brought regarding a claim for which bringing an action is otherwise barred by another provision or rule of law.

The bill is double referred to Judiciary Committee if it passes this committee.

FISCAL EFFECT:

Neither FTB nor BOE is willing to guess what the fiscal effect of this new procedure would be, although FTB indicates that "to the extent that bonds are used, rather than cash payments? The collection of general fund revenues will be delayed."

Currently there are 221 income and corporation tax protests within the legal division of the FTB, totaling almost \$ 1 billion in tax liability (these figures don't include the smaller cases that are not run through the legal division). At the Board of Equalization appeal level, there are some 1100 appeals totaling \$ 132.8 million (this includes all cases, large and small). And the amount of refund suits filed in court in 1998 was \$ 25 million.

This bill will make it possible for large companies to share their cash flow problems with the state, at least for a time, by filing a suit for refund guaranteed by a surety bond. Eventually, the state will get its money, but only after several years of litigation. This situation is likely to be magnified during recessionary times, when cash is short all around. Sponsors correctly indicate that this would be partially offset by the interest differential between amounts owed to the state versus amounts that must be refunded to the taxpayer.

Committee staff estimate, based on the above data, that the bill's negative cash flow effect on the General Fund will be in the tens of millions of dollars annually for several years.

COMMENTS:

A. Purpose of the bill

The bill, jointly sponsored by the California Manufacturing Association and the California Taxpayers Association, is intended to allow taxpayers to challenge tax assessments in court without having to pre-pay their tax liability. They argue that this is a taxpayer right in most other states and at the federal level. And they indicate that the prepayment requirement effectively and unjustly deprives many taxpayers of their right to a judicial determination of tax liability.

B. Constitutional question

Article XIII, Section 32 of the Constitution states: "No legal or equitable process shall issue in any proceeding in any court against this State or any officer thereof to prevent or enjoin the collection of any tax. After payment of a tax claimed to be illegal, an action may be maintained to recover the tax paid, with interest, in such manner as may be provided by the Legislature."

This section reflects a widely recognized policy allowing revenue collection to continue during litigation, in order to protect the collection process and to prevent unnecessary interruption of governmental services dependent on revenue (*Pacific Gas and Electric Co., v. State Board of Equalization*. That opinion noted that "the fear that persistent interference with the collection of public revenues, for whatever reason, will destroy the effectiveness of government has been expressed in many judicial opinions."

Nevertheless, another case, *Franchise Tax Board v. Superior Court*, found that the provision allowing litigation of residency cases without prepayment of tax did NOT violate the constitutional anti-injunction provision. Legislative Counsel has opined that the *FTB v. Superior Court* decision, although it deals with a residency issue and not the question of amount of tax due, provides justification for the Legislature to allow taxpayers to challenge their tax assessments without requiring them to pay the tax first.

C. Not "merely" a cash-flow issue - state and local government can't spend surety bonds. Sponsors attempt to minimize the difficulty the state would experience under this bill, arguing that any tax ultimately due would eventually be paid, with interest. The state would not actually be out any money in the long run - it would merely experience a cash flow delay.

While this is true, the state can't spend surety bonds in the short run. And the state can't simply borrow to cover the difference; the state can borrow for short periods, but litigation of substantial tax matters often takes many years. The state would have the options of reducing spending, increasing other peoples' tax, or hoping that the current economic boom will last forever.

D. Benefits only largest corporations - little relief for "average taxpayer"

This bill would not provide a significant benefit to small or medium-sized taxpayers. It is apparently very difficult to obtain a surety bond for any but the largest taxpayers, who are large enough to effectively self-insure. Small taxpayers who wish to challenge their taxes in court would still have to pay their taxes first and then sue in court for a refund.

Support and Opposition

Support:

California Manufacturers Association
Cal-Tax
Texaco, Inc.
Smurfit-Stone Container Corp.
Board of Equalization

Oppose:

Dept. of Finance
California Tax Reform Association

SUBJECT: LITIGATION (95%); TAXES (95%); SALES TAX (92%);

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CALIFORNIA COMMITTEE ANALYSIS

STATENET

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SENATE Committee on Governmental Organization Bill No. SB 1520

Date of Hearing: March 31, 1998

COMMITTEE: SENATE Committee on Governmental Organization

BODY:

SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION

Senator Ralph C. Dills, Chair

1997-98 Regular Session

Staff Analysis

SB 1520 Author: Kopp

As Introduced: February 10, 1998

Hearing Date: March 31, 1998

Consultant: Steve Hardy

SUBJECT

Administrative Procedures Act: State Board of Equalization

DESCRIPTION

SB 1520 would restrict ex parte communications with members of the State Board of Equalization (BOE), as specified, in a petition or appeal that is or may come before the Board or a hearing officer of the BOE, whether the petition or appeal is from a decision of the BOE staff or a decision of another governmental entity.

PRIOR LEGISLATION

SB 523 (Kopp)⁴ Chapter 938. Statutes of 1995. Revised the Administrative Procedures Act for administrative adjudications by expanding the hearing procedure options available to state agencies as specified. Among its many provisions, this bill restricts ex parte communications to the presiding officer from any employee or representative of an agency that is a party, or from an interested person outside the agency without notice and opportunity for all parties to participate in the communication.

BACKGROUND

Under current law, the Administrative Procedures Act (APA) provides for the conduct of administrative adjudication and rulemaking proceedings of state agencies. The APA was enacted by the Legislature in 1945 in response to a study and recommendations by the Judicial Council of California. Existing provisions pertaining to ex parte communications and administrative adjudication procedures of the APA, do not apply to members of the BOE.

The author is carrying this measure on behalf of the California Tax Reform Association. The sponsor states that California's unique tax appeals structure puts the BOE, which is responsible for tax administration, in the role of hearing tax appeals on a quasi-judicial basis. For appeals, the BOE is California's approximate equivalent of a tax court. While many tax practitioners have sought the creation of a tax court, BOE members have argued against a separate tax court, since one of their roles has been to hear tax appeal cases.

SB 1520 seeks to make sure that the BOE acts somewhat like a court in its judicial role, by providing simply, that ex parte communications about cases pending before the court shall be prohibited. In that sense, it requires that BOE members act as judges do when hearing cases, namely that they cannot have private communications with those bringing cases before them.

Judges too are elected officials, and communicate freely with all parties, except about the specifics of cases, which are before them. The sponsor believes these tax appeals involve highly sensitive and important issues, and the appeal process should be one in which even the appearance of private negotiated agreements with those sitting in judgment should be avoided.

In opposing this measure, the BOE believes that 1) every member of the public has a right to speak to his or her elected representative about a matter upon which the public official may be voting; 2) It is not uncommon for BOE and/or Franchise Tax Board (FTB) staff not to provide all relevant information about a taxpayer's case to the BOE when such information could assist the taxpayer's case. When this happens, the taxpayer may contact Board Members who then may intercede to require staff to consider such information and respond to it; 3) BOE members have a constitutional responsibility to oversee the operations of their agency; and 4) In many instances a taxpayer may contact a BOE member about his or her case and not do an adequate job of expressing his or her position. In such an instance, a BOE member will want to speak to the taxpayer's representative assisting the taxpayer in order for the member to obtain additional information.

The BOE states that it is not a Tax Court, nor does it ever want to be a Tax Court. The people created the BOE to keep the system simple, accessible, fair and inexpensive. SB 1520 would change that to the detriment of the taxpayer.

Other opponents believe that what is being proposed is unfair. The purpose of ex parte rules, in a judicial or quasi-judicial setting, is to protect against unfair prejudice by one side or the other. Unless these rules also apply to staff members here, their application would not serve such a purpose. This legislation, if enacted, would create an imbalance that does not exist today.

SUPPORT: California Tax Reform Association (Sponsor)

OPPOSE: State Board of Equalization
Pacific Telesis
American Telephone and Telegraph

FISCAL COMMITTEE: Senate Appropriations

SUBJECT: TAXES (92%); AGENCY RULEMAKING (90%);

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CALIFORNIA COMMITTEE ANALYSIS

STATENET

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Assembly Committee on Revenue and Taxation Bill No. AB 3820

Date of Hearing: May 2, 1994

COMMITTEE: Assembly Committee on Revenue and Taxation

BODY:

Date of Hearing: May 2, 1994

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION

Johan Klehs, Chair

AB 3820 (W. Brown) - As Amended: April 28, 1994

SUBJECT Creates an additional state tax appeals board and prescribes its various duties

DIGEST

Majority Vote. Fiscal Committee.

Existing law:

- 1) Provides for several tax administering agencies, including the Board of Equalization (BOE), Franchise Tax Board (FTB), Controller, Employment Development Department, and the Department of Motor Vehicles. The two largest agencies are the FTB and BOE.
- 2) Specifies that the FTB administers the personal income tax and the bank and corporation franchise tax. Administrative responsibility for income tax withholding is delegated by the FTB to the Employment Development Department. The members of the Franchise Tax Board are the State Controller, the Director of Finance, and the Chair of the Board of Equalization.
- 3) The BOE administers the state's other major taxes. Specifically, the board has responsibility for the state and local sales and use tax, local transactions and use taxes,

gasoline and other fuel taxes, the alcoholic beverage tax, the insurance gross premiums tax, the cigarette and tobacco products tax, hazardous waste taxes and fees, and other limited taxes. The BOE also assesses the property of public utilities and common carriers, and provides certain administrative and oversight functions with respect to the local property tax.

The Board of Equalization comprises four elected members, one from each equalization district, and the State Controller. The board hears appeals relating to all of the taxes it administers, as well as the taxes administered by the FTB.

Appellate Functions

Under current law, a taxpayer who disputes the assessment of state taxes administered by the Board of Equalization and the Franchise Tax Board has several means of appeal. The BOE or FTB first make an administrative determination and either agree or deny the petition by the taxpayer for redetermination or refund. For those taxpayers whose petitions are denied, they may request a hearing before the Board of Equalization. The Board, upon granting a hearing, may also approve or deny the taxpayer's petition. If the taxpayer is denied, he or she may then appeal to the

Superior Court. A taxpayer who disputes the assessment of the state taxes administered by the BOE may file suit in Superior Court earlier, if he or she so wishes, but only after first exhausting his or her administrative remedies. A taxpayer disputing the assessment of the state taxes administered by the Franchise Tax Board may appeal to Superior Court only after either: (i) paying the tax in dispute; or (ii) their appeal has been denied by the BOE.

When a property taxpayer disputes a local assessor's assessment, that taxpayer may appeal to the local board of equalization or assessment appeals board. If the taxpayer wishes to appeal the local board decision, the taxpayer must appeal to superior court but the court may only hear questions of law, not valuation.

The BOE is constitutionally required to annually assess public utilities and common carriers (such as telephone, railroads, canals, pipelines). These are referred to as state assessees. Under current law, when a state assessee wishes to appeal their assessment, the state assessee appeals directly to the BOE itself, since it is the assessor. If the BOE denies their appeal, they then may appeal to the Superior Court, but the Court, unlike non-state assessees (most property taxpayers), may consider all evidence relating to the valuation of the property admissible under the rules of evidence.

This bill:

- 1) Creates the Board of Tax Appeals (BTA), which would be an additional route of appeal to superior court in the current tax appeals process. After appeal to the Board of Equalization, the taxpayer could appeal to the Board of Tax Appeals, provided that the taxpayer files an appeal to the BTA within 30 days of the date the decision of the BOE was served on the taxpayer. The BTA must provide 60 days notice to the parties once it sets a time, date and place to hear the appeal.

However, appeals of the state taxes assessed by the Franchise Tax Board would be directly appealed to the BTA, not the BOE as under current law.

- 2) Provides that an appeal to the BTA would be a full evidentiary hearing and would not be restricted to the record of the redetermination proceedings before the Board of Equalization or Franchise Tax Board.
- 3) Provides that the determination of the BTA shall become final 30 days after being provided to the taxpayer, BOE or FTB. However, the taxpayer may appeal the determination of the BTA within 6 months of the date the determination become final to the Court of Appeal provided it has been certified by the BTA or to superior court, provided that the taxpayer has paid the disputed taxes.
- 4) Authorizes the BTA to certify a determination. The Court of Appeal may then reject or hear the appeal of a certified case. A determination is considered certified only if the BTA has made a finding that the case involves issues of broad importance or first impression that require quick resolution in order to provide guidance in the disposition of similar cases. Additionally, a determination is considered certified if the immediate parties to the case stipulate that it shall be certified. If the Court of Appeal does not wish to hear the appeal, it is then sent to superior court.
- 5) Provides that a small claims division of the BTA would be established to hear proceedings involving appeals of less than \$ 35,000. Small claims decisions would not be published and would not be precedential.
- 6) Provides that the BTA shall be composed of seven members appointed by the Governor, subject to confirmation by the Senate. Board members must have been members of the State Bar for 10 years prior to their appointment. The terms of the BTA members shall last six years, except that the members initially appointed to the board shall serve terms of two, four, and six years, respectively. The Governor shall designate a board chair every two years who may sit in the first, second or fourth appellate judicial district and hear appeals arising in that district. The chair shall be in charge of the administration of the board.

FISCAL EFFECT

State: The Board of Equalization estimates that the elimination of income tax appeals from its duties as provided in this measure, would result in cost savings of \$ 458,963 for 1994-95 and \$ 920,987 for 1995-96. The Judicial Council, in regards to two similar bills in 1992, estimated that a seven judge tax court would have an initial cost of between \$ 8.5 and \$ 9.5million annually.

Local: None.

COMMENTS

1) This Bill Changes The Current Tax Appellate Process

This bill would alter the current process for tax appeals. Currently, if a taxpayer appeals the state taxes administered by the Franchise Tax Board (namely, the Personal Income and Bank and Corporation Tax), the taxpayer first appeals administratively through the FTB. If the FTB administratively denies the appeal, the taxpayer may then

appeal to the Board of Equalization; or if they prefer, pay the disputed tax and proceed to Superior Court. If the BOE decides against the taxpayer, the taxpayer may then appeal to Superior Court. Under this bill, the taxpayer would no longer appeal to the BOE after being denied administratively by the FTB. Instead, the taxpayer would directly appeal to the Board of Tax

Appeals. Alternately, if a taxpayer appeals the state taxes administered by the Board of Equalization, under current law, the BOE first considers the appeal administratively. If the BOE administratively denies the appeal, the taxpayer then appeals to the five member board itself. If the five member BOE decides against the taxpayer, the taxpayer may then appeal to Superior Court. Under this bill, the taxpayer would appeal to the Board of Tax Appeals, not Superior Court. The BTA member whose appellate district corresponds with the taxpayer or a hearing officer if provided by the BTA would hear the case and make a determination. If any of the parties wish to appeal that decision, they may then do so before the seven members BTA. The taxpayer, FTB, or BOE, if not satisfied with the Board of Tax Appeals decision, could then file in the Court of Appeal. However, as recently amended, the taxpayer would be required to pay the disputed tax prior to filing with the Court of Appeal which has the ability to approve or deny a case that has been certified by the BTA.

In order to be certified by the BTA, the BTA must first make a finding that the case involves issues of broad importance or first impression that require quick resolution in order to provide guidance in the disposition of similar cases. If the Court of Appeal rejects the case, it is then sent to superior court. The only other way to be certified is if the immediate parties to the case stipulate that it shall be certified.

2) Why Add An Additional Appeals Step?

There have been a number of attempts in the last several years to alter California's tax administration. This bill is one of three measures this year that proposes significant changes to the current functions of the Franchise Tax Board and Board of Equalization. Much of the movement behind changing the system of tax administration is due to the fact that California is one of the few states to have multiple tax collection agencies with split administrative functions. Proponents of consolidation efforts believe that a consolidated tax administration would produce long term savings, would provide more administrative consistency and accountability, and increase taxpayer convenience.

In addition, the current appellate process has raised questions as to the appropriateness of the BOE hearing appeals on its own decisions. Under the existing two tax agency system, personal income and bank and corporation taxpayers who cannot resolve a tax issue with the FTB, can appeal FTB's decision to the Board of Equalization. This independent review of taxpayer appeals by a separate tax authority has generally been considered a benefit to taxpayers.

On the other hand, taxpayer disputes related to sales tax and other BOE administered taxes are also appealed to the Board of Equalization. Some have argued that having the Board of Equalization review its own staff decisions is not an ideal appeals process. In addition, they believe that there could be the potential for conflicts of interest for the Board members since they are elected on a partisan basis and may solicit campaign

contributions from certain taxpayers who may be appealing a tax dispute in front of the BOE sometime in the future.

This bill adds an additional appeal opportunity to the current process by creating a Board of Tax Appeals. However, it is unclear why this bill is structured in this manner. Since the two main arguments behind changing California's tax administration are consolidation and the potential problem of the BOE reviewing its own staff decisions, this bill doesn't seem to completely address either argument. This measure only partially consolidates appellate functions. Instead, it adds another level of appeal to BOE administered taxes when there is little evidence that additional appeal is needed. According to the Board of Equalization, less than one percent of the business tax and franchise tax appeals are ultimately taken to Superior Court. One might expect a higher percentage being taken to court if taxpayers felt they needed additional appellate options.

In addition, this measure still allows the BOE to make decisions regarding disputed taxes involving taxpayers with whom Board members may have potential conflicts of interest and still allows the BOE to review its own staff decisions. Perhaps this measure would be more effective if it consolidated some appellate functions or took over the BOE's appellate functions.

3) Is \$ 35,000 Level For Small Claims Division Too High?

Currently, the federal limit for disputed taxes to be considered by a small claims division is \$ 10,000. This bill has a level 3 1/2 times the federal amount. Since California's taxes are about 1/3 of federal taxes, the limit could be set at \$ 3,500. The \$ 35,000 level proposed under this bill for consideration by a small claims division could result in most cases being handled by the small claims division.

4) Related Legislation

SCA 5 and SB 87

SCA 5 and SB 87 both by Senator Kopp are similar to this bill. Those companion measures eliminated the Franchise Tax Board and Board of Equalization and replaced them with a Department of Revenue, headed by a Revenue Commissioner. In addition, SB 87 created a Board of Tax Appeals, whose structure is nearly identical with the provisions of this bill. SCA 5 is currently on the Senate Inactive File. SB 87 failed 11-2 on the Senate Floor earlier this year.

AB 15 (Klehs) which is currently in the Senate Revenue and Taxation Committee, would eliminate the Franchise Tax Board and place its duties under the Board of Equalization. The BOE would retain all current appellate duties.

In his January budget, the Governor proposes consolidation of the Department of Franchise Tax Board and Board of Equalization into single Department Revenue. BOE would be limited to its stated constitutional duties, namely assessment of utility taxes and tax appeals. There is no provision for a tax court. This is the second consecutive year the Governor has proposed this. Last year, the Administration did not introduce

this plan into bill form. SB 1829 (Campbell) was amended this week to create a consolidated Department of Revenue.

The Legislative Analyst's Analysis of the 1994-95 Budget Bill makes a recommendation, which is similar to the Governor's.

Sumi Sousa
322-3730

SUBJECT: APPEALS (98%); TAXES (95%); LITIGATION (93%); CONFLICT OF INTEREST (93%);

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CALIFORNIA COMMITTEE ANALYSIS

STATENET

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SENATE Committee on Revenue and Taxation Bill No. AB 15

Date of Hearing: March 16, 1994

COMMITTEE: SENATE Committee on Revenue and Taxation

BODY:

SENATE REVENUE & TAXATION COMMITTEE

AB 15 - Klehs

Senator Leroy F. Greene, Chairman Amended 3-14-94

Hearing: March 16, 1994 Fiscal: YES

SUBJECT: State Tax Administration: Abolishes Franchise Tax Board and transfers its powers and duties to Board of Equalization

DIGEST -- WHAT THE BILL DOES

Existing law provides for several tax administering agencies, including the Board of Equalization (BOE), Franchise Tax Board (FTB), Controller, Employment Development Department, and Department of Motor Vehicles. The two largest agencies are the FTB and the BOE.

The BOE administers the state and local sales and use tax, local transactions and use taxes, the gasoline, jet fuel and use fuel taxes, the insurance gross premiums tax, the cigarette and tobacco products taxes, the alcoholic beverage taxes, the hazardous waste taxes and fees, the energy resources and emergency telephone users surcharges, the timber tax and the private railroad car tax. The BOE also assesses the property of public utilities and common carriers, and provides certain administrative and oversight functions with respect to the local property tax.

The BOE comprises four elected members, one from each equalization district, and the State Controller. The board itself is responsible for setting the values for the board roll (utilities and common carriers). It also hears appeals relating to all of the taxes it administers, as well as the taxes administered by the FTB. The FTB comprises the Controller, the Director of Finance, and the Chairman of the BOE. It administers the personal income tax and the bank and corporation tax. Administrative responsibility for income tax withholding is delegated to the Employment Development Department. In

addition the FTB administers the homeowners and renters property tax assistance program (for low income elderly or disabled homeowners and renters).

The FTB and the BOE adopt rules and regulations for the taxes, which their departments administer.

Under existing law, when a taxpayer disputes an amount of state tax he or she may protest to the FTB or the BOE (depending AB 15 Klehs on the agency levying the tax). The appropriate agency deals with the protest by reexamining the issue administratively and either agreeing with the taxpayer or denying the petition for redetermination or refund. The taxpayer then may request a hearing before the Board of Equalization. If the hearing is granted, the Board may either grant or deny the taxpayer's petition. After exhausting these administrative remedies the taxpayer may bring an action against the state in superior court.

When a property taxpayer disputes a local assessor's assessment, he or she may appeal to the local board of equalization or assessment appeals board. If the taxpayer wishes to appeal the local board decision, he or she may do so in superior court. However, under present law the court may not hear questions of valuation, but only questions of law. Thus, the valuation question is effectively concluded at the local board level.

When a state assessee (public utility or common carrier) wishes to appeal the determination of the "state assessor" (the BOE) the assessee appeals to the BOE itself. Subsequent appeals of BOE decisions are made to the superior court. Unlike local appeals, however, state assessees may have a trial de novo, considering all questions of law AND valuation.

THIS BILL would eliminate the Franchise Tax Board and assign its present responsibilities to the Board of Equalization. The bill does not amend the tax laws which the FTB administers; it simply provides that references to the FTB shall hereafter mean the BOE. The bill would not alter the BOE's appeals functions.

The bill would become operative on January 1, 1996.

FISCAL EFFECT:

Administrative savings & costs due to consolidation

Although the bill is intended to achieve greater efficiency, it is not clear that substantial savings would, or could, be achieved immediately. It is likely that there would be substantial initial costs, which would probably more than offset any savings for some time. Neither the BOE nor the FTB has completed a cost/savings analysis of consolidation. Before consolidation actually takes place, it would be advisable to have the advantage of a full study by a competent and independent third party.

Past studies have shown little duplication of collection or auditing functions, although these studies were not done with consolidation in mind. A consolidated agency under a single executive would probably be more capable of coordinating its various functions than are the present two agencies. For example, although one large agency would certainly need a larger personnel office than either of the two present offices, it should be

less than twice as large. The same may be true of some of the auditing, legal, hearing, collecting, cashiering and administrative functions.

It is important to bear in mind, however, that both existing agencies are staffed by highly trained and loyal individuals who have been with their respective agencies for longer, on average, than the employees of most agencies. It is likely that the new agency would desire to retain as much of this talent as possible.

And, offsetting the potential for staff savings, the "natural law of administrative realignments" dictates that whenever two or more agencies are joined together, additional levels are inevitably added to the bureaucratic pyramid. Thus, large staff reductions (the major component of any serious administrative savings) would be unlikely.

A recent study by the Auditor General, which refuted the conclusion of the previous Little Hoover Commission study, concluded that consolidating the cashiering functions of the two agencies would not be justified; there could be savings of over \$ 300,000 annually, but the initial costs would be over \$ 600,000, and most of the savings could be achieved (and have, in fact, already been achieved) administratively, without consolidation.

At the Committee's March 31, 1993 hearing the Executive Officer of the Little Hoover Commission indicated that the Commission's 1986 report made a "conservative" estimate of net savings due to consolidation would be over \$50 million. In fact that conclusion was not based on detailed analysis of any aspect of consolidation other than the above-mentioned cashiering function; the data presented for other aspects of consolidation were either derived from the slimmest analysis or were entirely unsupported (e.g., over half of the savings suggested in the report would be due to reassignment of 117 personnel years to audit activities). Committee staff examined the report at the time of its release and found it to be wanting in most important respects; it clearly did not provide a sufficient basis for making this important administrative decision.

Transitional costs could be very large if it is intended to fully integrate the tax administration functions. The best example of such costs would be in computer systems. FTB uses an IBM computer system, while the BOE uses UNISYS machines. (BOE is currently converting its operations to the Teale Data Center's IBM system.) If a single management information system were desired, it would require an enormous effort to bridge the two departments' current systems.

The Legislative Analyst, in last year's Analysis of the Budget, recommends that FTB and BOE be consolidated. She indicates that there would likely be long-term cost savings and other benefits. She recommends that the Legislature create a Department of revenue, and require the two agencies to develop a consolidation plan over the next year, to include specific goals and a timetable for integrating their activities. She also indicates that achieving savings and other benefits would require some up-front investment to pay for costs associated with consolidation, including planning, integration of computer systems and integration of physical plant. "These additional costs, however, would be more than offset by long-term savings resulting from the efficiencies attributable to the integration."

Revenue effect of consolidation

Whether there would be a tax revenue effect due to the proposed consolidation would depend upon how effectively the shift of responsibilities is carried out. Since both agencies are generally agreed to be efficient tax agencies, there probably would be little revenue increase due to consolidation, even if their actual combined operation were administratively more efficient. There would, however, be a risk of temporary but substantial revenue reduction if the transition is not smooth.

COMMENTS:

A. Purpose of the bill

The bill is intended to achieve savings and administrative simplification through folding Franchise Tax Board into the Board of Equalization.

B. Recent history

Last session, Senator Kopp introduced SB 23 and SCA 25, to consolidate FTB and BOE, and to establish a tax court. This committee passed the bills and sent them on to Judiciary where the tax court provision was converted into a Board of Tax Appeals. Both bills passed out of Judiciary, but SB 23 died in Appropriations and SCA 25 died in Constitutional Amendments.

Late last session a renewed effort to consolidate FTB and BOE was initiated jointly by Assemblymen McClintock and Isenberg, using SB 1533 as the vehicle. Amendments were approved in Ways and Means to fold both tax collecting agencies into a new revenue department headed by a three-person board. But late opposition from the business community, which favored retaining the BOE, caused the effort to wither. As a compromise, the budget bill was amended to contain funding for a "strategic plan" for consolidation if subsequent legislation provided the authorization for the plan. But no subsequent legislation surfaced, and the Governor vetoed the funds.

This year the governor proposes BOE/FTB consolidation as part of his budget. Last April 21, this Committee heard and approved Senator Kopp's SB 87 and SCA 5, which would have combined the tax collection functions of the BOE and FTB into a new Department of Revenue, and would have created a new Board of Tax Appeals.

SB 87 died on the Senate floor in January; SCA 5 is on the Senate's inactive file.

Speaker Brown has introduced AB 3820, establishing a Board of Tax Appeals, which would take over the appeals functions of the Board of Equalization.

C. Consolidation - Pros & Cons

Lacking complete analysis of the proposed agency consolidation, policymakers are left with arguments and conjectures. There are as many opinions as there are observers -- every taxpayer probably has views as to how taxes could be collected more effectively, more efficiently, or more humanely.

The following are the major arguments, which have been put forward concerning consolidation:

Pro:

Multiple tax collection agencies confuse taxpayers

Most studies conclude that consolidation would produce savings in the long run
California is the only state where the tax administration functions are so oddly split

Consolidation would allow for greater administrative flexibility

Consolidation would permit more administrative consistency among taxes

Con:

FTB and BOE are each larger than practically any state's combined agency; consolidation may increase complexity by adding more administrative levels

BOE and FTB are presently considered by other state tax administrators to be models for efficient state tax administration, indicating that there may not be much reason to reform the agencies

While consolidation may result in a single administrator for both agencies, there may be little real integration of most major functions (since there is presently little duplication); the whole could be as large as (or possibly larger than) the sum of the parts

D. Creation versus evolution of tax administration

There is little doubt that if California were created anew, there would only be one state taxing agency. However, California's tax structure has grown and evolved for over 100 years. It is the way it is because various economic and political forces caused it gradually to take its current form.

Most of the idiosyncrasies which we see in our structure exist for real reasons, some of which may, admittedly, be outdated.

But for all their peculiarities, the taxing agencies have become a remarkably effective (albeit quaint) institution when compared with those of other states. The question presented by the bill is whether the present separate agencies have become so odd and out of date that they warrant wholesale reform.

E. What level of consolidation is intended?

The bill is silent on how the shift from FTB to BOE should take place. The provisions of the bill could probably be accomplished by simply disbanding the actual Franchise Tax Board, consolidating the top management of the two agencies into one directorate under the BOE, and printing a new letterhead.

However, presumably the bill is intended to accomplish more far reaching consolidation, including merging top management, combining processing, auditing, collections, taxpayer services, etc. functions wherever this would achieve savings, greater efficiency or enhanced revenue.

Should language be added to the bill specifying the Legislature's intended level of consolidation? Given the bill's January 1, 1996 implementation date (as proposed to be amended), should the agencies be required to report to the Legislature in 1994 on their consolidation implementation plan?

F. Who should administer a consolidated agency?

Proponents argue that a consolidated tax agency should be administered by an elected body because they believe elected officials tend to be more responsive than an appointed body.

However the Legislative Analyst suggests that an executive director appointed by the Governor and confirmed by the Legislature would offer "the most clear-cut chain of command and the best opportunity for effective leadership in the area of tax policy." The Analyst believes that the current method of board administration results in an "organizational ambiguity" that can result in staff working at cross-purposes.

G. Handling of income and corporation tax appeals

Under the existing two-tax-agency system, personal income and bank and corporation taxpayers who cannot resolve a tax issue with the FTB can appeal FTB's decisions to the Board of Equalization. This independent review of taxpayer appeals by a separate tax authority has generally been considered a benefit to taxpayers.

On the other hand, taxpayer disputes related to sales tax and other BOE-administered taxes are also appealed to the Board of Equalization. Some have argued in the past that having the Board of Equalization review its own staff decisions is not an ideal appeals process.

By placing the administration of the state's income taxes directly under the jurisdiction of the Board of Equalization, this measure eliminates the current system's separate review process for income tax appeals. If the two tax boards are combined, a separate appeals process for sales and income tax disputes might be established, perhaps along the lines suggested in Senator Kopp's SB 87 (a separate Board of Tax Appeals).

H. How large should a tax collection agency be?

When consolidated with FTB, the new BOE would be by far the largest tax collection agency among the states, and second in size only to the Internal Revenue Service. And it would rival or exceed in size the tax agencies of all but ten or fifteen countries in the world. In consolidating all the taxes currently administered by BOE and FTB (income, corporation, sales, tobacco, alcohol and property taxes and the various fees for toxics, etc.), some might fear that the agency would have too great an ability to correlate data from the various taxes--in short, a "big brother" concern.

Support and Opposition

SUPPORT: California Manufacturers Association
Cal-Tax

OPPOSE: California Tax Reform Association
Franchise Tax Board
State Bar of California
Controller Gray Davis

Consultant: Martin Helmke

SUBJECT: TAXES (97%); PROPERTY TAX (94%); INCOME TAX (93%);

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CALIFORNIA COMMITTEE ANALYSIS

STATENET

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SENATE Floor Bill No. SB 87

Date of Hearing: January 31, 1994

COMMITTEE: SENATE Floor

BODY:

THIRD READING

SENATE RULES COMMITTEE Bill No. SB 87

Office of
Senate Floor Analyses
1020 N Street, Suite 524
445-6614

Author: Kopp

Amended: 1/27/94

Vote Required: 21

SUBJECT: Department of Revenue: State Tax Court

SOURCE: Author and Governor's Administration

DIGEST: This bill replaces the Franchise Tax Board and the State Board of Equalization with a Department of Revenue as specified. The department would be under the control of a Revenue Commissioner appointed by the Governor.

Establishes a Board of Appeals which would conduct de novo administrative review of all tax matter determinations made by the Department of Revenue as specified.

Becomes operative only if SCA 5 is approved by the voters.

Senate Floor Amendment of 1/27/94 deletes appropriation language from the bill.

ANALYSIS:

1. Tax Administration

Existing law provides for several tax administering agencies, including the Board of Equalization (BOE), Franchise Tax Board (FTB), Controller, Employment Development Department, and Department of Motor Vehicles. The two largest agencies are the FTB and the BOE.

The BOE, which was created in 1879, administers the state and local sales and use tax, local transactions and use taxes, the gasoline, jet fuel and use fuel taxes, the insurance gross premiums tax, the cigarette and tobacco products taxes, the alcoholic beverage taxes, the hazardous waste taxes and fees, the energy resources and emergency telephone users surcharges, the timber tax and the private railroad car tax. The BOE also assesses the property of public utilities and common carriers, and provides certain administrative and oversight functions with respect to the local property tax.

The BOE comprises four elected members, one from each equalization district, and the State Controller. The board itself is responsible for setting the values for the board roll. It also hears appeals relating to all of the taxes it administers, created in 1950, when the Franchise Tax Commissioner was abolished, as well as the taxes administered by the FTB.

The FTB comprises the Controller, the Director of Finance, and the Chairman of the BOE. It administers the personal income tax and the bank and corporation franchise tax. Administrative responsibility for income tax withholding is delegated to the Employment Development Department. In addition the FTB administers the homeowners and renters property tax assistance program (for low income elderly or disabled homeowners and renters).

The FTB and the BOE adopt rules and regulations for the taxes, which their departments administer.

SCA 5 removes from the Constitution references to and all powers of the Board of Equalization. Companion SB 87 eliminates both the FTB and BOE, and replaces them with a Department of Revenue, headed by a Revenue Commissioner appointed by the Governor and confirmed by the Senate. The Commissioner is to hold office at the pleasure of the Governor. The new Revenue Department would have all of the duties (except judicial) of the present FTB and BOE, as well as the Controller's present administrative functions regarding the estate tax, and property tax assistance and postponement programs. SB 87 provides for appointment of a deputy commissioner, and delineates his or her duties. The bill also requires the department to:

- prescribe rules for its operation,
- keep records of its proceedings, prescribe rules and regulations to govern local boards of equalization and local assessors,
- prescribe forms for property assessment,
- prepare and issue instructions to assessors to promote uniformity, and

-bring action in court to compel assessors and other local tax officials to comply with laws and rules.

The bill also provides for the department to survey local assessment procedures.

These requirements, and other provisions of the bill, establish for the department most of the administrative machinery, which the existing agencies now possess.

Board of Tax Appeals

Under existing law, when a taxpayer disputes an amount of state tax he or she may protest to the FTB or the BOE (depending on the agency levying the tax). The appropriate agency deals with the protest by re-examining the issue administratively and either agreeing with the taxpayer or denying the petition for redetermination or refund. The taxpayer then may request a hearing before the Board of Equalization. If the hearing is granted, the Board may either grant or deny the taxpayer's petition. After exhausting these administrative remedies the taxpayer may bring an action against the state in superior court.

When a property taxpayer disputes a local assessor's assessment, he or she may appeal to the local board of equalization or assessment appeals board. If the taxpayer wishes to appeal the local board decision, he or she may do so in superior court. However, under present law the court may not hear questions of valuation, but only questions of law. Thus, the valuation question is effectively concluded at the local board level.

When a state assessee (public utility or common carrier) wishes to appeal the determination of the "state assessor" (the BOE) the assessee appeals to the BOE itself. Subsequent appeals of BOE decisions are made to the superior court.

Unlike local appeals, however, state assessees may have a trial de novo, considering all questions of law AND valuation.

SB 87 creates a Board of Tax Appeals, which would have "all powers and duties, as prescribed by law, necessary to conduct de novo administrative review of all tax matter determinations made by the Department of Revenue." The board would consist of seven members chosen for their knowledge of tax law, who must have been members of the State Bar for at least 10 years. Member's terms would be 6 years; they would be appointed by the Governor, with confirmation by the Senate.

Hearings before the Board of Tax Appeals would be full evidentiary hearings not restricted to the record of the redetermination proceedings before the Department of Revenue. The hearing would be open to the public, and written findings of fact and conclusions of law, in the form of a notice of determination would be prepared.

A small claims division of the Board of Tax Appeals would hear proceedings involving appeals of less than \$ 35,000. Small claims decisions would not be published and would not be precedential.

Legislative History of Consolidation

Since 1927 there have been at least 17 separate studies by legislative committees or outside agencies recommending consolidation. The Little Hoover Commission noted in its 1964 report that consolidation was recommended by the Legislative Analyst in nearly every budget analysis report since 1943. (See attached Legislative Analyst 1993 report.)

Governor Wilson's last three budgets have proposed consolidation of the two agencies.

Since 1984, legislation has been introduced to accomplish consolidation, all were held in legislative committees until this session. AB 15 (Klehs) of 1993 abolishes the Franchise Tax Board and moves its duties into the BOE. It passed the Assembly 77-0 and is presently in Senate Revenue and Taxation Committee.

Prior legislation included:

1984	SCA 51 (Boatwright) and SB 2032 (Boatwright)
1989	SB 1025 (Alquist)
1990	SCA 29 (Kopp) and SB 1395 (Kopp) AB 1996 (Harris)
1991	SCA 25 (Kopp) and SB 23 (Kopp)
1993	SCA 5 (Kopp) and SCA 87 (Kopp) AB 15 (Klehs) AB 1026 (Peace)

State Comparisons

The 49 other states have single revenue departments, which are responsible for the collection of most, if not all, state taxes. 45 of these states and the federal government have appointed revenue commissioners.

Four states and the District of Columbia have established tax courts for the adjudication of tax issues. Another 21 states have independent boards of review similar to the proposed Board of Tax Appeals.

About half of these agencies have come into existence since the late 1960's. Most of these boards have three members who are appointed by the state's governors subject to legislative confirmation. In addition to California, only two other states--Nevada and Wyoming--have boards or commissions which provide administrative adjudication as well as performing administrative duties in relation to other aspects of the state and local tax system. Only in California are administrative tax adjudicators elected.

FISCAL EFFECT: Appropriation: No Fiscal Committee: Yes Local: No

There would be one-time costs to integrate the two different computer systems of BOE and FTB and make necessary facility changes. (BOE currently is converting its computer system to the same system as FTB is in, but that conversion won't be completed until the end of the decade.) After consolidation, there could be ongoing savings in administrative overhead, but it is unclear how significantly operational expenses would be reduced. The primary means by which these line expenses could be reduced is if the sales tax and income tax programs could be better integrated. An FTB survey of 22 other states indicates a greater tendency toward organizing their revenue departments by tasks (such

as auditing, collections and legal), rather than by tax programs (such as sales tax, income tax and property tax). This would indicate that some efficiencies by consolidating the agencies would be possible. FTB also indicates, however, that many states allow their employees, particularly in the audit and legal areas, to specialize in individual tax areas. This specialization would limit the extent that consolidation would result in net efficiencies.

SUPPORT: (Verified 1/28/94)

Little Hoover Commission
State Bar

OPPOSITION: (Verified 1/28/94)

State Board of Equalization
Cal-Tax
California Manufacturers Association
Franchise Tax Board

ARGUMENTS IN SUPPORT: According to the proponents, SB 87 and its companion measure is intended to achieve savings and administrative simplification through combining the two major tax entities into a single agency to be called the Department of Revenue. Consolidation would bring accountability and clarify management authority, which would direct the state's tax administrative resources into a unified mission. Consolidation of these agencies will give the public one tax agency to do business with concerning their taxes rather than having to be concerned with two entities.

Creation of a Board of Tax Appeal is intended to produce a greater degree of fairness at the judicial end of the tax system by preventing situations in which tax administrators effectively judge the taxes they themselves levy. It will provide impartiality by separating tax assessment functions from the quasi-judicial functions involved in tax appeals. Two of the three members of the Franchise Tax Board are also members of the five member BOE. The BOE serves a quasi-judicial role in hearing taxpayers appeals of its own decisions, as well as those of the Franchise Tax Board. Such a system does not provide taxpayers with adequate assurance that they will receive fair and objective administrative adjudication.

ARGUMENTS IN OPPOSITION: CMA states that a Department of Revenue would lack accountability, accessibility and independence. They believe there should be full-time, elected tax administrators who are directly accountable to the citizens of this state for their actions. They state it would eliminate the independence of tax collectors and administrators. There is little, if any, access to appointed administrators, which is not the case with elected officials. They are opposed to the idea of a Tax Appeals Board because the tax adjudicatory process will only become more costly, time-consuming and burdensome for taxpayers. Cal-Tax supports AB 15 concept.

SUBJECT: TAXES (95%); PROPERTY TAX (95%); SALES TAX (92%);

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CALIFORNIA COMMITTEE ANALYSIS

STATENET

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SENATE Committee on Judiciary Bill No. SCA 25

Date of Hearing: January 14, 1992

COMMITTEE: SENATE Committee on Judiciary

BODY:

SENATE COMMITTEE ON JUDICIARY

Bill Lockyer, Chairman

1991-92 Regular Session

SCA 25 (Kopp)

As amended April 22

SB 23 (Kopp)

As Amended March 4

Hearing date: January 14, 1992

Constitution/Various Codes

STATE TAX COURT

CONSOLIDATION OF FRANCHISE TAX BOARD AND BOARD OF
EQUALIZATION

HISTORY

Source: Author

Prior Legislation: SCA 29(1990) - Amended out

SB 1395 (1990) - Amended out

SCA 6 (1989) - Amended out

SB 124 (1989) - Amended out

SCA 51 (1984) - Held in this Committee

SB 2032 (1984) - Held in this Committee

Support: Unknown

Opposition: Franchise Tax Board; Board of Equalization; Judicial Council; California
Ass'n of County Treasurers and Tax Collectors

KEY ISSUE

SHOULD A SEPARATE TAX COURT BE CREATED TO HEAR ALL APPEALS ARISING UNDER STATE AND LOCAL TAX LAWS?

PURPOSE

The California Constitution presently does not provide for specialty courts, but does provide for county boards of equalization and assessment appeals boards to handle local property tax appeals. Existing law establishes the Board of Equalization and Franchise Tax Board to administer and hear state tax matters.

This constitutional measure and bill would abolish the Board of Equalization and the Franchise Tax Board and transfer their powers and duties, as well as some of the Controller's powers and duties with respect to specified tax matters, to the proposed Department of Revenue. The department would be an executive department. The commissioner would be appointed by the Governor, subject to Senate confirmation.

The measures would also establish a state tax court to adjudicate cases arising under state and local tax laws, except for taxes arising within the jurisdiction of the California Unemployment Insurance Appeals Board. The creation of the tax court would not affect any proceeding, prosecution, action, suit or appeal commenced before January 31, 1993 in any state court. However, appeals filed after July 1, 1992 would be heard by the tax court.

The tax court would consist of seven judges, who are required to have been attorneys for at least 10 years, chosen for their special knowledge of California tax law. Judges would be appointed by the Governor, subject to Senate confirmation, and would run for election and re-election in the same manner as Supreme Court justices. Terms are generally for 12 years.

Plaintiffs and others appearing before the tax court (except state or local officials) would be required to pay a \$ 25 fee (or other amount required by law). Proceedings before the tax court would be original, independent proceedings, and would be tried without jury and de novo.

SB 25 would also create a "Small Claims Division" within the Tax Court to hear tax cases involving a refund or liability claim of up to \$ 10,000 (exclusive of interest and penalties) or involving real property with an assessed value of up to \$ 1,000,000 or personal property with a cash value of up to \$ 1 million. An appeal to the Small Claims Division would be the taxpayer's election. The judgement would be binding on both parties as to that case.

The purpose of the bill is to consolidate tax matters into a single department and a single court.

COMMENT

1. Double-referral to Senate Revenue and Taxation Committee

The Senate Revenue and Taxation Committee has requested a dual referral of this measure so that they may consider the impact of the measures on tax

administration. The measures were referred to Judiciary Committee for review of the tax court issues.

2. Overview of tax court issues

The present tax procedures have been strongly criticized. Defenders of the present system say that the system is working in the great majority of the cases, and that it only needs fine-tuning rather than a radical overhaul. (See Comment 3.)

The proposal would postpone the taxpayer's liability to pay a disputed state tax assessment until the appeal is decided by the court. Concern has been expressed that this provision could cause havoc for state budgeting purposes and could invite frivolous appeals. Further, the measure does not adequately protect the state's interest by requiring the posting of any bond to guarantee payment should the taxpayer lose the appeal. (See Comment 5.) Opponents question whether the proposals would save costs. Judicial Council estimates initial operating costs for the tax court to be \$ 8.5 and \$ 9.5 million per year.

An appeal to the proposed Small Claims Division would be at the option of the taxpayer, but the judgement would be binding on the taxing authority.

3. Present appeals procedures

(a) State taxes

Under existing law there is no unified, statewide forum before which taxpayers may appear to contest tax assessments or to argue for refunds. Appeals involving state taxes are considered by a number of state agencies and boards, including the Controller's office, Employment Development Department, State Board of Equalization, Franchise Tax Board, Department of Motor Vehicles, Department of Insurance, the Horse Racing Board, and the Alcoholic Beverage Control Board.

A taxpayer who wishes to contest his tax liability must first attempt to reconcile the dispute with the taxing agency. If this is not possible, the taxpayer may, depending on the specific tax involved, first appeal the matter to a board of the taxing agency or immediately seek judicial relief in the superior court.

(b) Local property taxes

The California Constitution provides that local property tax assessments shall be equalized by county boards of supervisors acting as local boards of equalization, or by local assessment appeals boards created by the county boards of supervisors.

(c) Criticisms of present procedures

In 1979 the Commission on California State Government organization and Economy (the "Little Hoover Commission") filed its report on the "Tax Appeals System in California." It and other have raised three basic criticisms of the present procedures:

- Local and even state appeals boards sometimes lack the necessary expertise in the complexities of tax law.

- Local property tax appeals often result in contradictory holdings.

- At the state level there is the appearance of conflicts of interest in that tax appeals are usually heard by a board within the taxing agency, and the same staff both administers the tax and reviews the appeals.

(d) Defense of present local Procedures

Opponents contend that local boards of equalization have proven themselves to be a popular, efficient, and cost effective means of resolving disputes at the local level. They also assert that the proposed trial de novo reviews of local property tax appeals would seriously undermine administrative hearings and the decisions of local bodies.

Noting that 5,444 assessment appeals were filed in Los Angeles County during 1986/87 and that "only a half-dozen assessment appeals board cases are appealed to superior court each year," the opponent asserts that the proposed "trial de novo is not a proper way of dealing with any problems that might exist at the local level."

(e) Defense of present state tax boards

The Board of Equalization (BOE) asserts that the existing administrative process is also working well. The vast majority of petitions or appeals are resolved administratively. BOE also questions whether 7 judges and their staffs could handle the current workload (which is about 28,000 cases each year) handled by 316 board members, hearing officers, and attorneys.

4. Arguments for and against a state tax court

Proponents assert that:

- A separate tax court would provide special expertise in a complicated area of the law, and would provide for better qualified judges to hear tax matters.

- The existence of a tax court deciding tax appeals would promote uniformity, especially since selected decisions of the tax court would be precedent for future cases.

- The appearance of conflict of interest, presently found at the state level, would be avoided. Opponents raise several competing arguments:

- The creation of a specialty court would set an unfortunate precedent. Others could make equally valid arguments for separate courts.

- A tax court could be more expensive for the appellant than the current appeals procedure which resolves a great majority of the appeals at the administrative level. The de novo review would undoubtedly be more expensive for the taxing authority as additional expenses can be expected in the trying of additional cases and on a de novo basis.

- The proposed system could allow wealthy taxpayers to have "two bites" at the apple, seeking first a favorable administrative decision, and if unsuccessful, a de novo tax court review.

- Efficiency may suffer, as the court may not be able to handle the large workload.

5. Stay of state tax assessment pending appeal

These measures would provide that, except in cases involving property taxes, the timely filing of an action with the court would automatically prohibit the taxing agency from assessing or collecting the disputed tax until the case was resolved by that court. In contrast, current law requires the payment of the tax pending resolution of the appeal. (Comparing another state, the Oregon tax court statute requires a taxpayer to pay the disputed tax pending the court's resolution of the matter.)

Opponents point out two disadvantages of the proposed rule:

(1) The delayed collection of disputed taxes would result in uncertainty in the amount of revenue available to the state and could make budgeting very difficult.

(2) It could invite frivolous suits by sophisticated taxpayers who could receive a return for their money in excess of the interest rate charged by the state.

BOE also points out that if the stay of assessment provision remains in SB 23, the bill should be amended to allow for the assessment and collection of accrued interest in the case of a disputed tax bill eventually resolved in the state's favor.

Further, concern is also expressed that the bill fails to require the appellant to post a bond or other security to guarantee payment in the event the appeal fails. Without a bond, the appellant could dissipate the funds, leaving the state without the means to collect its assessment.

SHOULD NOT, AT THE VERY LEAST, THE APPELLANT BE REQUIRED TO POST A BOND TO GUARANTEE PAYMENT?

While a requirement to post a bond to ensure payment would protect the State's interest, it does not resolve the fiscal concern of being able to project and collect expected revenues for budgeting purposes.

6. Small Claims Division

The Tax Court would also have a "small claims" component which, at the election of the taxpayer, would hear 1) cases involving tax refund or disputed liability of \$ 10,000 or less or 2) proceedings relating to real or personal property which have an assessed or cash value of \$ 1,000,000 or less. These "small claims" proceedings would be informal, but attorneys, accountants, or such other third parties permitted by the court would be allowed to appear. The judgement would be binding on both parties.

Opponents have asserted that it should be able to appeal an adverse small claims division decision. They point out in that the regular small claims court procedure allows a losing defendant to appeal an adverse verdict since the forum was imposed upon him.

SHOULD THE BOE BE ABLE TO APPEAL AN ADVERSE JUDGEMENT IN A FORUM IMPOSED UPON IT?

7. Impairment of checks and balances

BOE also objects to the restructuring of California tax administration to create greater control over tax policy in the Governor instead of the elected Board of Equalization members. BOE asserts that the change would impair the current system of checks and balances.

SUBJECT: TAXES (95%); PROPERTY TAX (94%); APPEALS (92%);

68 of 72 DOCUMENTS

CALIFORNIA COMMITTEE ANALYSIS

STATENET

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SENATE Committee on Revenue and Taxation Bill No. SB 23

Date of Hearing: May 1, 1991

COMMITTEE: SENATE Committee on Revenue and Taxation

BODY:

SENATE REVENUE & TAXATION COMMITTEE SB 23 & SCA 25 - Kopp
Senator Wadie P. Deddeh, Chairman As introduced

Hearing: May 1, 1991 Fiscal: YES

SUBJECT: State Tax Administration: (1) Replaces Board of Equalization and Franchise Tax Board with a Department of Revenue; (2) Creates a tax court

DIGEST -- WHAT THE BILL DOES

Tax Administration

Existing law provides for several tax administering agencies, including the Board of Equalization (BOE), Franchise Tax Board (FTB), Controller, Employment Development Department, and Department of Motor Vehicles. The two largest agencies are the FTB and the BOE.

The BOE administers the state and local sales and use tax, local transactions and use taxes, the gasoline, jet fuel and use fuel taxes, the insurance gross premiums tax, the cigarette and, tobacco products taxes, the alcoholic beverage taxes, the hazardous waste taxes and fees, the energy resources and emergency telephone users surcharges, the timber tax and the private railroad car tax. The BOE also assesses the property of public utilities and common carriers, and provides certain administrative and oversight functions with respect to the local property tax.

The BOE comprises four elected members, one from each equalization district, and the State Controller. The board itself is responsible for setting the values for the board roll. It also hears appeals relating to all of the taxes it administers, as well as the taxes administered by the FTB.

The FTB comprises the Controller, the Director of Finance, and the Chairman of the BOE. It administers the personal income tax and the bank and corporation franchise

tax. Administrative responsibility for income tax withholding is delegated to the Employment Development Department. In addition the FTB administers the homeowners and renters property tax assistance program (for low income elderly or disabled homeowners and renters).

The FTB and the BOE adopt rules and regulations for the taxes, which their departments administer.

SCA 25 removes from the Constitution references to and all powers of the Board of Equalization. Companion SB 23 eliminates both the FTB and BOE, and replaces them with a Department of Revenue, headed by a Revenue Commissioner appointed by the Governor. The new Revenue Department would have all of the duties (except judicial) of the present FTB and BOE, as well as the Controller's present administrative functions regarding the estate tax, and property tax assistance and postponement programs. SB 23 provides for appointment of a deputy commissioner, and delineates his or her duties. The bill also requires the department to:

- prescribe rules for its operation,
- keep records of its proceedings,
- prescribe rules and regulations to govern local boards of equalization and local assessors,
- prescribe forms for property assessment,
- prepare and issue instructions to assessors to promote uniformity, and
- bring action in court to compel assessors and other local tax officials to comply with laws and rules.

The bill also provides for the department to survey local assessment procedures. These requirements, and other provisions of the bill, establish for the department most of the administrative machinery which the existing agencies now possess.

TAX COURT

Under existing law, when a taxpayer disputes an amount of state tax he or she may protest to the FTB or the BOE (depending on the agency levying the tax). The appropriate agency deals with the protest by reexamining the issue administratively and either agreeing with the taxpayer or denying the petition for redetermination or refund. The taxpayer then may request a hearing before the Board of Equalization. If the hearing is granted, the Board may either grant or deny the taxpayer's petition. After exhausting these administrative remedies the taxpayer may bring an action against the state in superior court.

When a property taxpayer disputes a local assessor's assessment, he or she may appeal to the local board of equalization or assessment appeals board. If the taxpayer wishes to appeal the local board decision, he or she may do so in superior court. However, under

present law the court may not hear questions of valuation, but only questions of law. Thus, the valuation question is effectively concluded at the local board level.

When a state assessee (public utility or common carrier) wishes to appeal the determination of the "state assessor" (the BOE) the assessee appeals to the BOE itself. Subsequent appeals of BOE decisions are made to the superior court. Unlike local appeals, however, state assessees may have a trial de novo, considering all questions of law AND valuation.

SB 23 creates a new tax court, which would have "judicial authority for the hearing and determination of all questions of law and fact arising under the tax laws of this state and its subdivisions... The court would consist of seven judges, who shall have been Bar members for at least 10 years, chosen for their knowledge of California tax law. Judges' terms would be 12 years; judges would be appointed by the governor, with confirmation by the Senate, and would be elected and re-elected in the same manner as supreme court justices.

Plaintiffs and others appearing before the tax court (except state or local officials) would be required to pay a fee of \$ 25 (or other amount as required by law). Proceedings before the tax court would be original, independent proceedings, and would be tried without jury and de novo. (This is intended to provide for trial de novo at the local level for property tax, but S16of Article XIII would probably need to be amended to permit trial de novo.)

A small claims division of the tax court would hear proceedings involving less than \$ 10,000 or property valued at less than \$ 1,000,000. The small claims proceedings would be informal, with parties appearing with or without attorney or accountant. The judgment in small claims court would be final and could not be appealed.

FISCAL EFFECT: Administrative consolidation

Administrative savings & costs due to consolidation although the bills (SCA 25 and its accompanying SB 23) are intended to achieve greater efficiency, it is not clear that substantial savings would, or could, be achieved immediately. It is likely that there would be substantial initial costs, which would probably more than offset any savings for some time. Neither the BOE nor the FTB has completed a cost/savings analysis of consolidation. Before consolidation actually takes place, it would be advisable to have the advantage of a full study by a competent and independent third party.

Past studies have shown little duplication of collection or auditing functions, although these studies were not done with consolidation in mind. A consolidated agency under a single executive would probably be more capable of coordinating its various functions than are the present two agencies. For example, although one large agency would certainly need a larger personnel office than either of the two present offices, it should be less than twice as large. The same may be true of some of the auditing, legal, hearing, collecting, cashiering and administrative functions.

It is important to bear in mind, however, that both existing agencies are staffed by highly trained and loyal individuals who have been with their respective agencies for longer, on average, than the employees of most agencies. It is likely that the new agency would desire to retain as much of this talent as possible. And, offsetting the potential for staff

savings, the "natural law of administrative realignments" dictates that whenever two or more agencies are joined together, additional levels are inevitably added to the bureaucratic pyramid. Thus, large staff reductions (the major component of any serious administrative savings) would be unlikely.

A recent study by the Auditor General (which refuted a previous Auditor General study) concluded that consolidating the cashiering functions of the two agencies would not be justified; there could be savings of over \$300,000 annually, but the initial costs would be over \$ 600,000, and most of the savings could be achieved (and have, in fact, already been achieved) administratively, without consolidation.

Transitional costs could be very large if it is intended to fully integrate the tax administration functions. The best example of such costs would be in computer systems. FTB uses an IBM computer system, while the BOE uses fairly new, but smaller, UNISYS machines. The software running on these two systems is totally incompatible. (It is even written in different computer languages.) If a single management information system were desired, it would require an enormous effort to bridge the two systems, and an even greater effort to reprogram one or the other agency's systems to fit the other's hardware and software. (A safe rule of thumb in such conversions is to make a conservative estimate, then triple it, and then apply Murphy's Law.)

Note that in her Perspectives and Issues volume of the 1991-92 budget analysis, the Legislative Analyst suggested that combining BOE and FTB could result in long-term savings (by sharing functions such as collections, data processing, communications, administrative services, and field facilities) and revenue gains (by enhancing cooperation and information sharing among the tax programs).

Revenue effect of consolidation

Whether there would be a tax revenue effect due to the proposed consolidation would depend upon how effectively the shift of responsibilities is carried out. Since both agencies are generally agreed to be efficient and effective tax agencies, there probably would be little revenue increase due to consolidation, even if their actual combined operation were administratively more efficient. There would be a risk of revenue reduction if the transition were not smooth, or if the resulting combined agency were substantially less efficient than the two present agencies.

FISCAL EFFECT: Tax court

An estimate has not been made of the cost of establishing and operating the proposed tax court system. However, the Judicial Council has prepared a preliminary estimate for a tax court proposal in prior legislation (SCA 6 / SB 124 -- Garamendi -- 1989): around \$ 5 million annually.

The filing of a petition in tax court before an assessment becomes final would permit the assessee to avoid paying the tax prior to appeal. As this is the converse of the present law (Article XIII, S32), which only permits appeal after the taxpayer has paid the tax, there would be an unknown but probably very large state and local revenue loss.

COMMENTS:

A. Purpose of the bills

The bills are intended to achieve savings and administrative simplification through combining the two major tax agencies into a single Department of Revenue (which would be by far the largest tax agency among the states, and second in size only to the Internal Revenue Service).

Also, by creating a tax court, the bills are intended to produce a greater appearance of fairness at the judicial end of the tax system by preventing situations in which tax administrators effectively judge the taxes that they levy.

B. Consolidation -- Pros & Cons

Lacking complete analysis of the proposed agency consolidation, policymakers are left with arguments and conjectures. There are as many opinions as there are observers - every taxpayer probably has views as to how taxes could be collected more effectively, more efficiently, or more humanely. The following are the major arguments, which have been put forward concerning consolidation:

Pro:

- Multiple tax collection agencies confuse taxpayers
- Most studies conclude that consolidation would produce savings in the long run
- California is the only state where the tax administration functions are so oddly split
- Consolidation would allow for greater administrative flexibility
- Consolidation would permit more administrative consistency among taxes

Con:

- FTB and BOE are each larger than practically any state's combined agency; consolidation may increase complexity by adding more administrative levels
- BOE and FTB are presently considered by other state tax administrators to be models for efficient state tax administration; this is evidence that there may not be much reason to reform the agencies
- While consolidation may result in a single administrator for both agencies, there may be little real integration of most major functions (since there is presently little duplication); the whole could be as large as (or possibly larger than) the sum of the parts

C. Creation versus evolution of tax administration

There is little doubt that if the opportunity were granted to create the world anew, there would be but one state taxing agency. However, California's taxing structure has grown and evolved for over 100 years. It is the way it is because various economic and political forces caused it gradually to take its current form. Most of the idiosyncrasies which we see in our structure exist for real reasons, some of which may, admittedly, be outdated. But through eons of stress and strain from without (taxpayers, federal law changes, economic restructuring, etc.) and from within (budget strictures, tax law changes, vigorous (or otherwise) administrators), the taxing agencies have become a remarkably effective (albeit quaint) institution, when compared with those of other states. The question presented by this bill is whether the present separate agencies have become so peculiar and out of date that they warrant wholesale reform.

D. Tax Court -- Pros & Cons

Pro:

- Replacement of the BOE with a tax court as the forum for adjudication of tax disputes would assure the appearance of greater fairness and equity.
- Trial de novo at the local property tax appeal level would provide taxpayers with a better opportunity to remedy incorrect or improperly applied assessment methods.
- The small claims division would provide a more accessible, and less intimidating, hearing than is presently available in superior court

Con:

- Except in aberrant cases, the present system is not particularly deficient.
- For small cases the present local property tax appeals and BOE hearings are informal, efficient, and, in the vast bulk of cases, provide satisfactory resolution.
- Present justice system is overloaded with other issues; tax court would increase this burden.

Support and Opposition

Oppose:

Judicial Council

County Clerks Association of California (unless amended not to apply to local property tax)

Board of Equalization opposed similar legislation in 1989

Consultant: Martin Helmke

SUBJECT: PROPERTY TAX (98%); TAXES (96%);

CALIFORNIA ADVOCATES, INC.



November 14, 2003

Mr. William J. Rosendahl, Chairman
California Commission on Tax Policy in the New Economy
1102 Q Street, Suite 6000
Sacramento, CA 95814

Dear Mr. Rosendahl:

Our firm represents the California Defense Counsel (hereinafter "CDC"), a statewide association of approximately 3000 lawyers specializing in representing defendants in civil litigation. We understand that the California Commission on Tax Policy in the New Economy will consider a proposal to establish a new California Tax Court at the Commission's November 17 meeting. We appreciate the opportunity to comment on the proposal.

CDC opposes the creation of a state tax court at this time. As you know, the California court system has undergone major changes and evolution in recent years, including the establishment of a state funding process, consolidation of municipal and superior courts, transfer of responsibility for facilities to the state, and other changes. The entire judicial branch is currently working diligently to implement these major reforms, and we see no justification for further burdening the system with the massive structural changes necessary to establish a separate tax court.

California also struggles with fundamental questions relating to properly funding the judicial branch and providing appropriate facilities for the public. We believe that these issues should be resolved prior to any serious consideration of devoting substantial resources to the establishment of a separate court system.

There are also important policy questions involved in a proposal which simultaneously fragments the existing state court system and shifts accountability away from the local level, if local property tax appeals were to be assigned to the state tax court system. CDC has traditionally opposed the creation of specialized business or tax courts, as confusing and ultimately detrimental to the existing judicial branch and we have seen no evidence warranting a change in our position at this time.

Mr. William J. Rosendahl, Chairman
California Commission on Tax Policy in the New Economy
November 14, 2003
Page 2

There are certainly profound policy questions surrounding tax policy in our new information-based economy, but we do not believe that establishment of a separate, tax-only court responds to these issue or is appropriate at this time. Thank you for considering our views.

Sincerely,

Michael D. Belote

MDB:cs

cc: Gene Wong, Chief Counsel, Senate Judiciary Committee
Drew Liebert, Chief Counsel, Assembly Judiciary Committee
Martin Helmke, Chief Consultant, Senate Revenue and Taxation Committee
Eileen Roush, Principal Consultant, Assembly Revenue and Taxation Committee
Dan Pone, Judicial Counsel
Raymond Coates, California Defense Counsel

November 12, 2003

Mr. William J. Rosendahl, Chairman
California Commission on Tax Policy in the New Economy
1102 Q Street, Suite 6000
Sacramento, CA 95814

Re: State Tax Court Option: OPPOSE

Dear Mr. Rosendahl:

The Consumer Attorneys of California (CAOC) appreciate the opportunity to comment upon the California Commission on Tax Policy in the New Economy's discussion regarding the creation a tax court, as a specialized forum for "resolving all tax disputes."

The Consumer Attorneys oppose the establishment of a separate tax court. It is our opinion that the existing court structure, is with its modern emphasis upon consolidation, is more than sufficient. Courts of General Jurisdiction through their adoption of common practices and procedures allow for the flexible and efficient use of judicial staff and facilities that best meet the demand of any increase in litigation within a given specialty of law. Additionally, a specialized tax court would set a precedent that would most probably result in requests for further fragmentation of the courts into specialized forums.

Under current law Californians have a "tax court" option: the Board of Equalization (BOE). The BOE in conjunction with the California Franchise Tax Board have settlement programs that permit taxpayers to pursue an administrative settlement process when seeking resolution of their tax disputes. The BOE and the Franchise Tax Board have qualified, professional staff available to the public. The existing structure is clear and most importantly provides for the public accountability of the BOE members. In contrast there is no public accountability provision in the tax court proposal.

At a time when budgetary constraints are of primary concern, any attempt to fragment the existing court system and to train and staff specialized courts with "tax law specialists" would be costly and time consuming. CAOC believes that the current judicial structure provides for cost effective, flexible responses to Californians' tax disputes.

For these reasons, the Consumer Attorneys of California oppose the establishment of a specialized tax court as recommended by the Commission. If you or your staff would like to discuss this matter further please contact me or one of our legislative advocates at our Sacramento Office.

Sincerely,



Bruce Brusavich
President



Judicial Council of California
ADMINISTRATIVE OFFICE OF THE COURTS

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Chief Justice of California
Chair of the Judicial Council

WILLIAM C. VICKREY
Administrative Director of the Courts

RONALD G. OVERHOLT
Chief Deputy Director

November 6, 2003

Mr. William J. Rosendahl, Chairman
California Commission on Tax Policy in the New Economy
1102 Q Street, Suite 6000
Sacramento, California 95814

Subject: Opposition to State Tax Court Option

Dear Mr. Rosendahl:

We have reviewed the discussion by the California Commission on Tax Policy in the New Economy of the option of creating a tax court, and we appreciate the opportunity to comment on the proposal.

The Judicial Council opposes fragmentation of the court system, which would be the result of creating a new tax court or other specialty courts. The thrust of modern court administration has been to avoid such fragmentation, to consolidate courts, and to adopt common practices and procedures that permit efficient, flexible use of judicial staff and facilities. Courts of general jurisdiction can better meet demand, as the volume of litigation rises and falls within specific areas of the law.

Numerous legislative proposals have been introduced over the last 25 years to create tax courts, all of which have been unsuccessful. [See e.g., AB 1155 and ACA 38 (1979), AB 2254 and ACA 38 (1980), SB 2032 and SCA 51 (1984), SB 124 and SCA 6 (1989), SB 23 and SCA 25 (1992).] The Legislature has consistently rejected the creation of tax courts based on many of the same concerns expressed by the Judicial Council and others about the inappropriate balkanization of the court system, as well as the inefficient and costly nature of the proposals.



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Past legislative proposals have included creating a separate five- or seven-judge tax court that would hold hearings throughout the state. [See e.g., SCA 6 (Garamendi) and SB 124 (Garamendi) of 1989, and SCA 25 (Kopp) and SB 23 (Kopp) of 1992.] Each of these proposals would have required the appointment of judges who are certified tax specialists. The tax courts would also have included small claims divisions and would have heard tax-related cases exclusively. When these proposals were being considered, the Judicial Council estimated that the costs of operating these tax courts could range from \$6.5 to \$7.5 million for the five-judge court, and \$8.5 to \$9.5 million for the seven-judge court. The present-day costs of operating such tax courts would of course be considerably higher. The cost would also depend on the structure and makeup of the tax court, including the standard for review and other applicable procedures, which are not specified in the option the commission is considering.

While tax matters can present unique and complex problems, it is also true that complexity can occur in any type of litigation. The creation of a specialty tax court would set an inappropriate precedent since other equally valid arguments can be made for separate probate courts, criminal courts, family law courts, personal injury courts, and so forth.

In addition, specialty courts are not necessary since the superior courts in each county can create separate departments or calendars within existing structures to deal with cases involving subjects such as tax, probate, product liability, personal injury, family, or criminal law. Under local rules, such specialization permits the judicial staff and court facilities to serve changing needs without inflexible constitutional or statutory mandates.

Furthermore, cases cannot be arbitrarily classified into segments dealing exclusively with one field of law. They do not divide neatly into tax, tort, contract, property, and other such categories. The field of tax law touches on a wide variety of legal fields, including probate, real property, divorce, and personal injury. Under the option being considered by the commission, a new state tax court would be established “to resolve all tax disputes, including personal income tax, corporate income tax, sales and use tax, property



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taxes, payroll taxes, and excise taxes.” (Commission, “Options for Revising the California Tax System,” June 15, 2003 draft, at p. 33.) The judges deciding such matters should not come from a specialized field that traditionally focuses primarily on matters related to the federal Internal Revenue Service.

For the above reasons, the Judicial Council opposes the creation of a specialty tax court and respectfully requests that the commission reject this option at its November 17, 2003, meeting. However, we would be pleased to meet with the proponents of this proposal and discuss how best to address the handling of tax cases in the courts. This could include possible rules changes, increased resource materials for judicial officers, improved calendaring and record-keeping systems and other case management enhancements to make the processing of tax cases as effective and efficient as possible. If you have any questions or need any additional information, please feel free to contact Daniel Pone, Senior Attorney in our Office of Governmental Affairs, at 916-323-3121.

Sincerely,

William C. Vickrey
Administrative Director of the Courts

WCV/DP/ml

cc: Martin Helmke, Chief Consultant, Senate Revenue & Taxation Committee
Drew Liebert, Chief Counsel, Assembly Judiciary Committee
Eileen Roush, Principal Consultant, Assembly Revenue & Taxation Committee
Fred Silva, Public Policy Institute of California
Gene Wong, Chief Counsel, Senate Judiciary Committee

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September 23, 2003

Commission on Tax Policy for the New Economy
William Rosendahl, Chair
1102 Q Street, Suite 6000
Sacramento, California 95814

STATEMENT PROPOSING THE CREATION OF
A TAX COURT FOR THE STATE OF CALIFORNIA

Dear Commission Members:

This paper elaborates on my remarks to the Commission at my appearance on September 9, 2003. It was a pleasure to appear before the Commission and to participate with a panel of talented and informed advocates. I thank the Commission for the opportunity to address a topic that has been of interest to me for many years.

In 1978 I chaired a task force of the California Commission on Governmental Reform (Post Commission) that examined conforming the California income tax with the federal tax system. Since that time California has made great strides conforming the Revenue and Taxation Code with the Internal Revenue Code. I believe that anyone who thinks seriously about state tax issues would agree that state-federal conformity contributes to simplicity, efficiency, and economy in the collection of state individual and corporate income taxes. Recently, along with Professor Joseph Bankman from the Stanford Law School, I had the privilege of working with legislative staff, Franchise Tax Board personnel, representatives of California CPA's, representatives of the State Bar, and representatives of other interested parties, in drafting legislation to combat abusive tax shelters (SB 614 and AB 1601, which has passed both houses of the Legislature and has been sent to the Governor). All parties to those discussions asserted that conformity with Federal legislation is an important policy goal in crafting a California response to abusive transactions. Conformity remains a central policy goal in all California tax legislation. I suggest that conformity with Federal procedures in tax dispute resolution with a matching dispute resolution process is an equally compelling concept.

The Framers of the Constitution of the United States envisioned a governmental structure based on a separation of the powers of the legislative, executive, and judicial branches. This separation of function is one of the recognized hallmarks of our system of government. Executive and policy functions are in the hands of the elected executive officers of government and the members of legislatures. The judicial function of interpreting and applying enacted laws to individual cases is in the hands of the judiciary. Of course, in California as in many other states, members of the judiciary are elected, most often after being appointed by the Governor.

The framers of United States' government were also careful not to provide for an elected tax collector. In its 2001-2002 annual report (page 5), the Board of Equalization describes itself as "the nation's only elected tax commission." The members of the California Board of Equalization are elected political people. Some are, or have been, members of the State Legislature subject to term limits, some members are, or have been, people who aspire to higher statewide political office. Only one member of the current Board had any particular expertise in taxation prior to serving on the Board.

In the context of resolving disputes between taxpayers and the tax collector, the elective nature of the Board of Equalization causes an inherent structural conflict. One can easily imagine that a campaign slogan for an elected tax collector would be, "Elect me and I will not collect taxes from you (even if those taxes are due under the law)." One member lists as an accomplishment of his current tenure on the Board the fact that he "is responsible for increasing the percentage of relief received by California taxpayers before the Board of Equalization." While that may be an appropriate position for an elected policy maker, it illustrates the inherent conflict between the executive function of the Board of Equalization, which is to supervise the collection of numerous taxes (and its concurrent role in developing tax policy and making recommendations to the Legislature), and a judicial function that involves the application of existing law to the facts of a particular case.

On the one hand, the job of the tax collection agency is to protect the State's revenue by collecting taxes that are due under the laws enacted by the legislature and signed by the Governor. An individual could campaign for the Board of Equalization on a position that big corporations and other big business, along with wealthy individuals, don't pay enough taxes. Another individual may campaign for the Board on the premise that taxes are bad for the California economy because they stifle investment. As elected officials, the members of the Board of Equalization have a legitimate policy role in the structure of the tax system which may be influenced by these varying positions. The overall position of the Board of Equalization could vary with each election cycle as the philosophy of the majority changes with new membership. That result is appropriate for the Board in its executive and policy functions. However, when these varying and changeable political views are brought to the judicial function of deciding individual cases, the result is an inconsistent jurisprudence that does not provide guidance, and therefore certainty, to taxpayers planning transactions for the future. Current interpretation of the tax law could change after the next election. In addition, the

application of the elected member's political philosophy to the decision of individual cases may lead to results that are unfair either the taxpayer or to the State of California.

Two cases recently decided by the Board of Equalization illustrate the conflict. In LCI Logic Corp. and Cypress Semiconductor Corp., on a two to one vote, the Board allowed the refund of research credits in excess of the taxpayers' state tax liabilities. One member of the Board was disqualified from participating because the member owned stock in one of the parties. One member was disqualified because of a campaign contribution from a company with the same issue pending before the Board. Of the three members deciding the case, one member was reported in the press as stating that granting the refunds was important "to encourage companies to invest in California"; a laudable policy goal but not an appropriate factor in applying the law to a specific case. Another member was reported as complaining about the "tally of givebacks that day," which also is an appropriate policy position but not a grounds for deciding individual cases. In addition, the President Pro Tem of the Senate attempted to affect the decision with a letter claiming that, "a misreading of this statute in favor of LSI Logic would result in revenue losses in the hundreds of millions of dollars, as other taxpayers would attempt to use the same inappropriate interpretation to yield a sales tax refund on top of fully utilized research credits."

The case illustrates another flaw in the existing structure. The taxpayer-favorable decision is the end of the road. Although a taxpayer who is dissatisfied with the ruling of the Board of Equalization may file a claim for refund and then file suit for a refund in the Superior Court (after again going through the administrative process), there is no equivalent provision for the Franchise Tax Board to challenge a taxpayer-favorable interpretation by the Board of Equalization.¹ There are two problems here. This system results in an unbalanced state of the law where taxpayer-favorable positions are not subject to review. In addition, because Superior Court Judges do not publish opinions, there is no readily available way to discover the law in this area. As a consequence the law becomes a "private" body of law known only to the practitioners who handle significant numbers of cases before the Board of Equalization, but unknown to business people who are trying to plan transactions that are affected by the State tax law.² This uncertainty can have a detrimental impact on business expansion plans.

A state tax court would eliminate the dilemma currently caused by California's politically oriented dispute resolution body. Creation of a state tax court also would achieve an economy and efficiency in the administration of the state tax law consistent with the principles adopted by the Commission. The concept of a state tax court offers several advantages.

¹ For an example of a challenge to a taxpayer favorable decision by the Board of Equalization see Proposition 22 Legal Defense and Education Fund v. State Board of Equalization, Sacramento Co. Superior Court No. 01CS00718 (2001), which is cited in the Board of Equalization 2001-2002 annual report, p. 47, but not otherwise readily available for study.

² Board of Equalization opinions, although not all are regularly published, are available on commercial electronic legal databases.

- (1) A centralized tax court would develop a consistent body of discoverable interpretative law, based on precedent, to serve as a guide to the application of California tax statutes. Judges could be appointed with sufficiently long terms to provide consistency in the decision making process. Members of the court could be selected on the basis of expertise in the tax law and the possession of judicial temperament to decide cases by applying the law to the facts as found. Thus, the law would be applied based interpretation of the intent of the Legislature and the Governor, rather than on the basis of the policy views of independent elected officials sitting as judges.
- (2) The creation of a tax court would free the Board of Equalization to better function as a policy and executive organization. Creation of a tax court does not suggest termination of the important role of the Board of Equalization.³ This also may positively influence the effectiveness of the Board as the State's principal tax collection agency. Like the United States Treasury Department, the Board of Equalization could influence tax policy through legislative recommendations, adoption and approval of regulations, and decisions on litigation positions.
- (3) Development of a consistent and accessible body of law interpreting California tax provisions would help to improve the California business climate. Investment decisions are based on assessment of after-tax rates of return. Calculating that return requires some level of confidence that there will not be retroactive applications of the tax law through varying and changeable interpretations of the law. The turnover of an elected board every four years increases the risk that the law will change. The possibility of an anti-taxpayer position increases the risk of an investment causing the investor to require a higher before-tax rate of return to compensate for the increased risk. That puts California at a competitive disadvantage. The possibility of a taxpayer-favorable shift in the Board of Equalization offers a lottery for higher after-tax rates of return. The uncertainty on either side discourages investment.
- (4) A state tax court could develop a fairer and more accurate dispute resolution system based on rules of evidence, findings of fact, and application of the law to the facts as found. The existing system relies on factual development by staff and optional brief appearances before the Board. Decisions are often made at the staff level, which is the repository of expertise for interpreting the law. Appearance before the Board may affect the outcome through attempts to sway the Board with emotional appeals. One Board member indicates that a more taxpayer-favorable outcome can be achieved through the simple expedient of demanding an immediate vote by the Board members. A look at the Board's crowded agenda for its monthly two-day sessions makes it clear that the proceedings do not involve substantive hearings on individual cases. A state tax court would result in cases more thoroughly considered by judges whose sole responsibility would be resolution of disputes brought before it, with a reduced reliance on staff expertise for final decisions.
- (5) Finally, conformity with the Federal tax litigation process would result in increased efficiency in the decision-making process. Practitioners familiar with Federal tax litigation procedures would be familiar with California procedures. This conformity would reduce costs inherent in a system that requires California specialists focused on varying procedural requirements. The structure could be simplified with a single administrative review of proposed assessments by a hearing officer attached to the Franchise Tax Board or Board of

³ Because the Board of Equalization would maintain its authority mandated in the State Constitution, there is no need for a constitutional amendment to create a tax court as an arm of the Legislature.

Equalization.⁴ Appeals from the tax court, by both parties, could be taken to the Courts of Appeal, thereby unburdening the Superior Court from having to decide tax issues and removing one level of hearing from the process. For parties who prefer a decision in the Superior Court, like the Federal system, taxpayers may be given an option to pay the tax and file a refund suit in Superior Court, which thereafter may be appealed to the Courts of Appeal. I believe that this arrangement would produce a balanced and discoverable body of interpretation of the California tax law that would reduce uncertainty in the application of the Revenue and Tax Code.

STRUCTURE OF A CALIFORNIA TAX COURT

Subsequent to my appearance before the Commission, I have given some thought to how I would structure a California tax court. These thoughts are preliminary and require further study, but might be a starting point. Again, the overriding theme is conformity with Federal procedures. Also, I believe that creation of a state tax court would shorten the dispute resolution process by reducing the number of steps taken before a case is resolved. The system would not be duplicative, one level of administrative appeal and the hearing before the Board of Equalization could be eliminated. In addition, this proposal would reduce the need for staff at the Board of Equalization to find facts and draft decisions proposed for Board adoption. Some of the staff might be shifted to staff the tax court. Overall the tax court would create efficiencies in the decision making process that could result in cost savings to the State.

- The court could include five judges, appointed by the Governor and confirmed by the Board of Equalization or the Legislature. The court would be an administrative court formed under the legislative power rather than a court with stature equivalent to the Superior Court.
- The terms of appointment should be from 12 to 15 years.
- Each judge would probably require three law clerks and a secretary. The court also would require a clerks' office and clerical personnel. The total number of people required would be in the range of 50.
- Cases would be heard by a single judge who would make findings and draft an opinion. At the request of the chief judge or some number of the other judges, cases would be decided by the full court.
- The court would develop its own procedures and rules of evidence. Following the lead of the U.S. Tax Court, strict evidentiary rules may not be necessary.
- The court would publish its opinions as deemed by the judges to be significant. Other cases might be decided by unpublished memorandum decision.
- The court might appoint masters to hear small tax cases, cases involving less than \$5,000 of tax deficiency and for which the taxpayer elects a small case procedure. Decisions in small tax cases would be final, with no right to appeal.

⁴ This is analogous to the appeals function of the Internal Revenue Service.

- Decisions of the tax court would be appealable to the California Courts of Appeal. The appropriate appellate court might be the District Court of Appeal for the district of the taxpayer's residence, or all appeals could be concentrated in the Third District (Sacramento) which might have one or two judges appointed with some experience in tax matters.
- Appeals would be allowed both to the taxpayer and the Franchise Tax Board.
- Petitions for hearing before the tax court would be filed after an assessment by the Franchise Tax Board becomes final. Taxpayers would not be required to pay the tax before filing with the tax court.
- The administrative procedure before a final assessment could be shortened to include a single appeal before an appeals officer of the Franchise Tax Board or Board of Equalization.
- The tax court jurisdiction would include the individual income tax, the corporate and bank franchise taxes, sales tax disputes, and disputes over other taxes as the Legislature would determine. The list might include all taxes administered by the Board of Equalization. The tax court might also be empowered to here appeals of local tax assessments following denial by a county board of supervisors.⁵
- An alternative option to the tax court would remain for taxpayers to pay the tax and file a suit for refund in the Superior Court, in which case the taxpayer would forego recourse to the tax court.

In summary, I believe that creation of a tax court for California tax disputes would avoid the conflict that is inherent in combining the executive and policy making roles of the elected members of the State Board of Equalization, and would enhance the efficiency of the tax collection process by conforming dispute resolution with the Federal Income tax system. The stature of the Board of Equalization as the central policy agency for California taxes would be enhanced by removing it from the dispute resolution process.

Respectfully submitted,

Daniel L. Simmons

C: The Honorable Carole Migden, Chair, California Board of Equalization
The Honorable Bill Leonard, Member California Board of Equalization

⁵ Here I think I might restrict the right to appeal to questions of law, rather than a reassessment of fair market value.

John Warren
Steven Kamp
Eric Miethke

From: Professor Daniel Simmons
Sent: Friday, November 14, 2003
Subject: State Tax Court Proposal

California Commission on Tax Policy for the New Economy
Bill Rosendahl, Chair

Dear Commissioners:

I have read letters from the Judicial Council and trial lawyers opposing the idea of a State Tax Court. They raise concern regarding an alteration of the roles of judges, or the appointment of judges, to create a specialized judicial expertise in taxation. I appreciate the concern regarding a specialized judiciary, although I do note that even with consolidation the Superior Courts, counties create specialized dockets for family matters, drug matters, traffic matters, etc. I do not understand the interest of the trial lawyer organizations, except to assume that someone is mounting a lobbying campaign.

Please recall that in my statement before the Commission, and in greater detail in my follow-up paper of September 23, 2003, I advocate the creation of an administrative court to hear tax disputes, rather than a court under the judicial branch. I base that recommendation in part on the long-held opposition of the state's judges to a specialized bench. Also, the creation of an administrative level tax court conforms with the Federal system, which has value in developing procedural rules. The process of decision making in the Tax Court is not nearly as constrained by technical rules of process and evidence as one encounters in judicial courts. I happen to believe that the resolution of disputes involving highly technical and complicated issues is, as a consequence, more efficient and accurate than is possible in the courts. Nonetheless, for the reasons that I discussed in my letter of September 23, the existence of a dispute resolution process apart from elected administrators and policy advisors would be helpful to assure fairness in the resolution of cases on the basis of the facts and the law pertaining to the particular parties before the decision maker.

Thank you for considering my views. If I can be of any assistance, please don't hesitate to let me know.

Daniel L. Simmons

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Administrative Court Task Force, Committee on State and Local Taxation,
Section of Taxation, American Bar Association**

Model State Administrative Tax Court Act

10/28/03 DRAFT (NOT APPROVED BY THE AMERICAN BAR ASSOCIATION)

EXPLANATION

Summary

In many states, a taxpayer who desires to contest the state tax authority's determination of a tax liability, or denial of a refund claim, faces one or both of two obstacles that seriously undermine the public's perception of the fairness of tax decisions made by the State.

First, in over twenty states, the taxpayer must present his legal challenge and make his factual record to a hearing officer who is employed by the same taxing authority that made the determination in issue. In addition, the standard for judicial review of the internal hearing officer's factual conclusions is typically extremely onerous, e.g., the hearing officer's findings will be upheld by a reviewing court unless "arbitrary and capricious," "without rational basis," "clearly erroneous," or "against the manifest weight of the evidence in the record." No matter how conscientious and fair the particular hearing officer, the hearing officer's status as an employee and agent of the tax collector creates an unavoidable perception of bias.

Second, in some states, the taxpayer must pay 100% of an asserted liability for tax, interest and penalty as precondition to challenging the state's determination of a tax liability ("pay-to-play"). In other states, the taxpayer must post a bond—which can be very expensive—before the taxpayer is allowed to challenge the state's assessment in court ("bond-to-play"). By imposing a substantial cost upon the exercise of a taxpayer's right to contest revenue department determinations, pay-to-play and bond-to-play provisions in more than twenty states discourage taxpayers—particularly smaller taxpayers—from challenging revenue department determinations that are not clearly justified by existing law or by the taxpayer's facts.

Basic fairness, and perhaps Due Process, demand that a taxpayer be allowed to make his case against an assertion of tax liability, or denial of a refund, before an independent adjudicatory body. For the same reasons, in the usual case a person challenging a tax assessment should not be required to pay the amount in issue, or post a bond, as a condition to receiving an initial hearing—even if that hearing is before an unbiased, adjudicatory body.

To address these instances of unfairness, and to make available to taxpayers in all states the best practices of the independent state tax tribunals that now exist, the Section of Taxation's Committee on State and Local Taxation proposes the following Model State Administrative Tax Court Act ("the Model Act") for consideration by the states. Drafted by the Committee's Administrative Court Task Force, the Model Act would establish within the executive branch of government a tax court with virtually the same powers as a state trial court of general jurisdiction, but with its subject matter jurisdiction limited to taxes.

The tax court would replace the state's internal hearing system and, ideally, would also replace the jurisdiction of the state's general trial court, as to most or all of the taxes collected by the state's revenue department. The tax court would assume jurisdiction after exhaustion of non-hearing administrative procedures within the department of revenue. Its proceedings would be *de novo* and without a jury. The court would include both a regular and a small claims division. Judicial appeal from a tax court decision would be prosecuted in the same manner as an appeal from a decision of a trial court of general jurisdiction, except there would be no right to appeal a decision of the tax court's small claims division.

As a further incentive to states to end the unfairness of their current adjudictory systems, the Committee also recommends the adoption of federal legislation that would grant a person engaged in interstate commerce the right to challenge state tax determinations in the federal courts, if the relevant state's system for adjudicating tax controversies contains either of the unfair features described above.

How the Model Act Relates to Prior State Tax Court Proposals

In 1957, the American Bar Association first sponsored a study of state tax courts. The ABA study prompted the National Conference of Commissioners on Uniform State Laws to promulgate a Model State Tax Court Act, which was designed to provide a model for state legislatures to use in establishing such a court

During the late 1960's a special Subcommittee on State Tax Courts of the Section of Taxation's Committee on State and Local Taxes reviewed the 1957 Model Act, studied subsequently enacted legislation, and prepared a proposed Revised Model Act (Revised Model State Tax Court Act 1971-12) that clarified some of the ambiguities of the 1957 Model Act and placed the proposed court in the state's judicial system.

After a review of Revised Model State Tax Court Act 1971-12; the independent tax court statutes enacted in recent years by Massachusetts, New York, Maryland, West Virginia and New Jersey; the literature reflecting the latest thinking on the operation of state tax tribunals; and the experience of attorneys with extensive experience litigating state tax cases, the Committee's Administrative Court Task Force has prepared the Model State Administrative Tax Court Act, which would establish a tax court within the executive branch of government with plenary jurisdiction over tax matters.

The Model Act uses the terms “[general trial]” and “[statute]” to indicate to the draftsman that reference to local usage and statutes must be inserted at this point. Other insertions are suggested by the use of material in brackets.

A detailed commentary follows the Model Act’s text.

MODEL STATE ADMINISTRATIVE TAX COURT ACT

Section 1. Statement of purpose

To increase public confidence in the fairness of the State tax system, the state should provide an independent agency to resolve disputes between the department of revenue and taxpayers, prior to payment of the taxes in issue and without the necessity of posting a bond. By establishing an independent tax court within the executive branch of government, this Act provides taxpayers with a means of resolving controversies that ensures the basic elements of due process and fairness. The tax court shall provide hearings in all tax matters except those specified by statute, and render decisions and procedural orders relating to the administration of the hearing process. The administrative hearing process shall be commenced by the filing of a petition protesting a notice of a tax determination made by the department of revenue, including a determination that cancels, revokes, suspends or denies an application for a license, permit, or registration. A final decision of the tax court shall have the same force and effect as, and shall be subject to appeal in the same manner as, a final decision of a State trial court.

Section 2. Tax Court: Establishment

- (a) A tax court is hereby established in the executive branch of government. The tax court is referred to in this Act as the "Tax Court."
- (b) The Tax Court shall be a quasi-judicial agency that is separate from and independent of the authority of the [commissioner of revenue] and the [department of revenue].
- (c) The Tax Court shall have a seal.
- (d) The Tax Court shall be created and exist on and after January 1, 200_, but the judge[s] thereof may be appointed prior thereto and may then take any action that is necessary to enable the judge[s] properly to exercise after that date the duties, functions and powers given the Tax Court under this Act.

Section 3. Judges: Number; Appointment; Term of Office; Removal

- (a) The Tax Court shall consist of no less than one judge nor more than six judges, each of whom shall exercise the powers of the Tax Court.
- (b) The judge[s] of the Court shall be appointed by the Governor, with the advice and consent of the Senate, for a term of six years.
- (c) Once appointed and confirmed, the [each] judge shall continue in office until his or her term expires and until a successor has been appointed and confirmed.
- (d) Vacancies in the Tax Court occurring otherwise than by expiration of term shall be filled for the unexpired term in the same manner as original appointments.
- (e) If more than one judge is appointed, the Governor shall designate one of the members as chief judge of the Tax Court, in this chapter referred to as the "Chief Judge." The Chief Judge shall be the executive of the Tax Court and have sole charge of the administration of such Tax Court and shall apportion among the judges all causes,

matters and proceedings coming before the Tax Court. The Chief Judge shall serve in that capacity during the pleasure of the Governor.

(f) The Governor may remove a judge after notice and an opportunity to be heard, for neglect of duty, inability to perform duties, malfeasance in office, or for other good cause.

(g) Whenever the Tax Court trial docket or business becomes congested or the [any] judge of the Tax Court is absent, disqualified or for any other reason is unable to perform his or her duties as judge, and it appears to the Governor that it is advisable that the services of an additional judge, or judges, be provided, the Governor may appoint a judge, or judges, *pro tempore* of the Tax Court. Any person appointed judge *pro tempore* of the Tax Court shall satisfy the same qualifications that a judge of the Tax Court is required to satisfy.

(h) A judge may disqualify himself on his or her own motion in any matter, and may be disqualified for any of the causes specified in [judicial disqualification statute],

Section 4. Judges: Qualifications; Prohibition Against Gainful Employment

(a) The [Each] judge of the Tax Court shall be a citizen of the United States and of this State, and shall have been admitted to practice in the Supreme Court of this State and have been engaged in this State for at least five years preceding his or her appointment, in the active practice of law, governmental or private, or in the discharge of the duties of a judicial or quasi-judicial office. No person shall be appointed as a judge unless at the time of appointment the individual is knowledgeable of and experienced in matters of taxation.

(b) Before entering upon the duties of office, the judge shall take and subscribe to an oath or affirmation that he or she will faithfully discharge the duties of the office, and such oath shall be filed in the office of the Secretary of State.

(c) The [Each] judge shall devote his or her full time during business hours to the duties of his or her office. No person, while a judge, shall engage in the practice of law or other gainful employment or business, nor hold another office or position of profit under this State, any other State or the United States.

Section 5. Principal Office, Locations; Facilities

(a) The Tax Court's principal office shall be located in [the State capital or other city].

(b) The Tax Court shall conduct hearings at its principal office. The Tax Court may also hold hearings at any place within the State, with a view to securing to taxpayers a reasonable opportunity to appear before the Tax Court with as little inconvenience and expense as practicable.

(c) The principal office of the Tax Court shall be located in a building that is separate and apart from the building in which the department of revenue is located. When the Tax Court holds hearings outside of its principal office, it shall do so in a building that is separate and apart from any building in which the department of revenue is located.

(d) The State shall provide courtrooms, chambers and offices for the Tax Court at the its principal office and shall arrange for courtrooms, chambers and offices or other appropriate facilities when hearings are held elsewhere.

Section 6. Appointment of Clerk and Reporter; Expenditures of the Tax Court

(a) The Tax Court shall appoint a clerk and a reporter, and may appoint such other employees and make such other expenditures, including expenditures for library, publications and equipment, as are necessary to permit it to efficiently execute its functions.

(b) The reporter shall be subject to the provisions of [court reporter statutes] as if appointed by a judge of the [general trial] court, except where such provisions are in conflict with this Act.

(c) No employee of the Tax Court shall act as attorney, counselor or accountant in a matter involving any tax imposed or levied by this State or any of its political subdivisions.

(d) An employee of the Tax Court may be removed by the judge [Chief Judge], upon notice and hearing, for cause, including neglect of duty, inability to perform duties, or malfeasance in office.

(e) In addition to the services of the official reporter, the Tax Court may contract the reporting of its proceedings and, in the contract, may fix the terms and conditions under which transcripts will be supplied by the contractor to the Tax Court and to other persons and agencies.

Section 7. Jurisdiction of the Tax Court

(a) Subject only to the provisions of section 15 of this Act relating to judicial review, the Tax Court shall be the sole, exclusive and final authority for the hearing and determination of questions of law and fact arising under the tax laws of this State. For purposes of this section, the following statutes are not tax laws of this State, except to the extent that they preclude the imposition of other taxes: [Any laws regulating the payment of taxes or assessments over which it is not intended the Tax Court shall have jurisdiction, *e.g.*, Real Property Taxes, Workman's Compensation Laws, Racing Taxes, Commodities Assessments, etc.].

(b) Except as permitted under [other state law, such as the constitution of the State, a statute or case law], no person shall contest any matter within the jurisdiction of the Tax Court in any action, suit or proceeding in the [general trial] court or any other court of the State.

(c) Except as provided in [State statute regarding jeopardy assessments], the Tax Court shall hear cases prior to the payment by the taxpayer of any of the amounts asserted as due by the department of revenue and prior to the posting by the taxpayer of any bond.

(d) The Tax Court shall decide questions regarding the constitutionality of the application of statutes and the constitutionality of regulations promulgated by the department of revenue, but shall not have the power to declare a statute unconstitutional on its face. A taxpayer desiring to challenge the constitutionality of a statute on its face may, at the taxpayer's election, do so by one of the following methods:

- (1) commence a declaratory action in the [general trial] courts of this State with respect to the constitutional challenge, with the remainder of the matter stayed by the Tax Court pending final resolution of the constitutional challenge;
- (2) file a petition with the Tax Court with respect to all issues other than the constitutional challenge and preserving the constitutional challenge until the entire matter (the constitutional issue and any other issues) is subject to judicial review; or
- (3) bifurcate the matter by commencing a declaratory action in the [general trial] court with respect to the facial constitutional challenge and by filing a petition with the Tax Court with respect to the remainder of the issues.

Section 8. Pleadings

(a) A taxpayer may commence a proceeding in the Tax Court by filing a petition protesting the written notice by which the department of revenue has advised the taxpayer of its determination imposing a liability for tax, penalty or interest; denying a refund or credit application; canceling, revoking, suspending or denying an application for a license, permit or registration; or taking any other action which gives a person the right to a hearing in the Tax Court under the law. For purposes of this section, the term “taxpayer” includes a person challenging the validity or applicability of the tax and a person challenging the State’s jurisdiction over the person.

(b) The department of revenue shall file its answer in the Tax Court within 75 days from the date the Tax Court acknowledged receipt of a petition in proper form. Upon written request, the Tax Court may grant up to 15 additional days to file an answer. The department shall serve a copy on the taxpayer or taxpayer's representative, if any, and shall file proof of such service with the answer. Material allegations of fact set forth in the petition which are not expressly admitted or denied in the answer shall be deemed to be admitted. If the department of revenue fails to answer within the prescribed time, all material allegations of facts set forth in the petition shall be deemed admitted.

(c) The taxpayer may file a reply in the Tax Court within 30 days after filing of the department’s answer. The taxpayer shall serve a copy on the department of revenue and shall file proof of such service with the reply. If the taxpayer fails to reply within the prescribed time, all material allegations of facts set forth in the answer shall be deemed to be denied. When a reply has been filed, or, if no reply has been filed, then 30 days after the filing of the department’s answer, the controversy shall be deemed to be at issue and will be scheduled for a hearing.

(d) Either party may amend a pleading once without leave at any time before the period for responding to it expires. After such time, a pleading may be amended only with the written consent of the adverse party or by the consent of the Tax Court. The Tax Court shall freely grant consent to amend upon such terms as may be just. Except as otherwise ordered by the Tax Court, there shall be an answer or reply to an amended pleading if an answer or reply is required to the pleading being amended. Filing of such answer shall be made within 75 days after filing of the amended petition, and filing of a reply shall be made within 30 days after filing of the amended pleading to which it responds. No amendment shall be allowed under this subdivision after the expiration of the time for filing the petition, if such amendment would have the effect of conferring jurisdiction on

the Tax Court over a matter which otherwise would not come within its jurisdiction under the petition as then on file. When an amendment of a pleading is permitted, it shall relate back to the time of filing of that pleading, unless the Tax Court shall order otherwise either on motion of a party or on the Tax Court's own initiative.

Section 9. Fees

(a) Upon filing a petition, the taxpayer shall pay to the clerk a fee in the amount of \$_____, except that, in case of petitions filed in the Small Claims Division as provided for in section 13 of this Act, the fee shall be \$_____. A similar fee shall be paid by other parties making an appearance in the proceeding, except that no fee shall be charged to a government body or government official appearing in a representative capacity.

(b) The Tax Court may fix a fee, not in excess of the fees charged and collected by the clerks of the [general trial] court, for comparing, or for preparing and comparing, a transcript of the record, or for copying any record, entry or other paper and the comparison and certification thereof.

(c) All fees and other moneys received or collected by the clerk pursuant to this section shall be paid over to the State Treasurer and shall be held in the General Fund as miscellaneous receipts.

Section 10. Discovery

(a) The [A] judge or the clerk of the Tax Court, on the request of any party to the proceeding, shall issue subpoenas requiring the attendance of witnesses and giving of testimony and subpoenas *duces tecum* requiring the production of any returns, books, papers, documents, and correspondence and other evidence pertaining to the matter under inquiry at any designated place of hearing in the manner prescribed by law in civil actions in the [general trial] courts of this State.

(b) Any employee of the Tax Court designated in writing for the purpose by the judge [Chief Judge] may administer oaths.

(c) Any party to the proceeding may cause the depositions of witnesses residing within or without the State to be taken in the manner prescribed by law for like depositions in civil actions in the [general trial] courts of this State. To that end, the party may compel the attendance of witnesses and the production of returns, books, papers, documents, correspondence and other evidence pertaining to the matter under inquiry.

(d) Any witness subpoenaed or whose deposition is taken shall receive the same fees and mileage as a witness in a [general trial] court of this State. Witnesses for the State or its political subdivisions shall be paid from moneys appropriated therefor. Payment of fees and mileage to other witnesses shall be made by the party at whose instance the witness appears or the deposition is taken.

(e) The Tax Court may enforce its orders on discovery and other procedural issues, among other means, by deciding issues wholly or partly against the offending party.

Section 11. Hearings

- (a) Proceedings before the Tax Court shall be tried *de novo* and, to the extent permissible under the constitution, without a jury.
- (b) Except as set forth in this Act or otherwise precluded by law, the Tax Court shall take evidence, conduct hearings and issue final and interlocutory decisions.
- (c) Hearings shall be open to the public and shall be conducted in accordance with such rules of practice and procedure as the Tax Court may promulgate. Notwithstanding the foregoing, on motion of either party the Tax Court shall issue a protective order when the party opposing disclosure of certain information shows good cause to protect the information from being disclosed to the public.
- (d) The Tax Court shall not be bound by the rules of evidence as applied in civil cases in the [general trial] courts of this State. The Tax Court shall admit relevant evidence if it is probative of a material fact in controversy. The Tax Court shall exclude irrelevant and unduly repetitious evidence. Hearsay evidence shall be admissible if it is the kind of evidence on which reasonable persons customarily rely in the course of serious affairs. Notwithstanding the foregoing, the rules of privilege recognized by law shall apply.
- (e) Oral evidence may be taken only on oath or affirmation.
- (f) In the case of an issue of fact, the taxpayer shall have the burden of persuasion by a preponderance of the evidence in the record, except that the department shall have the burden of persuasion in the case of an assertion of fraud and in other cases provided by law.
- (g) Proceedings before the Tax Court, except those before the Small Claims Division as provided for in section 13 of this Act, shall be officially reported. The State shall pay the expense of reporting from the appropriation for the Tax Court.

Section 12. Decisions

- (a) Except when sitting as the Small Claims Division as provided in section 13 of this Act, the Tax Court shall render its decision in writing, including therein a concise statement of the facts found and the conclusions of law reached. The Tax Court's decision shall, subject to law, grant such relief, invoke such remedies and issue such orders as it deems appropriate to carry out its decision.
- (b) The Tax Court shall render its decision after a hearing, within six months after the submission of briefs subsequent to completion of the hearing or, if briefs are not submitted, then within six months after completion of the hearing. The Tax Court may extend the six-month period, for good cause shown, up to three additional months.
- (c) If the Tax Court fails to render a decision within the prescribed period, either party may institute a proceeding in the [general trial] court to compel the issuance of such decision.
- (d) The Tax Court's decision shall finally decide the matters in controversy, unless any party to the matter timely appeals the decision as provided for in section 15 of this Act.
- (e) The Tax Court's decision shall have the same effect, and shall be enforced in the same manner, as a judgment of a general trial court of the State.

(f) The Tax Court's interpretation of a taxing statute subject to contest in one proceeding shall be followed by the Tax Court in all future proceedings, and its application of a taxing statute to particular facts shall be followed by the Tax Court in all future proceedings involving similar facts, unless the Tax Court's interpretation or application conflicts with that of an appellate court.

Section 13. Small Claims Division: Creation and Jurisdiction

- (a) There is hereby established a Small Claims Division of the Tax Court.
- (b) The Judge[s] of the Tax Court shall sit as the judge[s] of the Small Claims Division.
- (c) Assuming the taxpayer makes a timely election to invoke its jurisdiction, the Small Claims Division shall have jurisdiction over any proceeding with respect to any calendar year for which the net amount of the tax deficiencies and claimed refunds in controversy does not exceed \$25,000, exclusive of interest and penalties.
- (d) A taxpayer may elect to proceed in the Small Claims Division by filing with the clerk a petition stating the taxpayer's claim, in the form prescribed by the Tax Court for filing small claims. The petition shall be filed within the time specified by law for appealing the type of determination of the department of revenue at issue. A taxpayer may not revoke an election to proceed in the Small Claims Division, and shall not have any further right to appeal or bring suit.
- (e) Within 30 days of the filing of the taxpayer's petition, or at such other time as the Tax Court may order, the [commissioner of revenue] shall file with the Tax Court an answer similar to that required by section 8 of this Act.
- (f) At any time prior to entry of judgment, a taxpayer may dismiss a proceeding in the Small Claims Division, by notifying the clerk of the Tax Court in writing. Such dismissal shall be with prejudice, and shall not have the effect of revoking the election made in accordance with subsection (d) of this section.
- (g) Hearings in the Small Claims Division shall be informal, and the judge may receive evidence as the judge deems appropriate for a determination of the case. Testimony shall be given under oath.
- (h) A judgment of the Small Claims Division shall be conclusive upon all parties and may not be appealed. A judgment of the Small Claims Division shall not be considered as precedent in any other case, hearing or proceeding.
- (i) The Tax Court shall not be required to publish decisions issued by the Small Claims Division.
- (j) Sections 1 to 12 and sections 14 to 20 of this Act shall apply to proceedings in the Small Claims Division unless expressly inapplicable thereto or inconsistent with the provisions of this section.

Section 14. Costs

- (a) Witness fees, expenses of service of process and other disbursements may be taxed as costs against the unsuccessful party, in the discretion of the Tax Court.

(b) If the State, or any official thereof, is the unsuccessful party, the costs shall be paid from the State treasury upon certificate of the Tax Court.

(c) If a governmental body other than the State, or any official thereof, is the unsuccessful party, the costs shall be paid from the funds of the governmental body upon the certificate of the Tax Court.

(d) If costs are taxed against an unsuccessful taxpayer, the Tax Court shall certify the amount of the same and the costs may be recovered in an action of contract.

Section 15. Appeals

(a) The taxpayer or the tax authority shall be entitled to judicial review of a final decision of the Tax Court, except a final decision of the Small Claims Division, in accordance with the procedure for appeal from a decision of the [general trial] court, but without regard to the sum involved. The taxpayer or the tax authority may obtain judicial review of an interlocutory decision of the Tax Court under the same conditions and in the same manner as an interlocutory decision of the [general trial] court.

(b) The record on judicial review shall include the decision of the Tax Court, the stenographic transcript of the hearing before the Tax Court, and all exhibits or documents admitted into evidence.

Section 16. Representation of taxpayers and the department of revenue

(a) Appearances in proceedings conducted by the Tax Court may be by the taxpayer or the taxpayer's spouse, by an attorney admitted to practice in this State, by an accountant licensed in this State, or by an enrolled agent authorized to practice before the Internal Revenue Service. The Tax Court may allow any attorney or accountant authorized to practice or licensed in any other jurisdiction of the United States to appear and represent a taxpayer in proceedings before the Tax Court for a particular matter. In addition, the Tax Court may promulgate rules and regulations permitting a corporation to be represented by one of its officers or employees.

(b) The [department of revenue] shall be represented in all proceedings conducted pursuant to the authority of the Tax Court by the [chief counsel] of the [department of revenue] or the [chief counsel's] representatives.

Section 17. Reports and Opinions, Publication and Sale

The Tax Court shall provide for the publication of its final decisions in such form it deems best adapted for public convenience. Such publications shall be made permanently available and constitute the official reports of the Tax Court.

Section 18. Service of Process, etc.

(a) The mailing by first class mail, postage prepaid, to the address of the taxpayer, as given on the taxpayer's petition, or to the address of the taxpayer's attorney or agent of record, if any, or to the usual place of business of the [department of revenue], or its

agent or attorney of record, shall constitute personal service on the other party. The Tax Court may order that further notice or notice by other means be given in any case.

(b) Mailing by registered or certified mail and delivery by a private delivery service approved by the Internal Revenue Service in accordance with Section 7502(f) of the Internal Revenue Code of 1986, as amended, of any pleading, decision, order, notice or process, other than a subpoena, in respect to proceedings before the Tax Court shall be deemed to have occurred on the date of mailing or the date of submission to the private delivery service.

Section 19. Rules and Forms

The Tax Court is authorized to promulgate and adopt all reasonable rules and forms as may be necessary to carry out the intent and purpose of this Act.

Section 20. Effective date

This Act shall take effect January 1, 200_ and shall apply to all proceedings commenced in the Tax Court on or after such date and shall apply to all administrative proceedings commenced prior to such date which have not been the subject of a final and irrevocable administrative action as of such effective date, to the extent this Act can be made applicable, except that the provision in section 2 of this Act for the appointment of [a] judge[s] to the Tax Court shall take effect on _____, 200_. Any administrative proceeding for which a hearing has commenced prior to the effective date of this Act shall be subject to automatic review by the Tax Court, which shall render the decision in such proceeding unless there is a prior settlement. This Act shall not affect any proceeding, prosecution, action, suit or appeal commenced in the judicial branch before its effective date.

COMMENTARY

A section-by-section explanation of the Model State Administrative Tax Court Act follows.

Section 1. This section provides a statement of the purpose for the creation of an independent administrative tax tribunal. The first sentence is taken from the legislation that established the West Virginia Office of Tax Appeals. The remainder of the section is drawn from the statement of purpose found in the legislation establishing the New York State Division of Tax Appeals.

Section 2. The Model Act places the tax court in the executive branch, in recognition of the reality that some states would not permit the creation of a tax court in the judicial branch without an amendment to the state constitution and that many states already have an adjudicatory body that addresses taxes within the executive branch. A state contemplating the establishment of a tax court could modify this section to provide that the tax court will be part of the judicial branch of government.

This section makes clear that the tax court is an independent, quasi-judicial agency that is separate from and independent of the [commissioner of revenue] and the [department of revenue].

Subsection (d) permits the first judge (or judges) to establish the court before the court actually has jurisdiction to hear cases.

Section 3. The number of judges needed by a state necessarily depends upon the volume of cases in the state. To provide flexibility, the Act provides that there will be at least one judge but no more than six judges. This and succeeding sections are written to apply in states requiring only one judge. In brackets are the changes necessary to accommodate states requiring more than a single judge. If the court will have more than one judge, the statute should provide for staggered terms (by having shorter terms for some of the judges that are first appointed).

Consistent with the practice in most states, the Act provides that judge(s) shall be appointed by the Governor with the consent of the Senate.

Subsection (e) provides for a chief judge when more than one judge is serving. Since it is possible that only one judge will be appointed in a state, subsection (g) is included to provide for the appointment of *pro tempore* judges.

Section 4. A judge of the court should have a minimum amount of legal experience, and the Act prescribes a period of active practice of five years.

A person appointed to the tax court should also have a minimum amount of tax knowledge before he or she should be allowed to be a tax court judge. In states with tax certification program, such as Louisiana and its Board Certified Tax Specialist program, consideration should be given to adding such a requirement to the qualifications of a tax court judge. Consideration should also be given to including a provision authorizing the Governor to request a list of potential judges from the governing board of the State Bar Association to insure qualified judges for the court.

This section also prohibits a judge from engaging in other employment during the time the person is serving as a tax court judge.

Sections 5 and 6. These sections provide for the offices and personnel of the court.

Section 5 provides that hearings will take place at the principal office of the Court as well as at other locations throughout the State.

Inasmuch as the appearance of independence is extremely important, Section 5 also provides that the principal office of the court will be located in a building that is separate and apart from the building in which the department of revenue is located.

Similarly, when the court is holding hearings away from its principal office, it should do so in a building in which the department of revenue is not also located. When the New York State legislature created the Division of Tax Appeals, it located the Division of Tax Appeals in Troy, New York while the Department of Taxation and Finance was (and is) located in Albany, New York. This furthered the separation of the two bodies.

Section 7. This section grants to the court jurisdiction in all tax cases, except those specifically excluded. Under this procedure, the court will have jurisdiction in all tax cases, unless the Legislature affirmatively removes that jurisdiction. Each state will have to make its own exclusions, based upon a survey of its statutes. While some states may include, for example, property taxes within the jurisdiction of the court, it is likely that many states will not have the court's jurisdiction include property taxes.

The exception contained in subsection (b) under the constitution and statutes deals primarily with original jurisdiction in the Supreme Court or other specific statutory exclusions.

Subsection (c) is an extremely important section in that it makes clear that a taxpayer need not pay, nor post a bond for, any amount asserted to be due by the department of revenue, prior to being allowed to challenge the assertion before an independent court (*i.e.*, it unequivocally provides that a taxpayer does not have to "pay-to-play" or post a "bond-to-play" to have the case heard in court).

Under the Model Act, the court's jurisdiction includes the ability to rule on the constitutionality of a statute as applied to a particular taxpayer, as opposed to the constitutionality of a statute on its face. This is because it is the province of the judicial branch of government to rule on the constitutionality of a statute on its face. The court's jurisdiction does, however, extend to ruling on the constitutionality of a regulation, both as applied to a particular taxpayer and on its face.

If the taxpayer desires to challenge the constitutionality of a statute on its face, subsection (d) provides that the taxpayer may proceed, at its election, in one of three ways. First, the taxpayer may commence a declaratory action in the state trial court with respect to the constitutional challenge and have the remaining issues stayed pending final resolution of the constitutional challenge. This would be the approach likely taken if the other issues are contingent upon the constitutionality of the statute.

As a second option, the taxpayer could file a petition in the new administrative court, which would adjudicate all issues other than the constitutional challenge. The case could then be appealed (with the constitutional issue and any other issue that remains in dispute) to the appropriate appellate court. This option would likely be taken when the other issues are unrelated to the constitutional challenge and their prompt resolution is more significant to the taxpayer.

The final option would be for the taxpayer to bifurcate the case, with the constitutional challenge proceeding directly through the judicial system and the remaining issues proceeding through the administrative tax court and, if necessary, to the appellate courts. This option would likely be used if the constitutional issue were separate and distinct from the remaining issues. Also, this option would allow the facial challenge to be handled by the judicial branch, while avoiding any prejudice to the taxpayer that might be occasioned by delaying presentation of his fact case to the administrative tax court, e.g., loss of witnesses and other evidence.

If it is decided to locate the tax court in the judicial branch of government, rather than the executive branch, these issues will be moot. In such a case, subsection (d) should be deleted.

Section 8. This section provides that a proceeding is commenced by the filing of a petition by the taxpayer. While it is acknowledged that in cases where jurisdiction over the person is at issue the term “taxpayer” is not accurate, the use of such term should not be viewed as having any bearing on the case.

Subsection (b) provides that the department of revenue is to file an answer within 75 days (which can be extended to a total of 90 days) after the petition is acknowledged by the court to be in proper form. If the department fails to answer within the prescribed time, then all material allegations of facts set forth in the petition are deemed to be admitted. Since the court receives the petition, reviews it for facial adequacy, and delivers a copy to the department, the taxpayer need not serve the petition on the department. This procedure is similar to that followed in the New York State Division of Tax Appeals.

Subsection (c) provides that the taxpayer may, but is not required to, file a reply within 30 days after service of the answer. If the taxpayer fails to reply within the prescribed time, then all material allegations of facts set forth in the answer are deemed to be denied.

The distinction in the results between when the department fails to answer as compared to when the taxpayer fails to reply is intentional. Since the taxpayer has the burden of proof over most issues, and since it was the department that issued the assessment of additional tax (or denied the claim for refund), the taxpayer is entitled to learn the department’s position through the receipt of an answer to the petition. Therefore, the Act, in effect, requires the department to answer timely the petition. On the other hand, in many cases the taxpayer is not represented and in other cases it is not always clear when a reply should be filed. To avoid unintended dismissals of the petition based on procedural complications, the Act does not require that a reply be filed and deems all material allegations of facts set forth in the answer to be denied.

Section 9. This section provides that a fee will be charged to the taxpayer for the filing of a petition. Although the Act provides that one fixed fee will be charged for the filing of a petition with the court and another for the filing of a petition with the Small Claims Division, a state could instead base the fee on the amount in dispute. The Massachusetts Appellate Tax Board currently bases its fee on the amount of tax in dispute subject to a maximum fee.

Section 10. This section provides for subpoenas and depositions. It also allows the court to permit other forms of discovery.

Section 11. This section addresses the hearing before the court.

Hearings shall be without a jury and de novo. Though jury trials could be had in the tax court, the Model Act does not contain provisions for jury selection. If such are needed, the local drafter should refer to his state's jury procedure.

While some jurisdictions currently provide that the hearing is open to the public (*e.g.*, Maryland and Massachusetts), others provide that the hearing is closed to the public (*e.g.*, New York State and New York City). The Model Act provides that the hearing is open to the public. Recognizing that occasionally there will be the need for a protective order, the Model Act provides for such an order upon a showing of good cause.

The Model Act provides that the court is not bound by the rules of evidence. Instead, all relevant evidence, including hearsay evidence, is admissible. Nonetheless, the rules of privilege still apply.

Section 12. Following the example of the New York State Division of Tax Appeals, the Model Act requires that written decisions be issued within six months (which time can be extended for an additional three months) after the submission of briefs subsequent to completion of the hearing or, if briefs are not submitted, then within six months after completion of the hearing.

Subsection (c) provides if the Court fails to render a timely decision, then either party may institute a proceeding in the judicial branch to compel the issuance of such decision. Consideration should be given to penalizing the judge for failing to issue a decision in a timely manner unless the failure is for good cause shown.

Subsection (e) provides that the tax court's decisions are to be considered as precedent and are to be given force and effect in other proceedings before the tax court.

Section 13. This section concerns proceedings in the small claims division of the court. Some states may wish to change the jurisdictional limits. The purpose of this section is to give the local drafter the recommended framework which can be adapted to the local situation.

Section 14. This section provides that either party may, in the discretion of the court, receive costs.

Section 15. This section requires the same procedures for appeal of tax court decisions as currently apply to appeal from the decisions of state courts of general civil trial jurisdiction, except that decisions of the court's small claims division are not appealable.

Section 16. This section specifies the persons who may represent the taxpayer.

Section 18. This section requires that the decisions of the court be published in a manner that makes the court's decisions "permanently available" to the public. This provision would authorize publication on a State-maintained website, as an alternative to publication in print.

Section 19. This section allows service by mail or private delivery service, as alternatives to personal service. The court may, by rule, allow filings by facsimile.

Section 20. This section authorizes the court to adopt rules, regulations and forms to carry out the intent of the Act.

Section 22. This section sets forth the effective date of the Act. Suits pending in the judicial branch at the time the Act becomes effective will not be affected. Proceedings pending in an administrative tax tribunal will generally be transferred to the new court.

Coordination with Administrative Statutes. State legislation adopting the Model Act should also include amendments to tax and other statutes, including any statutory provisions governing the review of administrative tax determinations, to insure that all intended tax contests will be handled by the new tax court.

From: Garland Allen [mailto:farrokhjune@hotmail.com]
Sent: Wednesday, December 03, 2003 8:14 AM
To: mjones@library.ca.gov
Cc: cfields@mofo.com
Subject: California Commission on Tax Policy in the New Economy- State Tax Court Proposal

Dear Dr. Jones:

I am vice-chair of an American Bar Association task force that is developing a model state administrative tax court legislation for consideration by the various states. We already have a draft model act, and the draft contains many of the features recommended by Mr. Simmons in his written proposal to the Commission.

What is the status of the Commission's work at this point? If the state tax court proposal is still active, could you put me in contact with the main people who are trying to advance this aspect of the Commission's recommendations?

Sincerely,

Garland Allen

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II. A little background

To my knowledge, all states allow a taxpayer who has received a tax assessment to have a hearing--an opportunity to present evidence and witnesses in a quasi-judicial setting--before the taxpayer reaches the regular court system. In the early days, that opportunity was limited to hearings before employees of the very agency that had made the tax assessment. What's worse, the internal hearing officer's decision was subject to limited review by the regular courts. Finally, many states required a taxpayer to pay the tax, as a condition to obtaining court review of the tax agency's determination.

For at least the last 45 years, there has been a recognition among tax lawyers and the organized bar that state taxpayers should be able to challenge a proposed tax assessment before a specialized tax court or tribunal that is independent and separate from the taxing agency. However objective and fair internal hearing officers might be, there is an unavoidable perception among the taxpaying public--if not the tax bar--that the forum is rigged so that the state always wins. Similarly, fairness suggests that a taxpayer should not be required to pay or post a bond (pay-to-play or bond-to-play) as a precondition to challenging a proposed assessment.

A few states have created a tax court in the judicial branch, and quite a few have established an independent tax court or tribunal in the executive branch of government. In general, tax practitioners and taxpayers in those states have had positive experiences. And a few states that once had "pay-to-play" or "bond-to-play" requirements have gotten rid of them.

But even today, there are still more than twenty states--including big ones like my own IL, TX, GA, and FL--where the first and last hearing before a person who is knowledgeable about taxes is in front of an employee of the tax department. And another 20 states or so--not the same ones, including NY (*for sales tax, or this was the case until recently, according to Art Rosen*), MI, NC, CA and CO--continue to condition judicial review--and sometimes even tax department or independent tribunal review--on the taxpayer's payment or bonding of all or part of the tax in issue.

The Committee on State and Local Taxation of the ABA Tax Section has created a task force to study the existing independent tax courts, the model acts previously put forward by NCCUSL in 1957 and the ABA in 1971, and to create a new model act that addresses these long-standing issues of unfairness and takes the best practices from all of these and creates a new model for states to consider.

III. You have the draft Model Act before you, starting on Page 4: Highlights:

Sec. 2. Establishment.

The tax court is established in the executive--not the judicial--branch of state government. Independent administrative tax courts have worked well in a number of states, and putting them in the executive branch solves several problems. Constitutional, for one. Most states without independent tribunals already

have hearing officers in the department of revenue, some of whom could be moved to the new court with minimum inconvenience and without reinventing the wheel.

Secs. 3 & 4 -- Judges.

Tax Court judges would be appointed by the governor, with consent of the state senate, for a term of 6 years--longer than the typical governor--to give political protection. They would be required to have 5 years legal experience and special knowledge in the tax field.

Sec. 5. Offices.

To promote the appearance of independence from the tax department, Tax Court offices and hearings would be located in buildings that are separate from those in which the tax department is housed.

Sec. 7. Jurisdiction:

The tax court would have exclusive jurisdiction over all taxes administered by the tax department, except those specifically excluded and except for judicial appeal remedies.

Taxpayer does not have to pay-to-play or bond-to-play in order to obtain a hearing and decision from the Tax Court.

Tax Court will have power to rule on the constitutionality of a statute as applied to a particular taxpayer, but not on the facial constitutionality of a statute--which is thought to be a purely judicial function. The court could, however, determine the constitutionality of a department regulation on its face or as applied.

Sec. 10. Discovery.

Authorizes subpoenas and depositions, and allows the TC to permit other forms of discovery.

Sec. 11. Hearings.

Hearings open to the public.

Court not bound by rules of evidence, but can take all relevant evidence.

On fact issues, TP has burden to prove by "preponderance of the evidence," except that the department shall have the burden in case of fraud.

Sec. 12. Decisions.

TC must issue decision within 6 months, or party can commence judicial proceeding to compel.

TC's decisions--interpretation of a statute and application of statute to facts--shall be considered precedent in other proceedings before the TC. In other words, TC cannot change its mind. But not precedent binding on judicial branch.

Sec. 13. Small Claims Division.

The Tax Court shall have a Small Claims Division, which a taxpayer may elect in any matter involving less than \$25,000/calendar year in controversy. If taxpayer elects this less formal procedure, the taxpayer (and the state) would give up the right to appeal.

SCD decisions would have no precedential effect in any other matter coming before the Tax Court.

Sec. 15. Appeals.

Either party, state or TP, can appeal regular decision of TC in same manner as parties can appeal decisions of the state's trial court of general jurisdiction, i.e., straight to the appellate court.

Sec. 16. Representation.

Specifies which persons may represent taxpayer. Permits, but does not require, attorneys.

Sec. 17. Publication of decisions.

TC regular decisions shall be published in a form that is "permanently available" to the public, which specifically includes website publication.

From: Garland Allen [mailto:farrokhjune@hotmail.com]
Sent: Wednesday, December 03, 2003 3:43 PM
To: dlsimmons@ucdavis.edu
Cc: wmw@jmbm.com; bill.rosendahl@adelphia.com; mjones@library.ca.gov; cfields@mofa.com
Subject: California Commission on Tax Policy in the New Economy- State Tax Court Proposal

Dear Professor Simmons:

Attached is a copy of the draft Model State Administrative Tax Court Act (MoSATCA), together with a portion of my presentation on the draft's background and highlights at a recent meeting of the National Association of State Tax Bar Sections in Washington, DC.

The ABA Task Force, which is a subcommittee of the ABA Tax Section's Committee on State and Local Taxation, would very much like to work with people, like yourself, who are interested in this subject and would be willing to help develop this national model legislation. As you will see, much of what we have done already tracks your own recommendations to the Commission.

At this point, the draft has no official ABA status, and there is no citation for it. It will not have ABA imprimatur until it undergoes a several levels of ABA review. The next step is a presentation to the appointing ABA committee at its January, 2004, meeting in Orlando.

I would be delighted to discuss this with you at your convenience. As you will note, I am copying Dr. Jones and Messrs. Weintraub and Rosendahl on this message, and also invite any of them to call me or Task Force chair Craig Fields about this subject as they may wish.

Sincerely,

Garland Allen

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