

SUBCOMMITTEE NO. 4

Agenda

Senator Richard D. Roth, Chair
Senator Steven M. Glazer
Senator Scott Wilk



Thursday, March 20, 2017
9:30 a.m. or upon adjournment of Session
State Capitol – Rose Ann Vuich Hearing Room (2040)

Consultant: Mark Ibele

Oversight Hearing: Board of Equalization

Evaluation/Audit of the Board of Equalization

Department of Finance, Office of State Audits and Evaluations

- Jennifer Whitaker, Chief, Office of State Audits and Evaluations
- Diana Antony, Manager, Office of State Audits and Evaluations

Board of Equalization

- David Gau, Executive Director
- Brenda Fleming, Acting Chief Deputy Director
- Michele Pielsticker, Chief, Legislative and Research Division
- Julia Findley, Chief, Financial Management Division
- Amy Kelly, Acting Chief Counsel

Reform Options for the Board of Equalization

Legislative Analyst's Office

- Seth Kerstein, Economist, Legislative Analyst's Office

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Subject

This oversight hearing will focus on the programs, activities, procedures, and reports of the Board of Equalization, the findings of the recent evaluation of that agency by the Department of Finance, Office of State Audits and Evaluations, and a consideration of reform measure options for the tax agency and the role of its board.

Board of Equalization Background

As stated in the BOE Strategic Management Plan 2015-2020:

“The mission of the Board of Equalization is to serve the public through fair, effective, and efficient tax administration.”

The Board of Equalization (BOE) administers tax and fee programs concentrated in four general areas: sales and use taxes, property taxes, special taxes, and the tax appellate program. BOE has over 30 tax and fee programs, which generated \$60.5 billion in revenue and accounted for more than 30 percent of all state revenue for fiscal year 2014-15. Of the \$60.5 billion, sales and use tax activities accounted for \$52.1 billion. Because a majority of sales and use taxes are self-assessed, BOE has developed an audit and compliance program to verify businesses remit the correct amounts and provide related education.

The BOE collects and allocates the state and local sales and use tax for cities, counties, and other districts. The over 30 tax and fee programs administered by BOE provide revenues to support state and local government programs and services, including but not limited to, schools and colleges, hospitals and health care services, natural resources, transportation, and housing. BOE is the nation's only elected tax commission, which consists of four elected board members, each representing an equalization district, and the State Controller, an ex officio member representing the state at large. The elected board members each represent a district with boundaries that encompass approximately the same population size.

As a whole, the five member board acts in a quasi-judicial capacity as the appellate body for appeals from various business tax assessments, Franchise Tax Board (FTB) actions, and public utility assessments. In its administrative capacity, the board issues rules and regulations. Additional board responsibilities are as follows:

- Establish and adopt BOE policies in monthly public meetings.
- Meet to hear and decide tax appeals, approve regulator changes, annually set property tax values for state assesses, consider reports from various department managers, and receive input from the public.
- Hire the executive director and approve the hiring of all executive leaders and career executive assignment personnel.
- Ensure the agency runs effectively and efficiently by setting policy and guiding executive leadership.
- Supervise policy development through four committees chaired by each of the four elected board members.

Individual board member's duties include facilitating and resolving constituent concerns, educating taxpayers, influencing public policy, and interacting with the media. Under the general direction of the board and in accordance with established policies, daily operation and management of the agency is delegated to the executive director and the executive team. As of July 2016, BOE had over 4,800 authorized positions to carry out its daily operations. These positions are organized into programmatic and administrative units within BOE's Sacramento headquarters, 22 field offices, and 4 out-of-state offices. This organizational structure administers the various programs within 12 departments and divisions.

Legislature's Evaluation Request

In response to concerns regarding the BOE's revenue-generating responsibilities – generally tax audits and collections – Senate Budget and Fiscal Review Subcommittee No. 4 worked with the Department of Finance (DOF) to structure an evaluation of BOE's compliance with legislative directives that govern its activities in this area. Subcommittee No. 4 approved the evaluation and its funding at its April 7, 2016 hearing. The evaluation was conducted by DOF's Office of State Audits and Evaluations (OSAE). In particular, the required evaluation was to focus on the BOE's compliance with *Provision 1* of the budget act, which reads:

*It is the intent of the Legislature that all funds appropriated to the State Board of Equalization for processing tax returns, auditing, and collecting owed tax amounts shall be used in a manner consistent with the board's authorized budget and with the documents that were presented to the Legislature for its review in support of that budget. **The State Board of Equalization shall not reduce expenditures or redirect funding or personnel resources away from direct auditing or collection activities without prior approval of the Director of Finance. The director shall not approve any such reduction or redirection sooner than 30 days after providing notification to the Joint Legislative Budget Committee.** Such a position shall not be transferred from the organizational unit to which it was assigned in the 2017–18 Governor's Budget and the Salaries and Wages Supplement, as revised by legislative actions, without the approval of the Director of Finance. **Furthermore, the board shall expeditiously fill budgeted positions consistent with the funding provided in this act.***

In addition, the scope of OSAE's work was to include an assessment of the supplemental annual report (SAR) provided to the Legislature regarding BOE's audit and collection activities. This report is governed by supplemental reporting language adopted initially in 2002. The reporting requirements read:

The BOE shall provide to the Chairs of the JLBC and chairs of the fiscal committees of the Legislature by December 1 of each year, beginning December 1, 2002, a report containing the following information: (a) description of the methodological approach used to conduct its audit and compliance activities, including the work plan relating to these activities; (b) the number of hours and costs associated with direct audit and compliance activities, as well as supporting (overhead) activities; (c) the revenues associated with its audit and compliance activities; and (d) data regarding the revenue and cost impacts associated with any increase or decrease in resources devoted to audit and compliance activities. Items b, c, and d should include prior-year actual data, current-year estimated data, and budget-year projected data. This information shall also be provided to the Department of Finance, in a format it specifies, with submission of documents used to prepare the Governor's budget as well as when BOE makes a request to alter funding or personnel services for audit or compliance activities. Such information shall also be provided as a part of any budget change proposal submitted to the Legislature regarding resources for auditing or compliance activities.

The reporting requirements for the SAR were augmented and tightened in 2006, 2010 and 2011 to impose reporting on other items including: audit selection methodologies, benefit-cost metrics, and the Statewide Compliance and Outreach Program performance. The SAR has been relied on by both the Legislature and DOF for purposes of evaluating the effectiveness of and return to revenue-generating activities. One of the SAR's key purposes is to allow for the Legislature and DOF to examine appropriate staffing levels between the state two main tax agencies (BOE and the Franchise Tax Board) and among their various revenue-generating units and activities.

After approval by the Subcommittee No. 4, the scope of the OSAE evaluation was subsequently broadened to encompass other components, including outreach activities and the BOE's remedies to the misallocation of sale and use tax revealed by the State Controller's review of the agency's internal accounting and administrative controls. SB 826 (Committee on Budget and Fiscal Review), Statutes of 2016, Chapter 23 specifies the scope of the OSAE evaluation, pursuant to the following budget bill language:

Of the amount appropriated in Schedule (3), \$750,000 shall be available for: the Office of State Audits and Evaluations to perform an evaluation of the activities of the State Board of Equalization's Sales and Use Tax Department, including, but not limited to, audits, collections, compliance enforcement, and outreach; the State Board of Equalization's taxpayer outreach and related activities; and the State Board of Equalization's corrective actions related to the Controller's internal accounting and administrative controls review. The scope and objectives of the evaluation shall be defined by the Department of Finance in consultation with the Legislature. A report shall be provided to the chairpersons of the fiscal committees of each house of the Legislature and the Chairperson of the Joint Legislative Budget Committee by March 31, 2017.

Findings of the Evaluation

The OSAE evaluation found specific instances of: inconsistencies in operations; breakdowns in centralized processes; misuse of budget resources and personnel; inaccurate and misleading reporting; failure to establish, document and maintain proper tax allocation procedures; and board activities contrary to state law and legislative directives. Even more troubling and noteworthy are the following findings and observations contained in the audit:

- BOE's operational culture impacts its ability to report accurate and reliable information to decision-makers.
- Certain board member practices have intervened in administrative activities and created inconsistencies, breakdowns, and activities not supported by law.
- BOE had difficulty providing complete and accurate documentation in response to evaluation inquiries.
- Individuals interviewed for purposes of the evaluation reported a fear of retaliation if staff did not respond to the directions of individual board members.
- Various levels of management were not aware of, and could not speak to, certain district activities for which they had oversight responsibilities.
- Staff resource utilization practices have negatively impacted personnel and accounting records and do not accurately depict current operational activities.

- Supplemental annual reports submitted to the Legislature do not comply with the budget act reporting requirements and are incorrect.
- BOE's corrective remedies regarding the misallocation of sales and use tax were themselves incorrect on a repeated basis.

Staff Comments

The BOE is a unique agency, not only for California, but nationally. California is the only state with an elected board that both administers the state's taxes and serves as appellate body for tax disputes. The institutional structure of the agency presents a significant challenge in applying the state's tax laws fairly, impartially and effectively. The OSAE evaluation provides a glimpse into the manner in which the agency's culture may significantly affect the application of the state's tax laws. From a 'good government' perspective, the findings of the OSAE evaluation of BOE are quite disturbing. As indicated by the evaluation, the examples of inappropriate use of resources, board member involvement, and inaccurate data and reporting, suggest a pattern established and abetted by an institutional culture. That is, the instances cited are neither one-time nor unusual; rather they distinctly appear to be indicative of a pervasive and potentially corrosive atmosphere.

The administration and collection of taxes is, for many of California's individuals and businesses, the most sensitive point of contact with their state government. As a consequence, the state's power and decision to tax its residents carries with it a reciprocal obligation to administer those taxes fairly and impartially. BOE has been given the charge of administering and adjudicating California law in this extremely sensitive and important area. Given this responsibility, the BOE is obligated go to tremendous lengths to assure that the tax law is administered appropriately and taxpayers are treated fairly. Unfortunately, the results of the OSAE evaluation are very concerning in this regard. In response to the evaluation:

- A BOE board member proposed the naming of a public trustee to manage the daily affairs of the agency.
- The State Controller called for stripping the agency of its tax administration, compliance, and audit functions.
- The Governor issued a letter that:
 - Directed the Department of Human Resources, and requested the Department of Justice, to investigate employee complaints and the potential misuse of state resources at the board.
 - Suspended the board's delegated authority in the expenditure areas of personnel, contracting and technology.
 - Convened legislative leaders to identify statutory changes to address problems at the board by June 2017.

The executive summary of the OSAE evaluation concludes with the statement:

“Information included in this report can be used by the board and BOE executive management to effectuate cultural change of its practices.”

The BOE should take steps to address the problems identified in the evaluation; however, given the highly critical findings of OSAE’s evaluation and the seriousness of the subject matter, such internal reforms are quite likely to be inadequate. In his letter, the Governor voiced his deep concern regarding the agency’s conduct, and his directives imply a distinct lack of confidence in the agency’s ability to undertake necessary changes on its own. Given these factors, the Legislature could consider further, and potentially more fundamental, reform options that would guard against abuse and partiality in the application of California’s tax laws. There are a range of additional more comprehensive options that could begin to address the multitude of issues raised by, or alluded to, in the evaluation that would help protect both California’s taxpayers and the state’s revenue system. These potential options range from alterations in the way in which the agency operates and its jurisdiction, to broad institutional changes in the overall structure of the agency. Several alternatives will be presented by the Legislative Analyst’s Office.