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## Creation of a State Tax Court Would Be a Step Backwards for Taxpayers

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### **A. Introduction: Commission on the 21st Century Economy**

On October 30, 2008, Governor Arnold Schwarzenegger signed Executive Order S-12-08<sup>1</sup> calling for the creation of a bipartisan Commission on the 21st Century Economy (“Commission”) to re-examine and modernize California’s revenue laws. The commission ultimately consisted of 14 members, seven appointed by the governor and seven appointed by legislative leaders. At the signing, the governor asked the commission to step back from the current fiscal crisis and evaluate California’s tax

structure. He wanted the commission to suggest changes to the revenue laws that would result in a more stable revenue stream and would better reflect California’s economy for the 21st century. The governor concluded that California’s “revenue stream is the epitome of boom or bust,” and that California needed a long-term solution to its revenue problem in order to achieve ongoing fiscal stability.<sup>2</sup>

### **B. Commission’s Findings**

In its report of September 29, 2009, the Commission focused on California’s three main taxes—the personal income tax, the corporation tax, and the sales and use tax—that constitute approximately 90 percent of the state’s General Fund.<sup>3</sup> The commission found that the tax system’s performance had become increasingly volatile and less diverse in terms of its revenue sources, primarily due to changes in the state’s economy and how these changes impact the tax system.<sup>4</sup>

When the basic elements of the tax system were established in the 1930s, agriculture and manufacturing

dominated California's economy. Since then, these sectors have waned in importance, and technology and service industries now drive the state's economy.<sup>5</sup> In addition to earning money differently, Californians also spend money differently. They spend more on services and intangible goods, which are not subject to California sales tax, and less on tangible, taxable goods. Other factors are also at work in the economy. Technology and globalization allow for easier movement of goods, services, labor, and capital across state and national borders.<sup>6</sup> Few political, economic, or business experts disagree with these findings by the commission.

The commission identified a number of deficiencies in California's tax system, namely, the failure to align the tax system to the economy results in an unstable and narrower tax base, the narrower tax base fosters higher marginal rates, and higher marginal rates discourage business investment and employment opportunities.<sup>7</sup> The commission concluded that a tax system should promote revenue stability, tighten the link between taxes and spending, and enhance competitiveness and growth.<sup>8</sup>

### **C. Commission's Recommendations**

Based on these working conclusions, the commission offered six recommendations to the legislature for further examination and consideration:

- Recommendation One: Reduce and restructure the personal income tax;
- Recommendation Two: Eliminate the corporation tax and the franchise minimum tax;
- Recommendation Three: Eliminate the state general purpose sales tax;
- Recommendation Four: Establish the Business Net Receipts Tax;
- Recommendation Five: Create an independent tax dispute forum; and,
- Recommendation Six: Establish a new Rainy Day Reserve Fund.<sup>9</sup>

### **D. Recommendation Five: Creation of Independent Tax Forum**

Five of the six recommendations, and particularly Recommendation Four, received considerable attention and scrutiny from the political press and the legislature. As a result, this article does not discuss those recommendations. Instead, it focuses on the less discussed Recommendation Five, which receives relatively little attention in the commission's report. The commission states:

California should create an independent body with tax expertise to resolve disputes between the state

and taxpayer. A taxpayer should be able to seek a ruling from the independent forum prior to having to pay the tax bill in question.<sup>10</sup>

The commission gives the following rationale for this proposal:

The current tax appeals process has some aspects that raise questions of fairness. A taxpayer's final prepayment stop for administrative review is a hearing with the elected members of the Board of Equalization (BOE), who are in general perceived to be the same people who administer the tax system. By creating an independent, experienced body to hear cases, the state will improve the fairness of the system. Allowing taxpayers to pay their tax bill after an independent body reviews their case will improve the appellate system's access to all taxpayers.<sup>11</sup>

The commission's report bases its rationale for the recommendation on two aims, each unobjectionable: (1) "Improving the fairness of the [current tax dispute resolution] system"; and (2) "Improving the appellate system's access to all taxpayers."<sup>12</sup> To achieve these goals, the Commission recommends the following:

Following the guidelines as set by the American Bar Association's (ABA) "Model State Tax Tribunal Act," the state should create an independent administrative body with tax expertise to resolve disputes between state and taxpayer. The judges should be trained in tax issues. The body will be the prepayment court for challenges to PIT, SUT, payroll and excise taxes, and the BNRT.

The ABA recommends that the governor appoint the head of the body, such as a judge, and that the entire body would report to the executive branch. Decisions would be rendered in writing and made public. Both sides would be able to appeal to Superior Court. (The current situation permits only the taxpayer to appeal, not the state agency).<sup>13</sup>

In sum, the commission's recommendation calls for (1) an independent administrative body comprised of gubernatorial appointees rather than elected officials; (2) decisions to be rendered in writing and made public; (3) a more formal adjudicatory process; and (4) permitting the tax agency to appeal to Superior Court.

I have no debate with the commission's desires to improve fairness in the system as well as taxpayer access; both are worthy goals that should be furthered whenever possible. However, whether its recommendations

would truly achieve these ends is debatable. As discussed below, the commission's recommendation seems to be based on a number of incorrect assumptions with respect to the current system. As a result, Recommendation Five, if implemented, is likely to do the *opposite* of what it was intended to do: It would substantially *reduce* both the fairness of the tax dispute resolution system and taxpayers' access to it.

### 1. Independence

With respect to achieving the commission's stated goal of improved fairness in California's tax dispute adjudication, the appointment of an independent administrative body is indeed important. However, the commission's recommendation is based on two major flaws.

First, the commission wrongly presupposes that the Board of Equalization (BOE), the existing administrative tribunal, is not independent. The commission states that the board members are generally perceived to be the same people who administer the tax system.<sup>14</sup> The commission misses the mark here:

(a) The commission glosses over the fact that the BOE is in fact a separate agency from the Franchise Tax Board (FTB)—which administers state income taxes and has its own employees and operations;

(b) The fact that two elected members of the BOE sit on the three-member FTB (the third is a gubernatorial appointee) actually furthers the commission's goals as it serves to ensure consistency and accountability between the two boards. As discussed in paragraph (c) below, this also serves to ensure that the people's right to vote on taxes remains a key taxpayer protection.

(c) The commission overlooks one very important trait that ensures the BOE's independence from California's tax bureaucracy: The members of the BOE are constitutional officers who are democratically elected every four years. This characteristic makes them directly accountable to the taxpayers/voters for their implementation of the state's tax laws. Moreover, as an elected body, the BOE reflects California's ethnic, racial, and gender diversity. Four of the five current board members represent historically underserved communities, and three of the five are women. The creation of a tax forum would eliminate a significant portion of the BOE's adjudicatory duties just as California's diverse population has finally achieved representation in California government. The decision as to who represents the voters in tax matters is best left to the voters and should not be stripped away to make room for more appointed positions that are not accountable or responsive to California taxpayers.

Second, in addition to unfairly criticizing the BOE's lack of independence, the commission assumes without

offering any evidence that unelected gubernatorial appointees will actually have *more* independence than elected constitutional officers. The commission's proposal is to follow the guidelines set forth by the American Bar Association's Model State Tax Tribunal Act. The act provides for the appointment of judges reporting to the executive branch and more legalistic processes than now exist. This proposed administrative body would suffer from appearances of progovernment bias, which is exactly what Recommendation Five criticizes and seeks to avoid. The "independent" judges would report to the governor who is also a member of the FTB, a party to the proceedings before these judges, through his appointee. In addition, the state and Consumer Services Agency, which controls FTB's budgeting, reports directly to the governor. It is difficult to understand how a change from elected constitutional officers to a system where power is concentrated in unelected gubernatorial appointees would improve independence and public accountability.

## **2. Public Decision-Making**

The commission correctly concludes that having decisions rendered in writing is important for taxpayers, both from the perspective of fairness and from the perspective of access to the system. However, the commission's statement that the BOE "does not make its decisions public"

is false. Under its regulations, the BOE publishes its decisions based on the same criteria considered by appellate courts.<sup>15</sup> Because the BOE hears such a large volume of routine matters that have no precedential value, most decisions are not published. However, board hearings are streamed live over the internet and board transcripts are available upon request at no charge to taxpayers. This is true for every single hearing before the board. Moreover, because all meetings of the BOE are subject to the Bagley-Keene Open Meetings Act, the deliberations of the members must take place in public. The administrative body proposed by Recommendation Five would deliberate privately, behind closed doors. In sum, the commission's statement that the BOE "does not make its decisions public" is wrong, and Recommendation Five may, ironically, diminish public access to the deliberative process in connection with tax cases.

## **3. A More Formal Hearing Process**

To further promote fairness and taxpayer access, the commission recommends a process based on [t]he guidelines as set by the American Bar Association's (ABA) Model State Tax Tribunal Act. Once again, these good intentions are misplaced. The commission fails to consider that the board's hearing processes are relatively simple when compared to the more formalistic and legal-

istic forum it proposes. The simplicity of the board's current adjudicatory process allows all taxpayers—whether individuals, small business owners or larger businesses—to represent themselves or to retain any other person most familiar with the case and best able to represent their interests, including their tax preparer, an enrolled agent, an accountant, or an attorney. The BOE's Rules for Tax Appeals do not follow formal rules of evidence or hearing procedure, as would be the case in the tax forum the commission recommends, thus simplifying the hearing process and the resulting costs of representation, which is of particular importance to individuals and small businesses. Notably, Recommendation Five is supported by members of the legal community whose interest in modifying the current administrative process, which is open to nonlawyer practitioners, is evident.

In further support of its recommendation to create an independent tax forum, the commission is critical of the BOE's practice of holding hearings that are generally 30 to 60 minutes in length. This conclusion seems unwarranted based upon BOE's appeals caseload, processes, and results. Most of the more than 5,800 appeals<sup>16</sup> filed with the BOE during its fiscal year 2007–2008 were resolved prior to a hearing date before the board members.<sup>17</sup> Of the appeals that do culminate with a hearing before the board members, most fit well within the 30 to 60 minute average hearing length due to the lack of com-

plexity of the issues. Further, upon request, the BOE may allot additional time for any hearing in order to ensure adequate time for argument by both parties regarding complex issues.<sup>18</sup> In sum, the current process is less formal and more cost-effective and gives taxpayers greater choice and flexibility in terms of how they would like to prosecute their appeals than that proposed by the commission. The commission's concerns regarding the length of time available for a hearing are unfounded.

#### **4. Government Agency Appeal**

Finally, the commission recommends that the FTB should be allowed to appeal from the decisions of the newly-established forum. The commission's recommendation to specifically allow the FTB a "right" of appeal is interesting and raises questions regarding the commission's true understanding of the current administrative process. The commission's recommendation implies that the FTB has no recourse from a decision of the BOE. This is wrong. The FTB may file a writ of administrative mandate with the superior court if the FTB believes the BOE failed to follow the law. Over the years, the FTB has chosen not to exercise this remedy, which speaks to the general satisfaction of the FTB members with the BOE's decisions. It is especially significant that under the existing system, the three-member FTB must make the de-

cision to move forward with a writ—not an unelected, unaccountable civil servant.

In contrast and to the detriment of California voters, the commission’s proposal to allow the FTB the “right” to appeal from the decisions of an independent tax forum likely would shift the decision from the elected members of the Franchise Tax Board to unelected civil servants. This runs counter to the commission’s stated goals of fairness and greater taxpayer access to the process. In addition, because of the probable shift in the appellate decision-making process from the three-member FTB to unelected civil servants, the commission’s recommendation will likely lead to an increase in the number of appeals a taxpayer will need to defend against, which will increase the costs of the appeals process for California taxpayers.

### **E. Conclusion**

The commission’s goals of improving the fairness of and taxpayers’ access to the current system are laudable. However, Recommendation Five would not advance these worthwhile objectives. It would work against them. Recommendation Five is badly misguided because it is based on a fundamental misunderstanding of both our current tax system and what it offers by comparison. The notion that the commission’s recommendation would produce unelected decision-makers that are more

independent than the current board members is illogical. Criticisms of the existing appeals process as not permitting written decisions and precluding the FTB from challenging a BOE decision in court evince a lack of knowledge of the current tax adjudicatory process that is unbecoming of a commission charged with such important responsibilities. Finally, suggesting that a more formal appeals process, driven by legal rules and procedures actually enhances fairness and public access, and is an improvement in this regard over the informal and flexible process in place today, lacks credibility.

Through it all, the commission’s report disregards the fact that establishment of a new tax forum would create a new layer of government bureaucracy, resulting in increased costs to the state, ultimately to be borne by taxpayers. The commission’s tax forum would create a new hearing venue for certain cases, while the BOE would continue to consider claims for refund for sales and use tax and insurance programs, as well as continue to hold hearings regarding proposed valuations for state-assessed property tax matters and the many other tax and fee programs the board administers. This duplication means that Recommendation Five would be another costly experiment for the state, at a time when taxpayers can least afford it.

For all of the reasons discussed above, the legislature and the governor should reject Recommendation Five.



**Notes**

<sup>1</sup> The governor also issued Executive Orders S-01-09, S-03-09, and S-15-09 with respect to the work of the commission on the 21st Century Economy. It was, however, S-12-08 that initiated the idea of the commission and generally laid out its task.

<sup>2</sup> Office of the Governor, Press Release—Governor Schwarzenegger and Legislative Leaders Work Together to Bring California’s Revenue System into the 21st Century (Oct. 30, 2008).

<sup>3</sup> Commission on the 21st Century Economy, Report (Sept. 2009), 4.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*, at 5.

<sup>7</sup> *Id.*, at 6–7.

<sup>8</sup> *Id.*, at 8.

<sup>9</sup> *Id.*, at 42.

<sup>10</sup> *Id.*, at A-19.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> California Code of Regulations, Title 18, § 5452 (2010).

<sup>16</sup> The board receives appeals with respect to the more than 30 tax and fee programs it administers, as well as from actions by the FTB, the Department of Toxic Substances Control, and the Department of Insurance.

<sup>17</sup> See State Board of Equalization 2007–08 Annual Report (June 2009), 44–46.

<sup>18</sup> The Board’s Rules for Tax Appeals specifically allow a party to

request additional time to present a complex matter. (California Code of Regulations, Title 18, § 5523.5, subdivision (d).)